




BUDGETING FOR FISCAL SPACE

ECONOMIC FORECASTING AND BUDGETARY SPACE

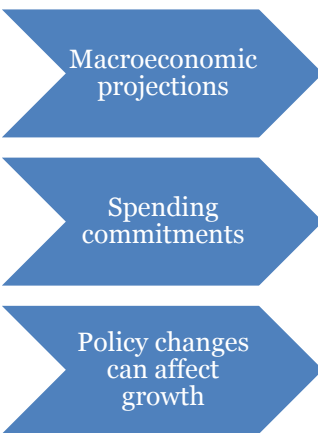
11th Annual CESEE-SBO Meeting
Warsaw, 21 May 2015

Sebastian Barnes

Counsellor to the Chief Economist, OECD
Member, Irish Fiscal Advisory Council (IFAC)



How much fiscal space is there?



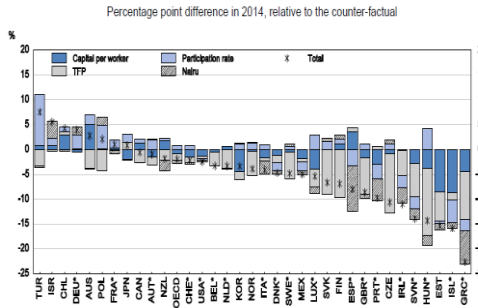
Macroeconomic
projections

Spending
commitments

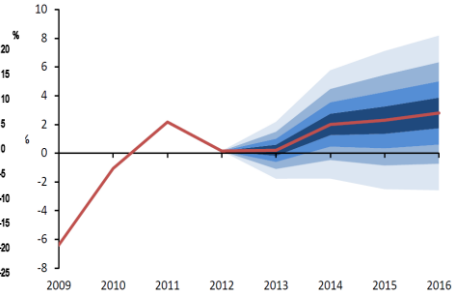
Policy changes
can affect
growth

Medium-term projections are important, but uncertain

OECD post-crisis revisions



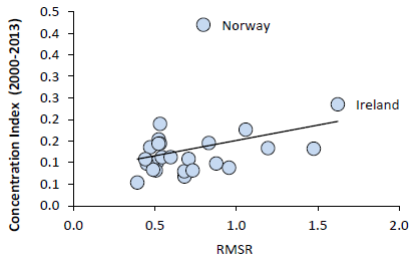
Fan chart for Irish GDP growth



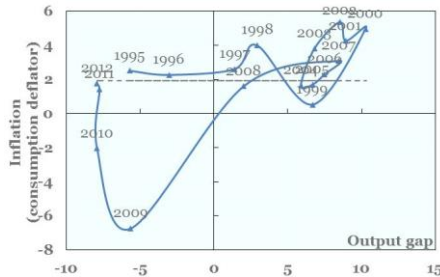
- Invest to make the best forecasts
- Always very uncertain
- Prudence is critical

Small, fast-growing, highly open economies: uncertainty and imbalances

Data uncertainty (RMS) and industry-concentration in mfg.



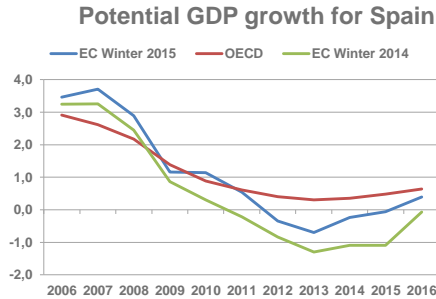
Inflation and output gaps in Ireland



- Higher volatility and uncertainty
- Risks of hard-to-detect imbalances



Choice of methodologies can help



Low cyclical, appropriate concept for public finances

- eg, treatment of investment and unemployment

Robustness to data changes

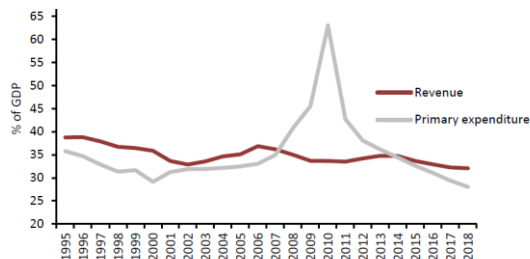
Do not rely on a single method

- look at other variables than GDP, eg CA balance, credit



Spending commitments – need realistic medium-term plans

Ireland: projected revenue and spending



Need a well-articulated plan for the medium term

Avoid using technical/bureaucratic assumptions

- “No policy change”

Need realistic assessment of cost of delivering current level of service

- “money illusion”



Health and demographic pressures

Scenario	Health spending assumption
EC projections	Demographic + unitary real income elasticity
OECD "cost containment"	healthy ageing, income elasticity=0.8, residual unwinds over time
OECD "cost pressure"	healthy ageing, income elasticity=0.8, residual=1.7% per year

