An Roinn Airgeadais
Department of Finance

Oifig an Aire
Office of the Minister

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

22 July 2014

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's June 2014 Fiscal Assessment Report which was published on Tuesday the 17th of June last. I am pleased to see that the Report gained a great deal of media coverage which provided a timely and informative widening of the discussion of fiscal policy. I note this was also discussed by the Oireachtas Joint Committee on Finance and Public Expenditure and Reform, and I made mention of it during my recent appearance before this committee.

As with the previous Fiscal Assessment Report, I am responding to your latest report by way of direct communication to the Council, in order to ensure this is done in a considered yet timely manner. Accordingly, my detailed response is in the appendix attached to this letter. I presume that the Members of the Fiscal Advisory Council will have no objections to the publication of this letter and its appendix on the Department of Finance's website. I have no objection to the Council putting it on your website as well, should you wish to.

Yours sincerely,

Michael Noonan T.D.
Minister for Finance

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Appendix – Response of the Minister for Finance to the June 2014 Fiscal Assessment Report published by the Irish Fiscal Advisory Council

Before addressing the key points raised by the Council in each Chapter of the Fiscal Assessment Report (FAR), I welcome the Council's endorsement of the macroeconomic forecasts underpinning the Stability Programme update in April 2014 and the Council's assessment that:

- the fiscal stance adopted by the Government is conducive to prudent economic and budgetary management and that we are complying with the fiscal rules; and
- Ireland's fiscal projections are both appropriate and consistent with compliance with all national and European fiscal rules.

Chapter 1. Assessment of the Fiscal Stance

1. Chapter 1 provides an assessment of the fiscal stance. This includes an overview of the strategy to resolve the crisis, and developments within this strategy. The chapter also gives an overview of remaining risks, which are expanded on in later chapters, including the risks surrounding growth and the risks to the budgetary aggregates, such as knock-on risks from growth, expenditure pressures, balance sheet and interest rate risks.
2. I welcome the Council's inclusion of a section of their report on the value of an effective fiscal framework, which is of considerable assistance in providing a summary of the rationale for many changes made in recent times. I agree with the Council's three high-level arguments for a strong fiscal framework, namely: taming the boom-bust cycle; moving to safer levels of debt; and enhancing the credibility of Ireland's fiscal sustainability during the transition to those safer levels. With regard to the Council's consideration of Ireland's fiscal framework, I note that it sees value in the Irish fiscal framework, highlighting how the national and European frameworks complement and reinforce each other – the SGP provides monitoring, peer pressure and credibility whereas the national rules provide a degree of domestic oversight and ownership. Such a succinct summary is a welcome input to the debate, and useful to assist in improving public knowledge around the Irish fiscal framework.
3. The Council note the weakness of the harmonised EU methodology for estimating and measuring Ireland's structural budget balance in real time, and recommend that alternative measures of the potential output of the Irish economy and structural balance be developed. The Council note, however, that the application of the Stability and Growth Pact rules is based on the Commission's use of the harmonised EU methodology. My Department completely

agrees with the Council on this point – we are very aware of the inadequacies of the harmonised EU methodology when applied to the Irish economy. My Department regularly highlights this issue in discussions with the Commission, and fully engages in the working group tasked with examining the methodology underlying Commission calculations. The calculation of the structural budget balance is a very complex technical exercise, and forecasting it for several years ahead is even more difficult. It is further complicated by the requirement for all member states to use the harmonised EU methodology. The Council quite rightly takes issue with some of the EU rules around the calculation the structural budget balance.

4. The Council also comment on the Government's fiscal stance and welcome its clear intention to meet the requirements under the EDP and subsequently to follow the adjustment path requirements of the preventive arm of the SGP and the national Budgetary rule. This includes the Council's recommendation that the previously -announced measures of €2 billion be implemented in Budget 2015. However, when commenting on the adjustment path to the MTO, the Council caution against an overly-ambitious adjustment path which is tighter than the minimum requirements. I will address these points later.

