Reflections on the Department of Finance Proposals on Reforming the Budgetary Framework

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Introduction

The proposals for the reform of the budgetary process are very welcome. As set out by the Department of Finance and the Department of Public Expenditure and Reform the main pieces of the reform involve a Fiscal Council, a set of fiscal rules, a medium-term expenditure framework and performance budgeting.

Fiscal council

The proposal to establish a fiscal council is a good idea. What will be important is how that council's reputation is established and developed so that its advice carries appropriate weight and its presence has adequate impact on the policy making process. The success of the Council will depend on its independence and the quality of its policy advice and, to make this possible, it will need to access appropriate expertise to allow it to develop its analysis and to present it in a well argued and publicly accessible format.

The role of the Fiscal Council in monitoring and advising on fiscal policy is not given sufficient attention in the Departments' proposals. The failure to recognise the pivotal role of fiscal policy in managing the economy over the last decade was a major element in the Irish policy failure.

Reflecting the paramount importance of advising on fiscal policy it should be called the "Irish Fiscal Council".

- It should have a broad remit. This remit should cover all aspects of fiscal policy.
- It should report to the Oireachtas.
- It should be free to publish its views as and when it wishes. However, it may feel it to be appropriate to provide a formal statement giving its advice once or twice a year.
- It should publish a recommendation on the appropriate stance of fiscal policy – probably in the autumn. It should also publish in the spring its opinion on the appropriateness of the fiscal stance in the previous budget.

Monitoring of fiscal policy

The key role of the Council should be both to recommend the appropriate stance of fiscal policy and to assess the implementation of that policy - to what extent are fiscal rules being complied with, and in the current situation, commenting on compliance with EU/ECB/IMF requirements. In undertaking this task the Fiscal Council should prepare a report prior to each Budget recommending the appropriate stance of fiscal policy. Each year, after each Budget, it should also evaluate the extent to which that Budget is consistent with the recommended stance. In considering the stance of fiscal policy this need not involve a detailed assessment of the different budgetary measures; many different budget configurations could be used to implement a particular fiscal stance. The optimal expenditure level and the optimal tax level are a matter for the government and the Oireachtas. However, it is the balance between the two –the surplus / deficit – that is crucially a matter for advice by the Fiscal Council. (However, as discussed below, the Council may also wish to advise on more detailed issues affecting fiscal policy.)

The Fiscal Council should set out its own framework for evaluating fiscal policy. The Council itself needs to articulate this framework which can be commented on and refined as best practice. This framework will then inform the approach the council will take to the evaluation of individual budgets.

To assess the stance of fiscal policy the Fiscal Council will need appropriate model(s) and methodology. If it does not know whether fiscal policy is stimulatory or deflationary it cannot judge what should be done and it could, as a result, give the wrong policy advice. The Department of Finance and the EU Commission both acknowledge that the prescribed "EU" methodology for assessing the stance of fiscal policy is not very appropriate and that it came up with the wrong answer for Ireland in the past. Kearney, 2002, discusses the merits and demerits of a number of different approaches to measuring the stance of fiscal policy.

In assessing the stance of fiscal policy an important issue will be to assess the likely potential output of the economy and the related structural deficit. However, this is not a simple task and the results will depend on the model(s) used to undertake it. Thus, while the Fiscal Council should undertake such work, it would not be appropriate to build the results of such research into formal rules. Instead, the Fiscal Council should use such research as a basis for formulating its policy advice.

The Fiscal Council needs to be in a position to commission modelling work to undertake the task of assessing the stance of fiscal policy (and the structural deficit) from whatever agencies it deems to be appropriate. Because policy operates in an uncertain world the Fiscal Council will also want to look at scenarios – "what ifs" on policy. This also needs a model(s).

In formulating policy recognition needs to be given to the fact that forecasts are not certain. The Oireachtas report pays too much attention to the issue of getting the forecasts right. In the past policy errors were not due to bad forecasts but to bad policy making. It would probably be appropriate to look at a range of forecasts (e.g. a fan chart) and test the appropriateness of policy in across a range of possible outcomes to arrive at a "no regrets" policy. This too needs some scenarios (and modelling).

