Irish Fiscal Advisory Council

How national budget policy works

Eddie Casey, 25 Sep 2022
Citizen's Assembly on Biodiversity Loss

The Government’s budget

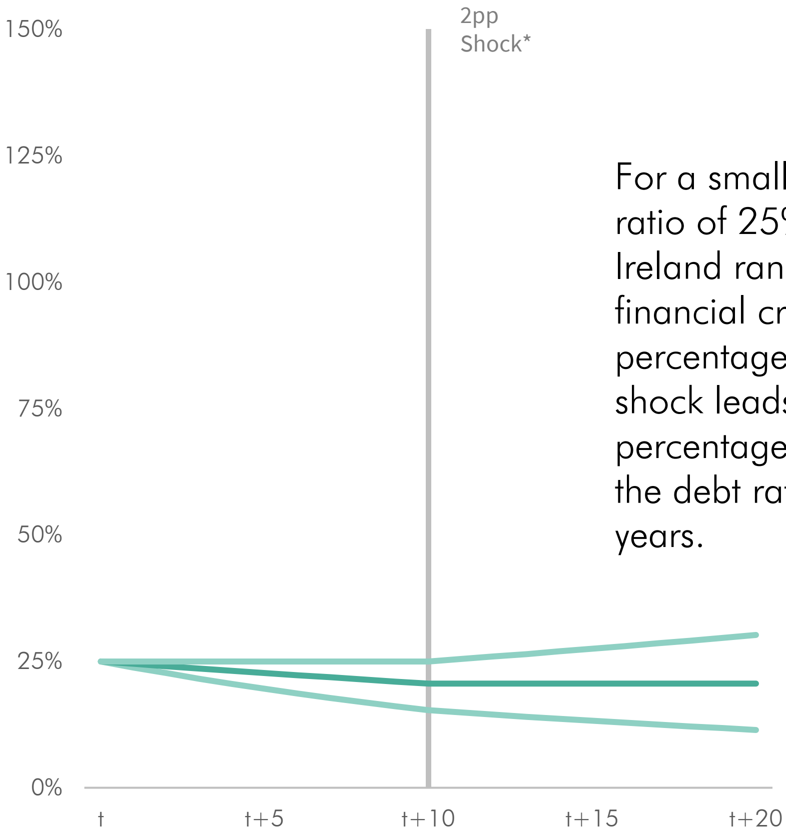
- The Government’s budget is not like a household’s budget
  - Strong borrowing capacity
  - State can always raise more tax in future

    But this has limits
  - People can choose to work elsewhere, firms can opt to relocate
- Government decisions have macro impacts

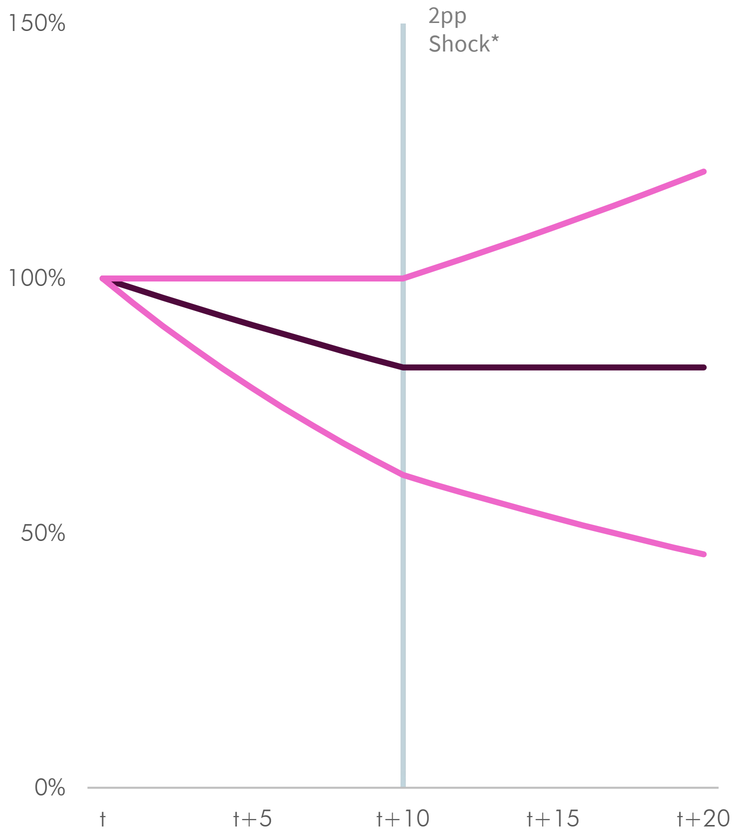
  Example: prices can rise more if jobs market is already strong and Government increases spending / cuts tax

Government debt can become unsustainable

Government debt ratio (% national income)



For a smaller debt ratio of 25%— what Ireland ran before the financial crisis—a 2 percentage point shock leads to +/- 9 percentage points on the debt ratio over ten years.