Chapter 2. Assessment and Endorsement of Macroeconomic forecasts

5. Chapter 2 sets out the macroeconomic forecast underpinning the SPU. This was produced by the Department of Finance and endorsed by the IFAC in advance in early April. The chapter sets out that the forecast was *'within an endorseable range'*. The FAR says that the medium-term forecasts (2016-18) are *'relatively optimistic'* but notes the considerable difficulty of taking a view on this given the openness of the Irish economy and the uncertainties associated with the underlying potential growth rate.
6. The Report recommends a number of changes to how the forecast process is carried out which I will refer to in turn:
    a. My Department will note the Council's point about the consistency of annual forecasts with the latest quarterly outturn, recalling that Irish quarterly estimates are volatile and prone to revision. During the forecast process my staff will set out in detail the assumptions around the quarterly and annual estimates and, where relevant, highlight them in text accompanying Budget or SPU.
    b. While recognising the need to follow the harmonised EU methodology where appropriate, my Department continually strives to use the most appropriate modelling techniques as part of its forecasting methodology and will note the Council's advice in this regard.

c. Finally, a statement on the overall balance of risks can be provided in future. By way of background, my Department intends to improve the comprehensiveness of the statement of risk in the upcoming Budget, which should address some of the concerns of the Council.

Chapter 3. Assessment of Budgetary Forecasts

7. I welcome the fact that the Fiscal Council have assessed the budgetary projections in the Stability Programme Update (SPU) as appropriate. The Council also state that the 2014 deficit target will likely be met with a margin. My Department estimates a General Government deficit of 4.8 per cent of GDP is on track to be achieved this year.
8. The Council forecast that a €2 billion package of tax and expenditure measures in the forthcoming Budget should see the deficit fall just below 3 per cent of GDP in 2015, in line with our Excessive Deficit Procedure (EDP) commitments. This is in line with the Department's forecasts in the SPU. As is the usual practice, decisions on the required level of consolidation to comply with our obligations will be taken in the Budget 2015 process taking account of the macroeconomic and fiscal performance during 2014, the forecasts for 2015 and subsequent years and the advice received from bodies such as the IFAC, the European Council and the European Commission.
9. While the budgetary projections in the Stability Programme Update 2014 are assessed to be appropriate, the Council state that a number of risks remain including uncertainties surrounding growth prospects and significant challenges on the expenditure side. Indeed, the report suggests that there is a 1-in-2 probability that the deficit target of less than 3 per cent of GDP will not be reached – dependent on the expected economic growth materialising. Similarly, the report estimates a 1-in-3 probability that the debt to GDP ratio will have failed to stabilise by end-2015. I would assure the Council that my Department takes these risks very seriously, and are monitoring them closely.
10. With regard to the comments on expenditure, including the expenditure challenges arising from demographic pressures, a Comprehensive Review of Expenditure (CRE) is currently underway led by the Department of Public Expenditure and Reform. The CRE involves all Ministers and their Departments in examining and proposing measures that will contribute to the overall expenditure targets set by Government for each of the next three years. This detailed analysis is necessary to allow Government to consider and decide on policy and expenditure options, taking account of policy and service priorities and other emerging demographic pressures over the next few years. The new Public Service Reform Plan that was

published in January 2014 includes more than 200 actions, with clear time lines for delivery. The implementation of this Plan can facilitate the ongoing delivery of services within the overall expenditure constraints.