While it should be open to the Fiscal Council to commission work on forecasting, it may well find that there is sufficient diversity of opinion and skills available already. The Swedish experience suggests that the Council should not invest too much resources into second-guessing the Department of Finance by carrying out its own forecasts

The Department itself might want to consider replacing point estimates for the major aggregates by a potential range of outcomes, as there is always a high degree of uncertainty about the future.

Micro-economics of fiscal policy

There are micro issues in relation to expenditure and taxation that the Council should be in a position to advise on if it feels that it is appropriate.

The structure of taxation matters both for incentives and income distribution, both of which can have implications for long-term growth.

Other Issues

The Fiscal Council will need a significant budget to commission the necessary research to underpin its work. Without such support it will find it very difficult to offer an informed opinion on fiscal policy. The Council should be able to commission such research from the bodies or individuals that it feels are the most appropriate. This process should be streamlined so that the Council can obtain the advice it needs in an appropriate time frame. Such an approach is preferable to the Council trying to develop its in house expertise to undertake all the research it deems necessary for its work.

While it may be wise for the Fiscal Council to confine its policy advice to one or two statements a year, it should be open to the Council to publish opinions as and when it deems appropriate. This would allow the Council to respond to major changes in circumstances within a year. While this should be unusual, we have seen in recent years that such "surprises" can happen. The opinions of the Council should be formally communicated to the Oireachtas by being lodged in the Oireachtas library.

The Fiscal Council may also wish to recommend improvements in the data available for monitoring fiscal policy. In particular, the exchequer returns do not provide adequate information to monitor the outturn of fiscal policy decisions over the course of the year. Also, the presentation of government accounts is archaic. There is a need to move to accruals accounting with the accounts presented in an economically meaningful way. These accounts need to be available on a consolidated basis for the public service.

Fiscal Rules

Fiscal rules can be a problem if they are not appropriate. It has been argued that the Stability and Growth Pact, because its approach was not appropriate to Irish circumstances over the 2000-08 period, made things worse, not better (FitzGerald, 2010 and O'Leary 2010). Thus fiscal rules need to be correct, providing appropriate incentives and guidance for policy makers.

Fiscal rules should not be just for today. An important test is whether they will still be valid in 2020 and also, if they had been in place in the last decade, would they have prevented the crisis?

The proposed rules in the Department's discussion paper are designed to put downward pressure on borrowing and debt – this is very appropriate to current circumstances. However, the rules are not derived from a theoretical model which would give you the optimal adjustment path for the economy. As the period 2011-14 is already spoken for in the IMF/EU agreement, rules for these years are not really important. For the period to 2015 any set of fiscal rules is limited by the need to reduce the budget deficit and the debt to GDP ratio as agreed with the EU/ECB/IMF. The immediate task as, set out in the Memorandum of Understanding, and later extended and revised in the Stability programme Update, is to reduce the budget deficit to less than 3% of GDP by 2015.

It is the policy after 2015 on reducing the debt burden that will be important and needs to be formulated. At that stage the economy should already be running a primary surplus. How fast should the debt be run down thereafter? This will also be affected by how much the state realises post 2014 for the banking and Nama assets. It is possible that this could push the debt GDP ratio below 90% by end 2015 which would, in turn, alter the appropriate adjustment path to a lower debt / GDP ratio.

An interim solution would be to legislate for the adjustment programme out to 2015 already agreed with the IMF/EU. One additional rule for the period to 2015 would be that, where the economy outperforms targets and the deficit comes in below target, that saving should be used to repay debt rather than to allow higher expenditure or lower taxes in future years. Also all sales of assets should be used to retire debt/ avoid borrowing. This could be important when it comes to selling the viable banks. At a later date rules appropriate for the post 2015 world would be enacted.

