



28 July 2016

Professor John McHale
Chair
Irish Fiscal Advisory Council
Whitaker Square (ESRI Building)
Sir John Rogerson's Quay
Dublin 2

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's June 2016 *Fiscal Assessment Report* which was published on 8th June.

In line with my response to previous Fiscal Assessment Reports, I am providing my written response in the attached appendix. It is my intention to publish this letter on my Department's website.

Yours sincerely,

Michael Noonan T.D.
Minister for Finance

Appendix – Response of the Minister for Finance to the June 2016 *Fiscal Assessment Report*

Introduction

I welcome the publication of the Irish Fiscal Advisory Council's Fiscal Assessment Report (FAR) following the 2016 Stability Programme Update (SPU). I agree with the Council's view on the "impressive" Irish economic recovery although the recent publication of the national accounts for 2015 highlight the complexity associated with analysing trends in the Irish economy. I note in relation to the fiscal stance, the Council's preliminary assessment that an overall budgetary package of €0.9 billion in 2017 is consistent with prudent economic and budgetary management. I welcome the Council's view that provided the economy continues to grow at sustainable rates, the use of the available fiscal space from 2017 onwards would be appropriate.

The correction of Ireland's excessive deficit represents a key milestone in our post-crisis progress, and indeed since the publication of the FAR, the excessive deficit procedure for Ireland has been officially closed.

While the Council acknowledges the strong pace of recovery of the Irish economy, I agree with its opinion on how quickly any hard-won credibility can be eroded. I take this opportunity to reiterate the Government's stated intention to comply with the fiscal rules in order to maintain and build on the prudent fiscal management that has laid the foundations for Ireland's continuing recovery. The Government's approach is not to jeopardise the emerging recovery by adopting inappropriate budgetary policies.

The Summer Economic Statement (SES) published subsequent to the SPU, provides a revised fiscal forecast, relative to the baseline SPU scenario. This indicates the Government will achieve a balanced budget in headline terms in 2018 and also reach our medium term budgetary objective by 2018, which is the main target of the domestic Budgetary Rule and the Preventive Arm of the Stability and Growth Pact. In my view, this update addresses certain budgetary forecast issues the Council set out in the FAR. The SES also provides some further detail on proposals contained in the Programme for Government, including the establishment of a Rainy Day Fund, which was also referenced in the FAR.

Turning to public expenditure issues, since the crisis there have been substantive reforms to how public services are managed and delivered. These reforms are designed to place an emphasis on prudent, sustainable growth in public expenditure. This renewed framework emphasises the importance of value-for-money, effectiveness of public spending and underpins the continuing need for reform in our public services. Most recently the Mid-Year Expenditure Report represents a new innovation which identifies baseline expenditure ceilings and provides the starting point for the examination and discussion of medium-term budgetary priorities by relevant stakeholders.

Dealing with the Council's comments on public capital spending, the SES sets out that gross voted capital expenditure will grow from €4 billion in 2016 to €7.1 billion in 2021. This represents an annual average increase of 12½ per cent. In total an additional cumulative €5.1 billion is to be allocated to capital expenditure in the period to 2021, over and above the amount set out in the Public Capital Plan.

Chapter 1 – Assessment of the Fiscal Stance

Turning to the assessment of the fiscal stance, certain observations on the SPU such as projections around the compliance of this year's public finances with the EU fiscal rules are largely addressed in the subsequent SES. The SES updates the baseline SPU budgetary position for additional revenue and expenditure developments and sets out medium-term fiscal projections which target a balanced budget in both structural and headline terms by 2018.

The Council advocate that should signs of overheating emerge, the Government may need to go beyond the formal implementation of the fiscal rules to ensure that the public finances remain on a sustainable path. This is a possibility that the Government has also identified and addressed in the SES. The Rainy Day Fund will perform a vital counter-cyclical role if circumstances warrant it.

The amount of fiscal space consistent with the SPU (the use of which is set out in the SES) remains illustrative for the period beyond 2017 given the inevitable variability associated with the harmonised methodology for calculating trend growth and its impact upon the expenditure benchmark. This is accentuated by the economic uncertainty arising from the result of the UK referendum.

The Council advocates continuing to abide by the expenditure benchmark even after the medium term budgetary objective (or 'MTO') is achieved. In all medium-term publications since Budget 2016, my Department's projections have not incorporated the additional space potentially arising if the expenditure benchmark were disregarded post-achievement of the MTO. With the added benefit of prudence, this has largely been on account of the technical complexity in targeting fiscal space on the basis of the structural budgetary position.

As noted above, the Rainy Day Fund, first aired in the May 2016 *Programme for a Partnership Government*, gives the Government scope to operate counter-cyclical fiscal policy, if needed. The SES commits €3 billion over 2019-2021 of the available net fiscal space to the Fund.