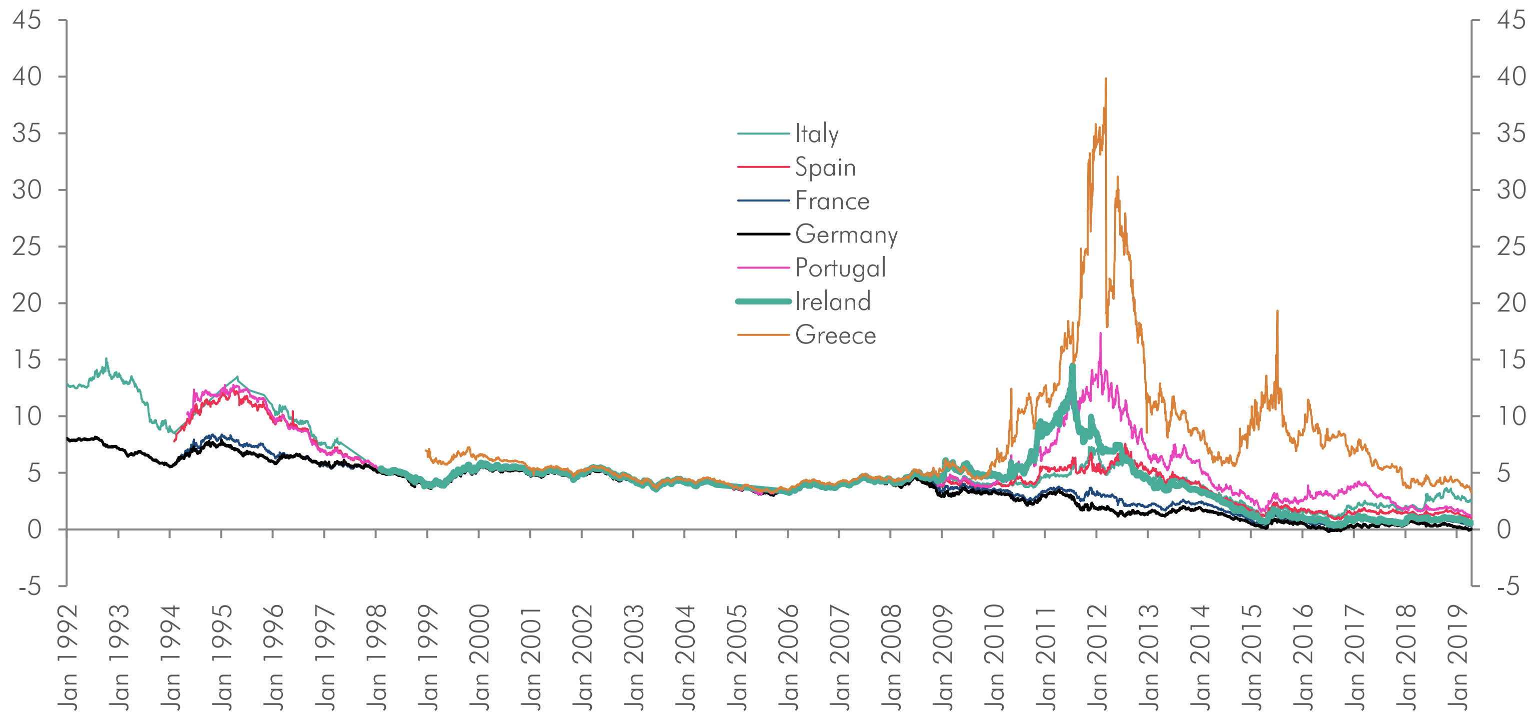
However, for a higher debt ratio, say 100%, impacts are four times wider +/-38 percentage points

Source: Barnes, Casey and Jordan-Doak, (2021). "Managing government debt at high altitude: velocity, instability and headwinds".
Note: For different starting debt ratios, the figure shows how debt ratios evolve for an illustrative interest-growth differential of -5% (bottom lines), -2% (middle lines), and 0% (top lines) and a primary balance = 0. * The shock shows what happens if the interest-growth differential worsens by 2 percentage points.

Often not a problem until very suddenly

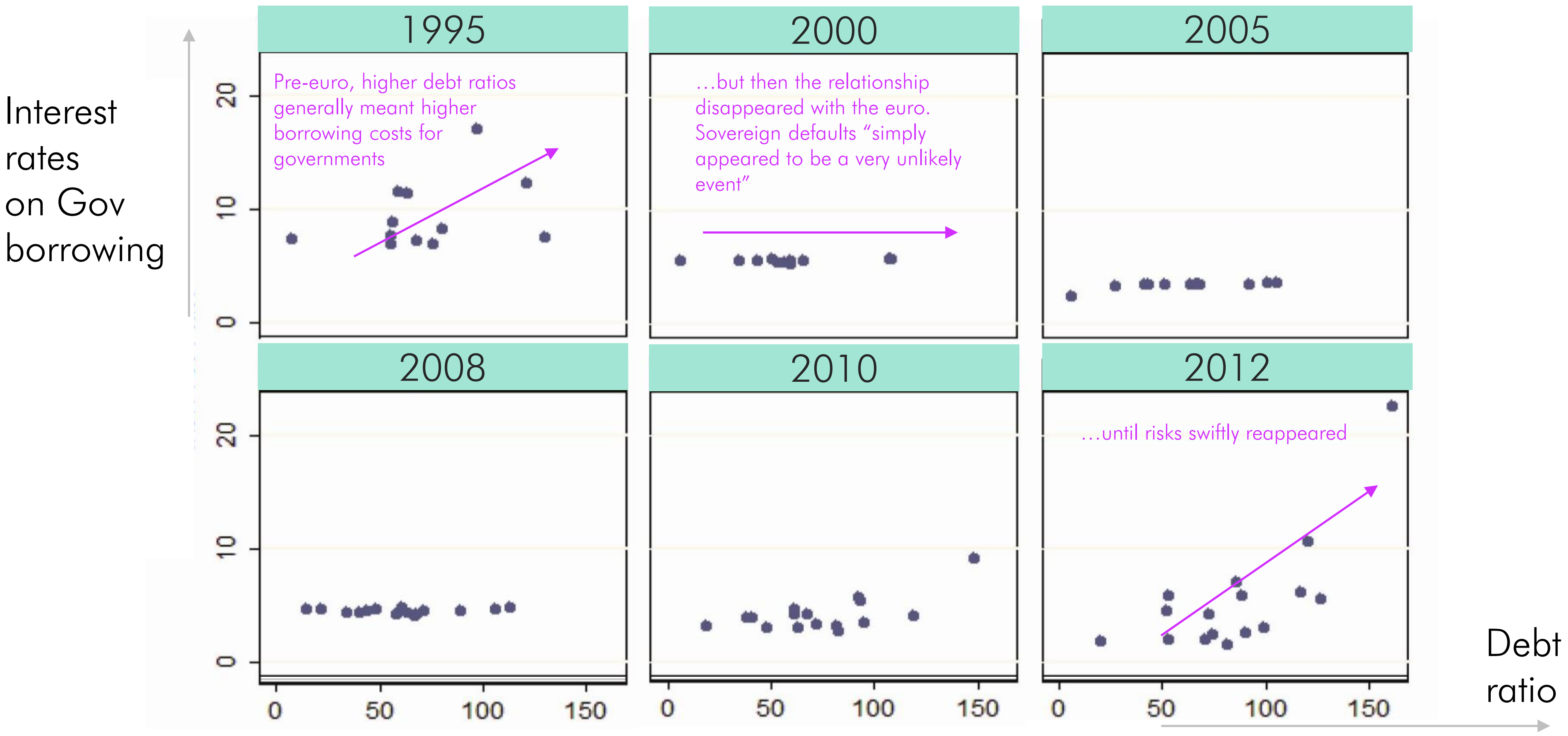
- When the financial crisis hit, countries could no longer borrow at low or sustainable rates
- Choice was 1) default, 2) overnight austerity (cut deficits instantly), or 3) seek emergency support to buy time