When this adjustment phase is over the rules to guide the optimal path for reducing the debt to GDP ratio should be specified. In practice allowance must be made for business cycle effects with the denominator cyclically adjusted to avoid pro-cyclical policy. If events turn out to be more favourable (potential output growth higher) then this probably should affect the pace of debt reduction rather than be reflected in greater expenditure or lower taxes. The same applies to asset sales. These should be used to reduce borrowing in the first instance and for those sales that take place when there is no borrowing, the funds should be used to reduce debt.

For the future there should be rules to stop the mistakes of the last decade being made again. The proposed rules do not do this. As discussed elsewhere (Conefrey and FitzGerald, 2010, Gros, 2011), the best indication that Ireland and Spain were in dangerous territory in the last decade was the growing balance of payments deficit. This issue has been recognised by the new EU Commission rules for fiscal policy which will take account of domestic imbalances – the balance of payments as well as the government balance.

In planning for the post 2015 situation what is needed is a combination of rules on government borrowing and debt PLUS a rule on the balance of payments. The Stability and Growth Pact (SGP) rules provide part of the necessary framework. However, there needs to be a rule which guides policy makers on the appropriate path to achieving full compliance with the SGP.

An example of a possible rule to deal with the dangers posed by an inappropriate balance of payments would be:

- Fiscal policy should be adjusted to ensure that the balance of payments deficit does not exceed a specified percentage of GDP(e.g. 2%) unless the fiscal council certifies otherwise. (This latter proviso would allow the Council to take account of a situation where the deficit reflected a surge in productive investment).

The sustainable expenditure growth rule is a good times rule and so does not apply during the current adjustment phase. It may need to be modified even in good times to take account of unfunded liabilities (public pensions) and the exchequer healthcare costs of the increase in the numbers of those aged 75 and over expected in the long-term. Furthermore the requirement of creating a rainy day fund also limits the extent by which expenditure could rise without increases in taxation. Rather than setting an expenditure rule *ab initio* future claims in broad terms could be estimated, given the structure of the population. In the same way we could estimate the broad orders of magnitude of output developments and associated government revenues. These together would then indicate the extent to which taxes might have to be raised or programmes changed. Although it might appear to be a remote possibility now, there could be a medium-term period of sustainable higher growth and it should not in itself be a basis for increased expenditure. Expenditure should always be judged on its merits. The importance of evaluating value for money is discussed further below.

The proposals in the Department's discussion paper are not fully worked out. For the period to 2015 enacting simple rules, as set out above, would be appropriate. However, more consideration is needed on designing rules for the longer term. Decisions on such rules should be postponed until a robust set of rules are identified, which meets the requirements set out above. The new Fiscal Council could advise on preparing such rules, rules which would guide policy makers (and the Fiscal Council) after 2015. These rules should be enacted in 2012 well before they would become effective.

Medium-term Expenditure Framework

There is too little discussion on getting good value for money on expenditure in the discussion paper. There should be a strong acknowledgement of the need to undertake appropriate *ex ante* and *ex post* evaluation of major expenditure programmes, both current and capital. The failure to do this properly over the last decade has contributed to Ireland's current difficult situation.

These evaluations should be independent, with that independence guaranteed by the Fiscal Council monitoring the way that they are undertaken (e.g. broad terms of reference). The old evaluation unit in the Department of Finance performed this task well, where its governance was a shared responsibility of the Department AND of the EU. This highlights the need for ensuring that evaluations are independent and undertaken using best practise. If they are to have maximum impact on the policy making process they need to be published formally (they are always available anyway under the Freedom of Information Act).

Expenditure decisions, both in relation to ongoing and new current expenditure, may benefit from micro analysis. There is a belief that cuts in programme expenditure already underway are in areas where it is easy to cut but that the long-term implications of the cuts have been ignored. These and similar areas would benefit from analysis. This work should be published.

There is nothing in the Department of Finance discussion document on what the optimal tax policy should be – for example implementation of the Commission on Taxation proposals. The Fiscal Council should also be able to advise on this issue if it so desires.