The FAR correctly highlights the potential distortionary impact GDP has in overstating the underlying health of the government accounts. Indeed the increase in GDP in the 2015 National Income and Expenditure data only emphasises this point. We are vigilant to such concerns and assess the sustainability of our public debt dynamics using a range of metrics. The most important one is whether our debt servicing capacity is improving. On any established measure of activity, our nominal economic growth is higher than the average cost of our debt. Our general government interest to revenue ratio is on a firm downward trajectory and stood at around 9.5 per cent last year, down from almost 12.5 per cent in 2013. This ratio is expected to continue to decline over the medium term. The gross general government debt to revenue ratio is another appropriate indicator and this ratio has also improved significantly in recent years, dropping to 286 per cent in 2015 from over 355 per cent in 2012. Indeed, validating this position, since these recent GDP revisions, independent commentators such as the rating agencies Fitch and Moody's have both stated that Ireland's debt sustainability continues to improve across a range of metrics.

Chapter 2 – Assessment and Endorsement of Macroeconomic Forecasts

I welcome the Council's acknowledgement of continued high levels of co-operation provided by my Department throughout the endorsement process in the context of this year's SPU.

On the supply-side, I welcome the Council's assessment that, overall, the economy does not appear to portray signs of overheating at the present. In particular, I note and share the Council's view of a lack of clear wage and price pressures in the labour market.

With regards to the medium-term, the Council suggests that the current cyclical position of the economy is likely to change quite rapidly. As acknowledged by the Council, I would recall however that signs of spare economic capacity remain, particularly in the labour market. On this basis it would appear that scope remains for further growth consistent with the economy operating broadly at its potential. This position is borne out by projections published in the context of the SES.

I also note the FAR's statement that additional fiscal stimulus beyond the 'no policy change' position set out in the SPU could raise growth to levels consistent with overheating. As outlined in the SES, the use of available fiscal space does not however on the basis of harmonised estimates lead to significant overheating of the economy.

I welcome the recognition in the FAR that estimates of the fiscal space should not serve as targets, and that discretionary tax and expenditure measures should rather be evaluated on their own merits.

The Council also draws attention to the need to develop alternative models for estimating the potential capacity of the economy. My Department recognises the importance of progress on this front. Substantial work has been undertaken by my Department to assess the performance of alternative models in the Irish context. This work was briefly summarised in Box 1 of SPU 2016, although its completion is now complicated by the publication of revised *National Income and Expenditure Account* figures for 2015.

Furthermore, in light of the significant revisions to GDP growth the appropriateness of publishing an alternative set of supply-side estimate in the context of SPU or Budget documents warrants careful consideration. As a pre-condition to such decision, the stability and sensibility of the alternative set of estimates would need to be ensured.

I would stress that my Department remains vigilant to signs of overheating. In assessing the cyclical position of the economy, my Department considers a wide range of economic indicators in conjunction with harmonised estimates of the output gap. On this basis, my Department's assessment is that the forecasts featured in both the SPU and SES are consistent with an absence of overheating pressures.

Finally, I note the risks outlined by the Council to the current macroeconomic outlook, particularly in relation to developments arising from Brexit. My Department will continue to monitor developments on these fronts.

Chapter 3- Assessment of Budgetary Forecasts

The FAR suggests that the Department of Finance may have taken a conservative approach to the 2016 SPU tax forecasts. I wish to clarify it is the established practice of my Department to revise in-year tax projections based only upon current performance, rather than on specific changes to forecasts for macroeconomic drivers. It should be noted that when preparing the SPU, only tax receipts from Quarter 1 had been booked, with some of the main headings actually performing below target. The FAR specifically refers to a corporation tax over-performance, with receipts coming in some €300 million ahead of profile. However, on an underlying basis, excluding a possible overpayment advised by the Revenue equalling this amount, corporate taxes were effectively on profile. It is in this context that the tax forecast was prudently left unadjusted. However, in the subsequent SES, the tax forecasts were revised in light of two further monthly tax outturns.

The FAR outlines that the Medium Term Expenditure Projections are likely to underestimate future spending levels for two reasons, in that they do not allow for the rising costs of providing public services in line with inflation and do not allocate available fiscal space.