Ten-year government bond yields (%)



Sources: DataStream

Country-specific risks were ignored for a long time before financial crisis



Whelan, K. (2013). Sovereign default and the euro. Oxford Review of Economic Policy Vol. 29, No. 3, SOVEREIGN DEBT: UNDERSTANDING BOND MARKETS DURING THE EUROZONE CRISIS (AUTUMN 2013), pp. 478-501

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Government's have a bias towards running deficits

Share of time spent in deficit

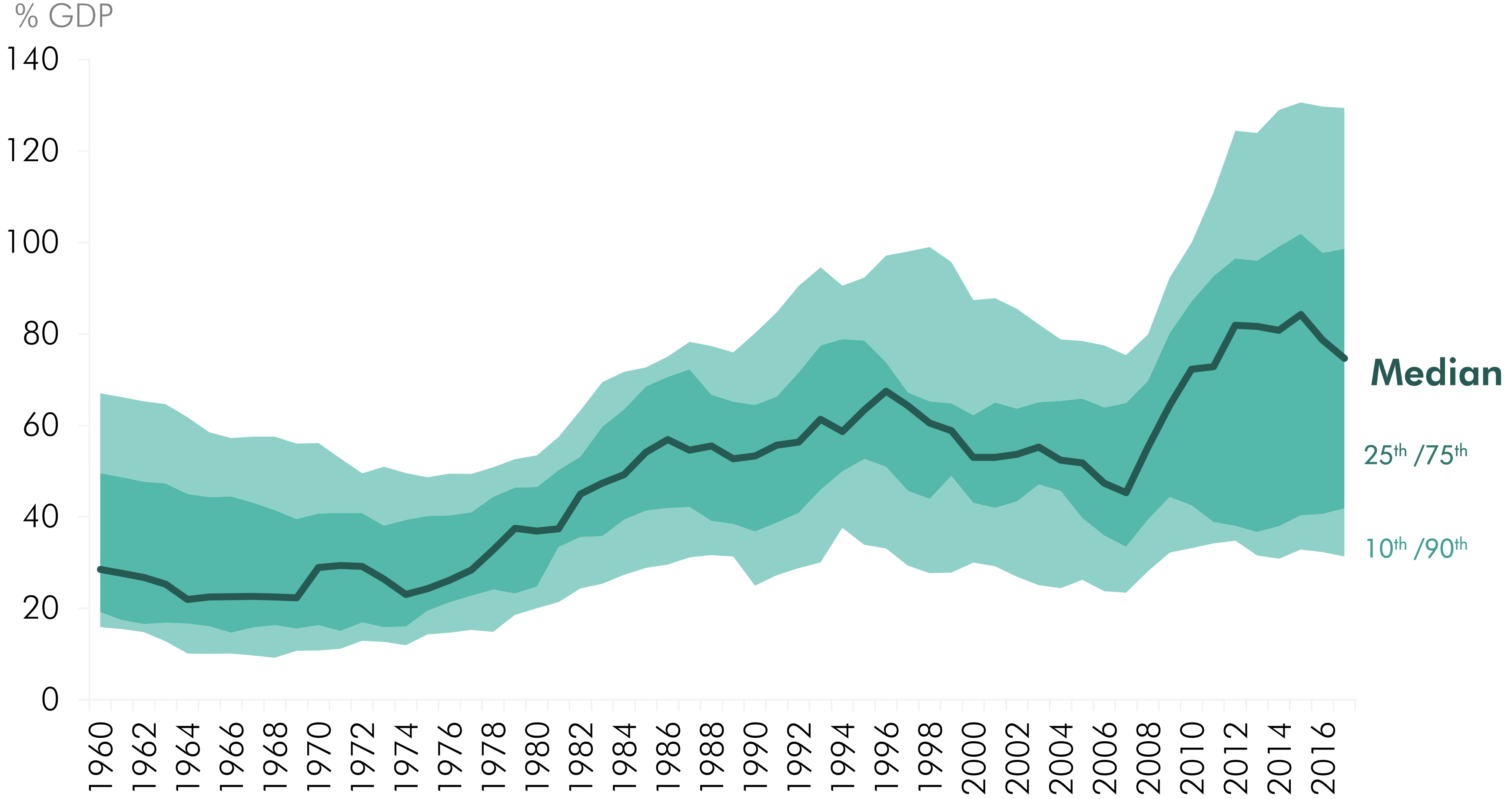
% years 1960-2014

	Australia	Austria	Belgium	Canada	Germany
% Last surplus	81 2008	83 1974	96 2006	74 2007	77 2012
	Denmark	**Spain**	**Finland**	**France**	**UK**
% Last surplus	51 2008	79 2007	25 2008	91 1974	85 2001
	Greece	**Ireland**	**Italy**	**Japan**	**Netherlands**
% Last surplus	81 1972	81 2007	100	70 1992	89 2008
	Norway	**New Zealand**	**Portugal**	**Sweden**	**USA**
% Last surplus	4 2014	48 2008	100	42 2008	92 2000

Source: Economic Outlook, OECD and Eichengreen and Wyplosz (1993) for older data.

This leads to a run up in debt

OECD Countries Debt Ratios



Source: IMF Historical Public Debt Database. https://www.imf.org/external/datamapper/datasets/DEBT

Why is there a bias to run deficits?

- Three reasons often cited:
  - "Short-termism": policymakers don't pay enough attention to the medium and long term.