11. Priority given to expenditure control by Ministers and their Departments is evidenced by the reduction in gross voted expenditure from its peak of €63.1 billion in 2009 to an estimated €53.0 billion in 2014. This reduction has been delivered through the efforts of all Departments and their agencies to seek savings, pursue efficiencies, and manage within constrained budgets, often while meeting increasing demands for the public services they deliver. The Department of Public Expenditure and Reform has introduced measures to help ensure that expenditure targets continue to be met and that public expenditure remains sustainable. The Medium Term Expenditure Framework, with three-year ceilings for Ministerial Vote Groups, has been placed on a statutory footing with the enactment of the Ministers and Secretaries (Amendment) Act 2013. The efforts made by Ministers and Departments to ensure adherence to allocations, along with the regular monitoring and reporting to Government, have ensured that the required fiscal targets have been consistently achieved.
12. Finally, the Council acknowledges that the task of projecting interest payments has been made more difficult in recent years owing to the substantial changes in the debt profile. In that regard, the NTMA have said that estimates of interest expenditure must therefore be prudent and provide for a greater deal of uncertainty. The NTMA have also commented that , as regards interest expenditure savings in 2013 specifically, it must be acknowledged that a significant element of the *"saving"* compared to *"Budget"* stems from the replacement of the IBRC promissory note with a portfolio of long-term Government bonds in February 2013. Accrued promissory note interest of some €1.9 billion was to impact the General Government deficit in 2013 but, following the February 2013 transaction, the impact of interest on the deficit was significantly reduced (by the order of approximately €1 billion) thus contributing a large part of the saving. Furthermore the impact of the downward trend in interest rates generally is an important factor in interest expenditure being lower than estimated.
13. My Department notes the Council's comments on the lack of information on non-tax revenue forecasts. They suggest it would be beneficial if more information was provided on the underlying assumptions behind forecasts of these aggregates. My Department will take this advice on board for future fiscal forecasts.

Chapter 4. Assessment of Compliance with Fiscal Rules

14. Chapter 4 provides an assessment of compliance with fiscal rules. The Council note that the SPU projections show compliance with the budgetary rule, the expenditure benchmark and the debt rule. As mentioned before, the Council suggest that the adjustment path to the MTO is tighter than the minimum required, and that this may present some risk. Officials from my Department met with the Council secretariat recently to clarify the position, but I will set it out here for clarity.
15. Like all other member states, Ireland is obliged to adhere to the EU fiscal rules. The objectives of these rules are to prevent the extreme crisis that we have experienced from reoccurring.
16. One of these rules is the obligation to reach a structurally balanced budget. The rules specify the need to make sufficient progress towards the medium term objective (MTO) of a balanced budget after taking into account the impact of the economic cycle (i.e. in structural terms). In particular, the preventive arm sets out the requirement for an annual correction in the level of the structural balance (an improvement of 0.5 per cent per annum as a benchmark), without specifying when this position should be achieved.
17. Ultimately, to reach structural budget balance, on the basis of current SPU estimates this requires structural improvement of a further 2.8pp post-2015. However, this does not necessarily imply further consolidation or tightening in fiscal stance. A reduction in the rate of structural employment will, for example, deliver ongoing structural budgetary improvements.
18. The Council states that the Government's recently published fiscal adjustment plans for 2016-2018 appear to go beyond the minimum requirements of the new fiscal framework and is ambitious. They suggest that a clear rationale should be provided for this deadline and that there is a case for a less ambitious medium-term fiscal stance that more closely follows the minimum requirements implied in EU fiscal rules.
19. The Treaty on Stability, Coordination and Governance in the EMU (sometimes referred to as the 'fiscal compact') mandated the European Commission with producing an actual timetable for participating Member States to achieve their MTOs. Last summer, the Commission outlined that Ireland should achieve its MTO by 2018. On this basis, the April 2014 Stability Programme Update set out a path for achieving a balanced budget by 2018.
20. Following discussions on the necessary consistency between the fiscal compact and the Stability and Growth Pact (SGP), and as part of a discussion on the 2014 Country Specific Recommendations, the European Commission has clarified that the deadline for MTO achievement is not fixed but the required annual improvement in the structural balance is. Consistent with SGP rules, Member States not at their MTOs must improve their structural balance by at least 0.5 per cent of GDP per annum.

21. In summary, last year the requirements of the fiscal compact set out a deadline for MTO achievement, whereas from this year onwards, the focus will be on the required fiscal effort. Therefore, following the formal adoption of the 2014 CSRs, we no longer need to reach a balanced budget by 2018; instead, we will have to deliver the required annual improvement in the structural balance, as the Council suggested.
22. As is normal after all Council publications, my Department will closely analyse their comments and discuss the details of their report with them as necessary.

Analytical notes

23. Finally, the Council have produced some analytical notes in this Fiscal Assessment Report, which provide additional detailed commentary on specific areas related to the Assessment Report. These include notes on house price risks, potential output estimation, tax forecasting error decomposition, DIRT forecast methodology and future implications of the debt rule.