The issue of indexation of costs is discussed in the Mid-Year Expenditure Report. Based on the analysis in that Report, the pre-crisis period has demonstrated the risks inherent in restating expenditure amounts ('ceilings') applying inflationary increases as a new baseline (i.e. floor) for any new increased expenditure. A key objective of the Medium Term Expenditure Framework is to ensure that Ministers and their Departments manage public expenditure strictly within their Expenditure Ceiling. This necessitates an approach to expenditure management in which a systematic programme of expenditure reviews and efficiency-generating reforms is underway in each sector to ensure that priority initiatives can be supported and developed within the allocated ceiling and are subsequently respected. In relation to allocation of fiscal space, the SES clearly sets out the allocation of available fiscal

space compliant with the budgetary benchmark, with increases included for current and capital expenditure to fund budgetary measures. The forthcoming budgetary preparations will consider specific allocation issues in relation to this fiscal space.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I welcome the Council's comprehensive assessment of Ireland's compliance with the fiscal rules. The accompanying detail on the requirements of the Preventive Arm, to which Ireland is now subject is especially important in ensuring our national fiscal framework is communicated in a transparent manner.

For 2016, the FAR outlines that on an ex-ante basis, Ireland's forecast structural improvement of 0.4 percentage points is lower than that envisioned at Budget time and falls short of the required improvement of 0.6 percentage points. I would note however that the European Council Recommendation (of 18 May 2016) affirms that based on the European Commission's own assessment, the European Council is of the opinion that Ireland is expected to broadly comply with the provisions of the Stability and Growth Pact. I would also highlight, as noted by both the European Commission and the Council that this shortfall, if ex-post turned out to be the outcome, would not constitute a 'significant deviation'. Furthermore, the projections are compliant with the requirements of the expenditure benchmark.

The FAR maintains that if a strategy of minimum compliance with the fiscal rules is followed, this could have implications on when the MTO is achieved. However, as outlined in the SES, the use of fiscal space is not expected to compromise achievement of the MTO in 2018. This projection will of course be fully reviewed in the context of Budget 2017's official forecasts.

On the Council's criticisms in relation to medium term expenditure projections and revisions to expenditure ceilings, I would point to Chapter 3 of the Mid-Year Expenditure Report published by the Department of Public Expenditure and Reform which examines the current framework in place for public expenditure planning and management and specifically addresses certain of these criticisms in the FAR.

The credibility of any medium term expenditure framework rests on how it balances the need to be firm and yet responsive. An overly mechanistic framework could be unresponsive to

needs, changing priorities or unexpected challenges, whereas an overly flexible system will be seen as a notional exercise rather than real expenditure control. In light of the very significant challenge involved in restoring Ireland's public finances to a sustainable footing, the scale of the fiscal consolidation required and the importance of maintaining political and public support for the objective of achieving stable public finances an excessively rigid adherence to the expenditure ceilings - which in any event were subject to a high degree of uncertainty - would have exacerbated the risk of failure.

The assessment in relation to revisions in the expenditure ceilings is based on an analysis of the changes in ceilings over the period since 2011. This, in fact, covers a period of significant expenditure consolidation where a certain degree of flexibility was required to meet deficit reduction targets while maintaining key services. Under the corrective arm of the Stability and Growth Pact to which Ireland has been subject up to the beginning of this year, the fiscal anchor has been the target for the headline General Government Deficit. The over-achievement of these targets has permitted revisions to Budget expenditure targets and expenditure ceilings.

Better than forecast economic and tax revenue growth and lower debt servicing costs allowed an easing of the consolidation burden while deficit targets were achieved. The ability to revise expenditure ceilings allowed Government to address social priorities and invest in infrastructure to support economic recovery during a period of significant and severe fiscal consolidation.

It is also important to note that the revision of the Government Expenditure Ceiling (GEC) by Government must be consistent with overall compliance with the SGP. Providing this is achieved, under the preventive arm of the SGP, changes in the GEC will be driven by changes in the amount that can be spent while still complying with requirements in relation to the MTO or the adjustment path towards the MTO. In practice changes in this can arise from changes in a broad number of projected / technical parameters.

The FAR notes that capital investment in the *SPU 2016* projections is projected to remain low by historical and international standards. The SES sets out that gross voted capital expenditure will grow from €4 billion in 2016 to €7.1 billion in 2021. This represents an annual average increase of 12½ per cent. In total, an additional cumulative €5.1 billion is to be

allocated to capital expenditure in the period to 2021 over and above the amount set out in the Public Capital Plan. As announced by the Minister for Public Expenditure and Reform, the mid-term review of the Capital Plan is being brought forward to early 2017.

As a final remark on the Council's assessment of compliance with the fiscal rules, I welcome the conclusion that the SPU forecasts indicate compliance with the debt rule on both a backward and forward looking basis.

Conclusion

I want to thank the Council for its continued input into the budgetary process in Ireland. The closure by the Council of the European Union of Ireland's excessive deficit procedure represents a further significant step in the process of returning to normality following our recent, challenging years. Ireland's public finances are now on a prudent and sustainable path. The Government's prudent budgetary management has laid the plans for our emerging recovery. Through a continuation of these policies which have served us well, we are well placed to achieve our medium term fiscal objective of 'balancing the books', in both structural and headline terms, by 2018.