  - "Common pool" problem: some constituencies care more about using common resources for their own local benefit => ignoring overall budget impact.
  - "Time inconsistency": governments might commit to keeping debt sustainable today but will find it difficult to follow through on this tomorrow => will fail to offset big expansions being run now, will find it hard to raise taxes later on, might not raise pension age as planned

So we have rules

- First wave of fiscal rules:
  - Overly simplistic – 3% GDP deficit; 60% GDP debt
  - No recognition of business cycle (maybe >3% deficits are temporarily okay in a recession?)

- Second wave:
  - Overly complex – structural balances, output gaps, spending rule linked to potential output (unobservables)
  - Highly procyclical – allowed spend more in good times, less in bad times
  - Weakly enforced

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So we have rules

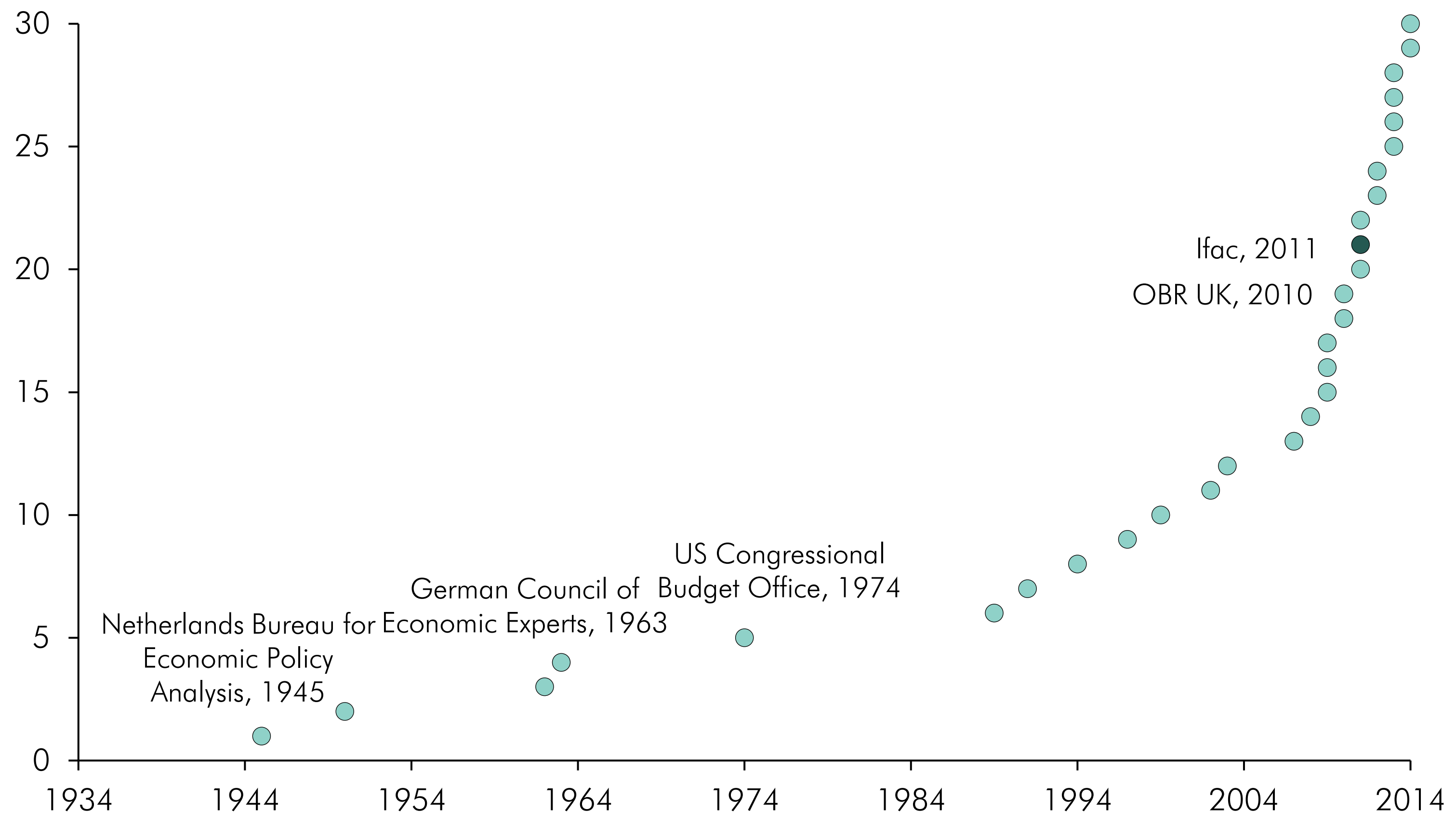
- Third wave?:
  - More than likely, the EU will move to a spending rule
  - Why?
    - That's what governments actually have most control over (revenues and hence deficits depend on growth)
    - Less reliance on unobservable things like output gaps
  - How will it work?
    - Idea would be to have some debt target in mind (example, 60% GDP)
    - Then set spending growth *before tax increases / cuts* that you are allowed for next 5-10 years based on expected "sustainable" growth in economy and revenue