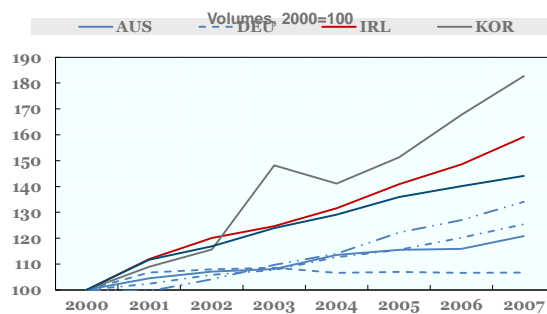
EC methodology is a good starting point

But, useful to look at assumptions

Uncertainty is high



Avoiding a spending build up



Locked in social commitments and higher wages

Avoid reform

Over-investment



Communications challenges: managing expectations

Risks

- Hard to keep down spending pressures
- Short-term in “good times”
- Soft budget constraints
- Hard to reverse once committed, even at an early stage

Need a very clear and coherent baseline

- Options for keeping money of the table – funds, rules etc.

Need widespread “ownership” of the public finances

- maximum transparency

IFIs (fiscal councils) can help to resolve the communication problem



Optimal debt and fiscal frameworks

Debt should be key medium-term objective of policy

Trade-off between ***stabilisation*** and ***meeting debt targets***

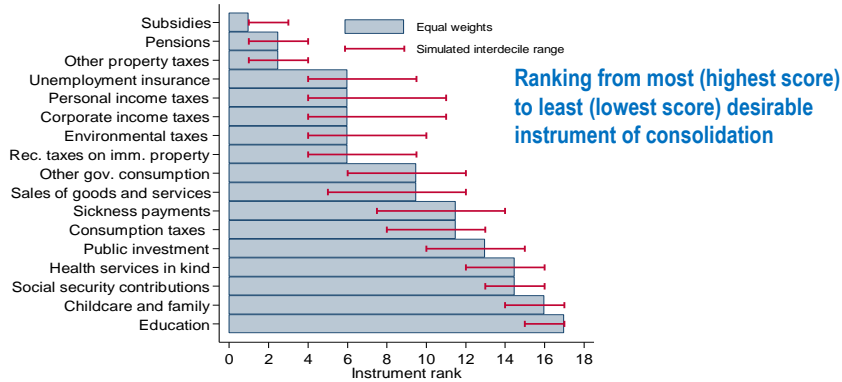
- Country-specific factors:
 - initial debt level
 - fiscal policy implementation
 - (exogenous) macroeconomic volatility
 - market perceptions of the critical debt level
 - *also depends on the quality of spending and supply-side impacts*

Budget balance rules paired with expenditure rules appear most effective (Guichard et al., 2007)



Interaction between growth and policies

Hierarchy of fiscal instruments

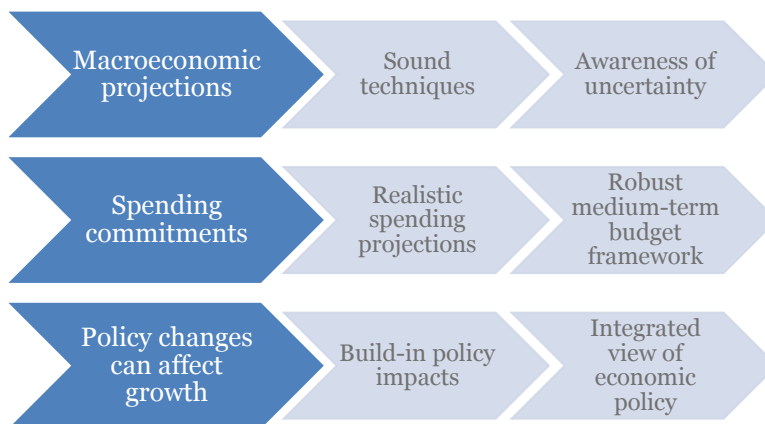


Note: The rankings are based on the assessment in Table 2. Scores of +1 and -1 are given to each + and - signs respectively, each objective is given a weight, and the resulting indicator is used to rank instruments. Each individual instrument score based on the assessment in Table 2 is kept with a probability of ¾ or increased by +1 with a probability of 1/8 or reduced by -1 with a probability of 1/8. Weights ranging each from 0.15 to 0.55 and summing to unity have been given to each objective. Weights have been restricted to no smaller than 0.15 because each objective is considered important. A total of 40,000 random draws have been made.

Source: Cournède, Goujard and Pina (2014).



How to manage fiscal space



Sound institutions and transparency can help achieve all three objectives



References

(Ollivaud and Turner, 2014), "[The Effect of the Global Financial Crisis on OECD Potential Output](#)", OECD Economics Department Working Paper 1166

(de la Maisonneuve and Oliveira Martins, 2013), "[A Projection Method for Public Health and Long-Term Care Expenditures](#)", OECD Economics Department Working Paper 1048

(Fall *et al.*, *forthcoming*), Government Debt and Fiscal Frameworks

(Guichard *et al.*, 2007), "What Promotes Fiscal Consolidation: OECD Country Experiences", OECD Economics Department Working Paper 553

<http://www.oecd.org/economy/>

www.fiscalcouncil.ie