And we have Fiscal Councils

- Have become part of international good practice
- Similar rationale as for independent central banks
- But fewer actual powers (can’t set policy; that’s up to politicians)
- Instead, they subject the public finances—which are usually obscure—to systematic, rigorous, and highly public scrutiny
- Can help voters elect competent governments & know trade-offs (example: same pension age, but higher PRSI)
- Helps encourage policymakers run more sustainable policy

Fiscal Councils

Number of fiscal councils



Source: Debrun and Kinda (2014) - updated to include Spain's AIReF.

Do Fiscal Council's work?

- Associated with more accurate forecasts (less over-optimism)

  Beetsma et al. (2018)

- Helpful influence on public debate

  Debrun, Gérard and Harris (2017)

- Positive association with budget balances, rules compliance

  Capraru et al, (2020), Lledo (2018), Beetsma et al. (2018), Debrun and Kinda (2017),

The Australians put it more colourfully…

THE AUSTRALIAN

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Save

Parliamentary Budget Office is keeping the bastards honest

By DAVID UREN
ASSOCIATE EDITOR (ECONOMICS)

12:00AM MAY 18, 2016

NO COMMENTS

Parliamentary Budget Officer Phil Bowen says of his office: 'It has helped to level the playing field ... [and] to say there has been no impact on transparency would be wrong'. Picture: Ray Strange.

The Council

Sebastian Barnes, chair

Prof Michael McMahon

Dawn Holland

Alessandro Giustiniani

Dr Adele Bergin

Budgeting today

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Government’s 5% Spending Rule

- Basic idea:
    - Real growth tends to be 3% per year, price inflation 2%
    - If we grow spending that fast, should be sustainable (as revenues will grow at same speed)
    - Temporary or one-off spending is excluded

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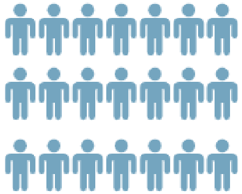
This means budget increases of about €4 to 5 billion each year

- But €2 billion usually eaten up by cost of "standing still"
  - o Demographic pressures: more retirees, schoolkids
  - o Rate increases: Welfare, pensions, public sector pay



- What about taxes? Rule doesn't allow for additional spending if you raise them. It should!

Lots of other pressures

Ageing costs

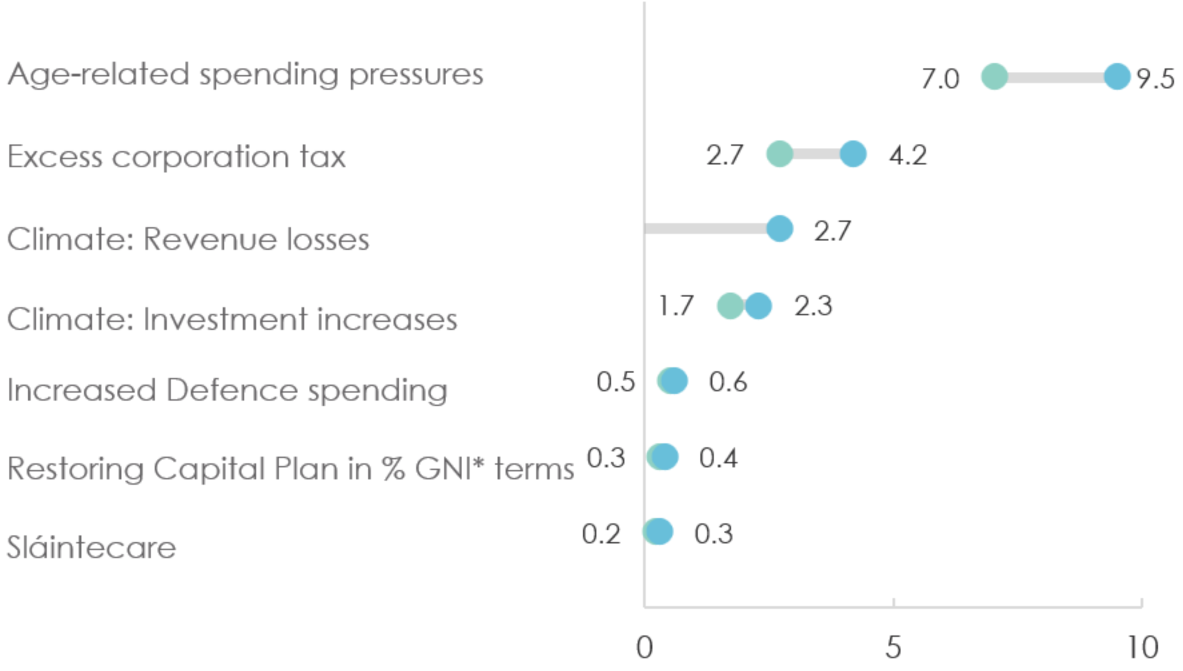
Overreliance on corporation tax

Climate Change

Sláintecare

Medium and long-term challenges need to be addressed

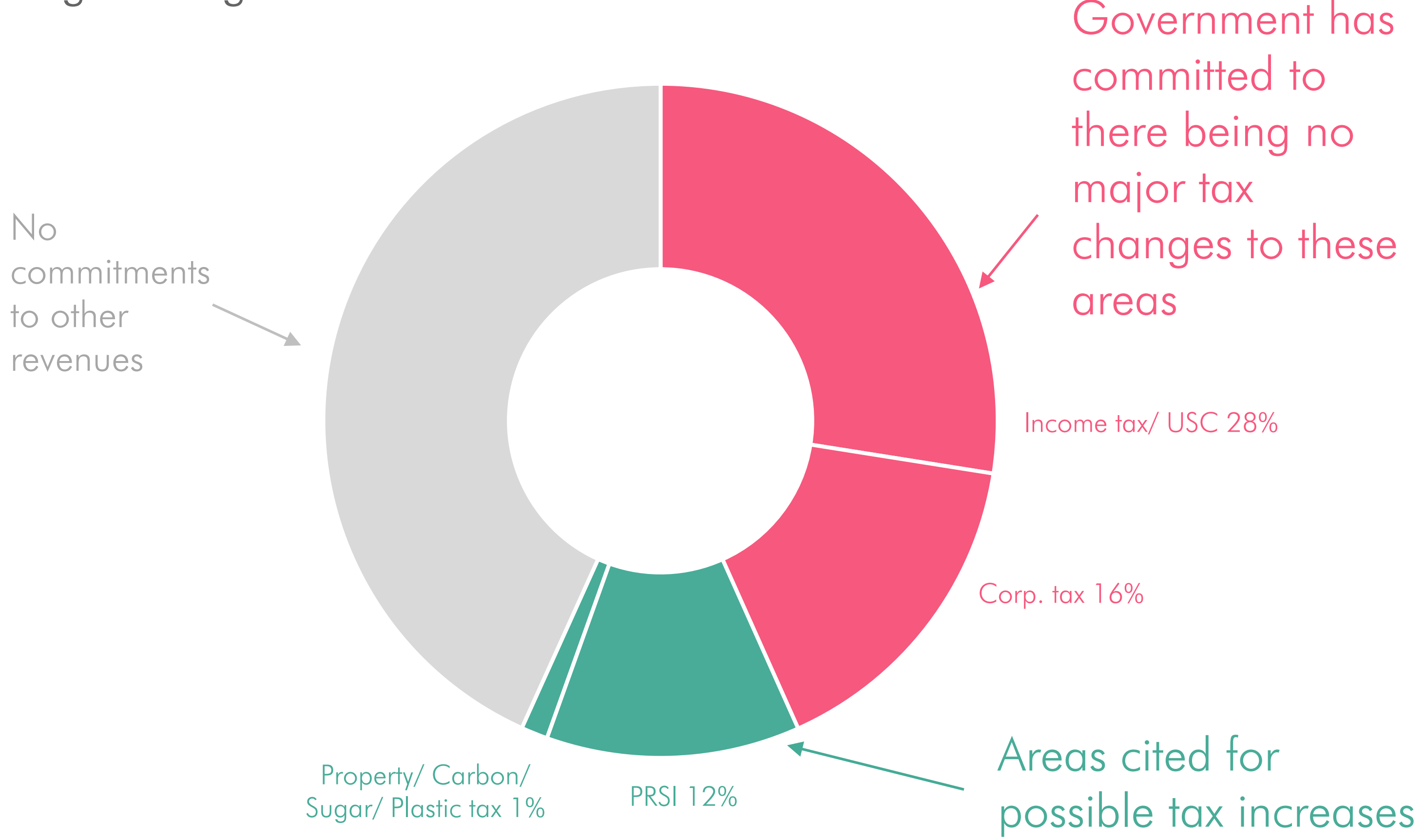
% GNI*, estimated cost range



...also housing

Only small areas where taxes might be raised

% total general government revenue in 2021



Key takeaways

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1) Budget = complex interaction between budgetary sustainability, fiscal rules, political behaviour, and competing demands

2) Ireland faces an ageing population, moderating growth, and big pressures

3) There are limited plans to introduce revenue-raising measures

Questions for you

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- What are budgetary costs/benefits of measures needed?
- Can you provide evidence, be transparent on these?
- Are there ways to address biodiversity loss without fiscal costs?
- Are there existing spending programmes/subsidies contributing to the loss that could be repurposed (ask IGEES, ESRI)?

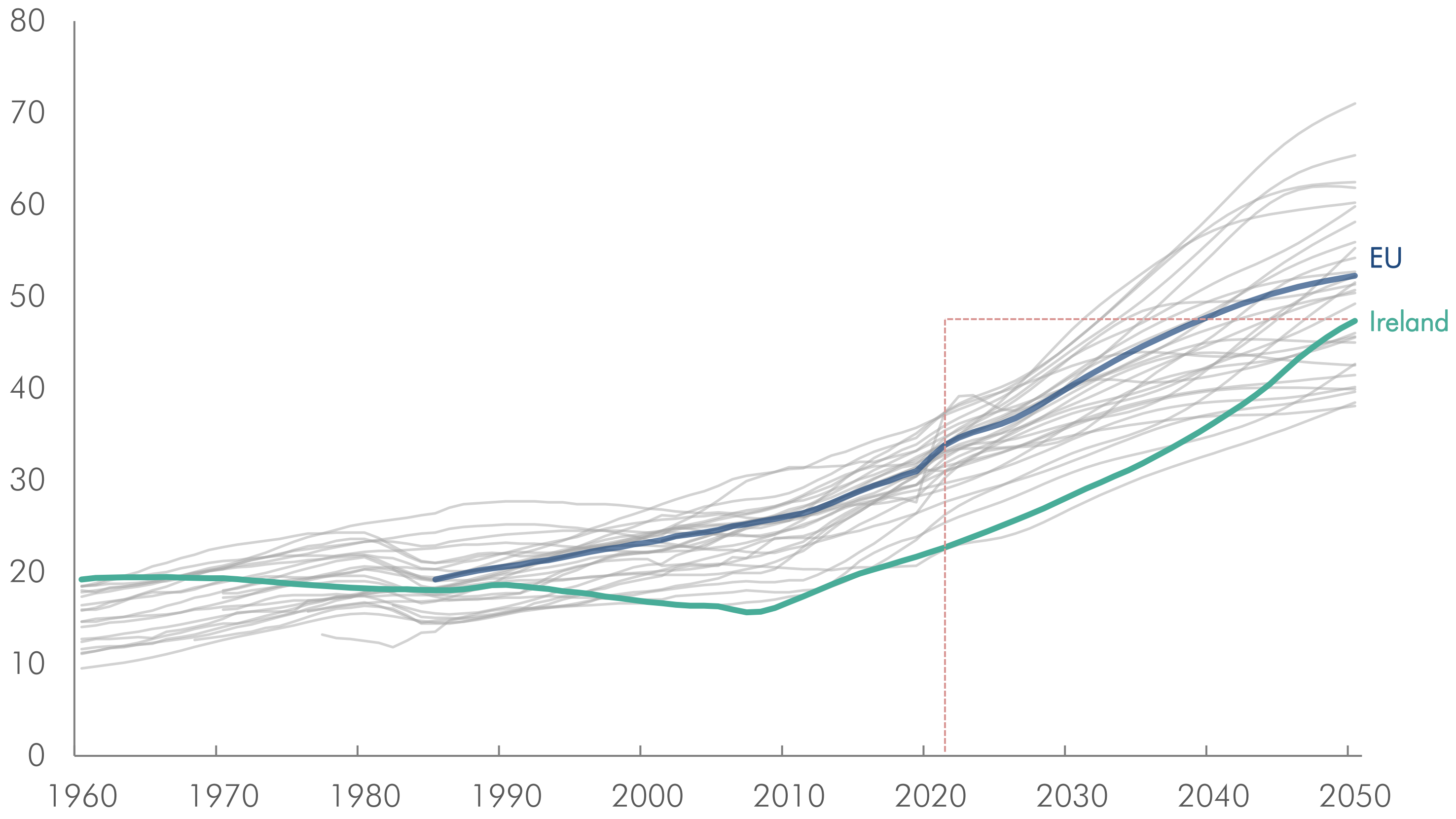
Thank you

Eddie Casey

www.FiscalCouncil.ie

Ireland is ageing rapidly

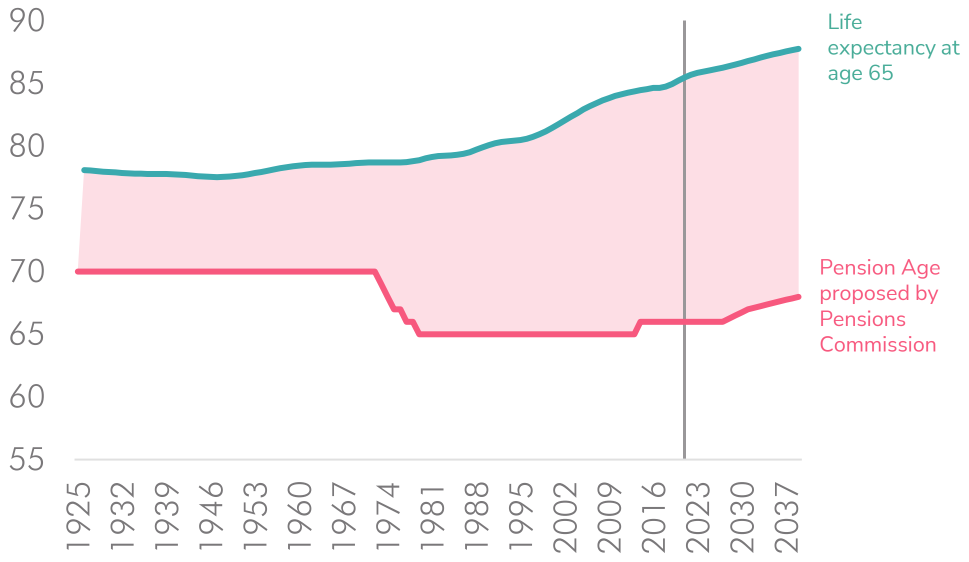
Ages 65+ as % of population aged 15–64



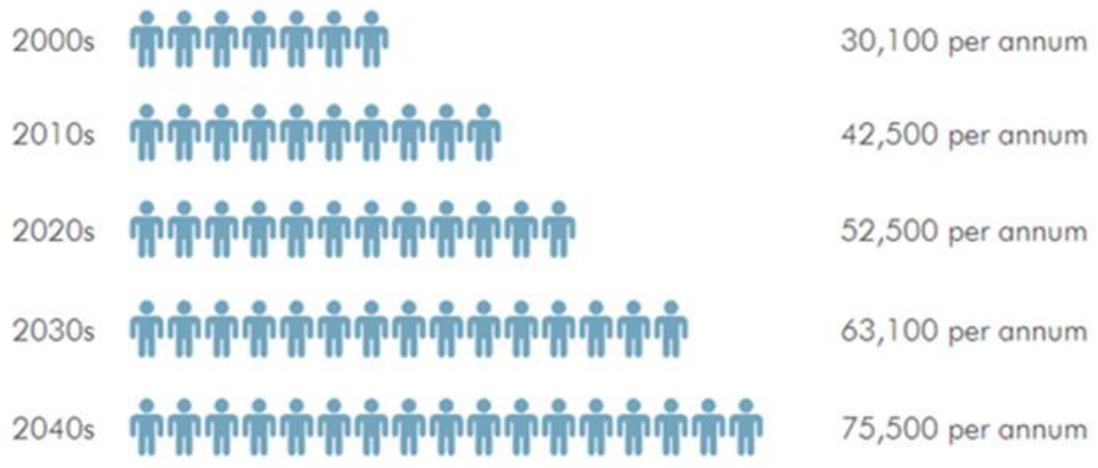
Source: Fiscal Council Long-term Sustainability Report (2020)

Ageing population

Life expectancy at age 65 is rising

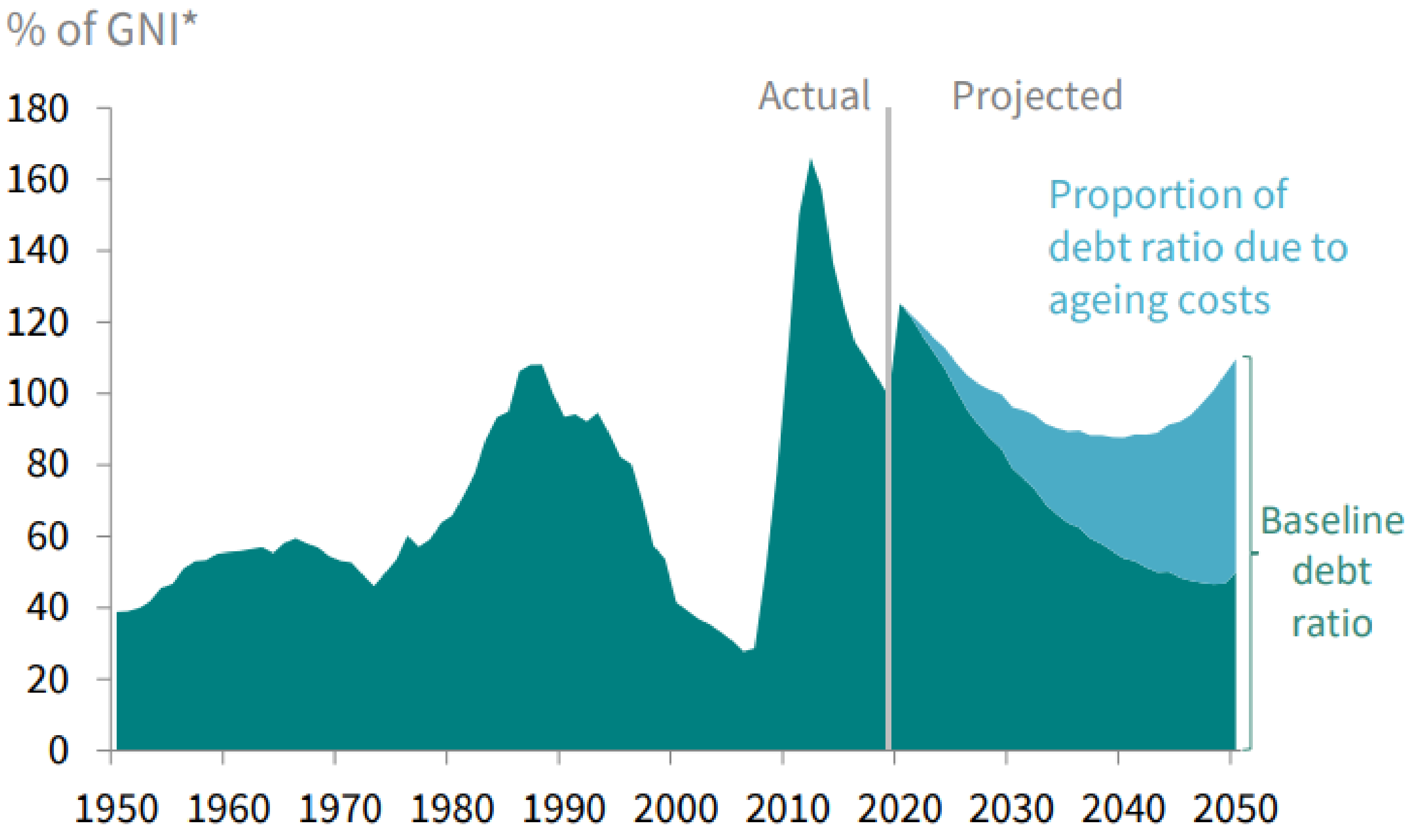


The number of people reaching age 65 is increasing rapidly



Sources: Fiscal Council workings (Long-term Sustainability Report).

Debt likely to fall more slowly and then begin to rise sharply after 2040



Sources: CSO; Department of Finance; and Fiscal Council calculations.

https://www.fiscalcouncil.ie/%20long-term-sustainability-report/