Appendix

Response of the Minister for Finance to the June 2017 Fiscal Assessment Report

Introduction

At the outset, let me say that I welcome the publication by the Irish Fiscal Advisory Council (the Council) of the June 2017 *Fiscal Assessment Report* (FAR). I note the acknowledgement by the Council that successive governments have achieved considerable success in stabilising the public finances.

As highlighted in the recently published *Summer Economic Statement (SES)*, ensuring sound and sustainable public finances is a key pillar of the Government's strategy for balanced economic growth over the medium term. In this regard, the Government will continue to implement sensible budgetary policies that are both compliant with our legal obligations as well as supportive of sustainable economic growth.

I note the Council's view regarding the economic outlook and the risks – upside and downside – facing the Irish economy. I broadly share these views and I would point out that these have been highlighted by my Department in the 'risk-assessment matrix' that forms an integral part of the *Stability Programme Update* (SPU). A key challenge for the Government will be to minimise the adverse impacts of shocks if and when they occur, and a crucial part of the mitigation strategy is to ensure that budgetary policy can support demand – including through the operation of the automatic stabilisers – in the event of a cyclical downturn. This is one of the reasons why the Government places a premium on debt reduction.

In this regard, I also note the Council's assertion that *"the fiscal rules present a reasonable framework under which policy could be navigated prudently in future years*". My own view is that a rules-based framework is crucial within a monetary union with a centralised monetary policy and decentralised budgetary policies. The Stability and Growth Pact (SGP) provides the appropriate framework to ensure budgetary discipline while at the same time providing sufficient flexibility for budgetary policy to support economic growth.

Having said that, I would stress that, irrespective of the fiscal rules, the Government is determined to implement sensible budgetary policies, to balance the books, to reduce public indebtedness and to re-build fiscal buffers to reduce the vulnerability of the economy.

In summary, the Government is committed to implementing sensible budgetary policies that ensure the public finances remain on a sustainable path and are supportive of continued economic growth over the medium term. So I am in broad agreement with the thrust of the FAR, although I would like to take this opportunity to respond to a number of specific issues raised.

Chapter 1 – Assessment of the Fiscal Stance

In relation to the fiscal stance, I note the Council's view that "*compliance with the letter and spirit of the domestic and EU fiscal rules for 2016 and 2017 has been insufficient*". However, my Department's analysis points to broadly compliant on the basis of both pillars of the preventive arm of the SGP.

It is also important to note that my Department projects broad compliance with the balanced budget pillar for this year. Furthermore, we are on track to achieve a balanced budget in structural terms next year. This implies that the fiscal stance being adopted is a prudent one.

Furthermore, an assessment of the fiscal stance must take into account all relevant factors. For instance, I would also highlight the establishment of a rainy day fund as set out in the recently published SES. Once the MTO has been achieved, annual transfers of €500 million will be made from the Exchequer to this fund. The establishment of this instrument will ensure that we have a prudent counter-cyclical buffer in place so that we can better absorb shocks. In tandem with this policy decision, the Government will be reassessing the way in which the Irish Strategic Investment Fund could potentially complement the role of the rainy day fund.

In addition, the Government is acutely aware that public debt remains high. While the debt-to-GDP ratio has fallen as a result of the increase in GDP, the stock of outstanding debt remains high, a point highlighted by my Department in its first *Annual Report on Public Debt in Ireland*, published in June. This analysis will be updated annually.

The recent publication by the Central Statistics Office (CSO) of a modified measure of Gross National Income (GNI*) is important in this regard. This is a superior metric for assessing fiscal variables, and shows that general government debt as a percentage of GNI* remains elevated at 106 per cent. My Department will place an emphasis on this measure of debt in future publications.

In Budget 2017, a 45 per cent of GDP target was adopted for our debt-to-GDP ratio. Following an opportunity to take stock of policy priorities, it has been decided to amend this target to 55 per cent of GDP. The extra flexibility this entails will be directed at boosting potential output by increasing capital expenditure in order to address emerging and identifiable bottlenecks in a targeted manner. This is a prudent approach which does not jeopardise the Government's key fiscal target of achieving a balanced budget; additional capital expenditure will, of course, be contingent upon the capacity of the economy to absorb the additional funding. Once major capital projects have been completed, the Government will target a further reduction in the debt ratio to 45 per cent of GDP.

Finally, I want to highlight that the €3.4 billion generated from the recent sale of the State's stake in AIB is being directed towards reducing debt, highlighting in concrete terms, the Government's determination to reduce public indebtedness. This helps to address both the current and future debt servicing burden and I should also acknowledge that this is part of meeting our ongoing EU obligations to reduce our debt-to-GDP ratio.

In summary, therefore, I view the stance of budgetary policy as being in compliance with the fiscal rules as well as being appropriate at this stage in the economic cycle. I have highlighted on a number of occasions that, while not yet overheating, if economic growth continues at the current pace imbalances could become more acute. I want to stress that the Government is acutely aware of this and pro-cyclical budgetary policies will be avoided.

Chapter 2 – Endorsement and Assessment of the Macroeconomic Forecasts

I welcome the Council's endorsement of the macroeconomic forecasts underpinning the 2017 SPU and also the Council's acknowledgement that there has been an improvement in the medium term macroeconomic forecasts which are now published on an *ex post* basis, i.e. incorporating the fiscal outlook as set out in Budget 2017.

While I note the widely acknowledged limitations of the harmonised methodology in estimating potential output for Ireland, as outlined on many occasions by my Department, I would highlight that assessment of compliance with the legally binding fiscal rules is made on the basis of the harmonised methodology. Having said that, it is important to expand the toolkit for assessing the cyclical position of the economy.

Chapter 3 – Assessment of Budgetary Forecasts

Turing to the budgetary projections in the SPU, the tax revenue shortfall against profile has been reduced from 2.4 per cent (€282 million) at the end of the first quarter to 0.5 per cent (€110 million) at the end of the second quarter. In year-on-year terms, tax revenue performance has been solid, with receipts up 4.0 per cent or €892 million in the first half of the year. This ensures a solid base going into the second half of the year and at this juncture provides a reasonable level of confidence that the overall tax revenue target of €50.6 billion can be achieved.

I note the Council's concerns around the volatility of Corporation Tax receipts. As a country that has been consistently successful in attracting leading multi-nationals to locate here and given Ireland's high level of integration with the global economy, it is not surprising that our corporation tax base has become concentrated (with approximately 80 per cent of receipts received from the multinational sector). This concentration has been acknowledged as a fiscal risk by my Department on several occasions, including in the recently-published SPU.

While Corporation Taxes are now expected to account for around just 15½ per cent of all Exchequer tax revenues, this is within the previous pre-crisis range from such receipts. It is important, however, to point out that the key Income Tax and VAT headings still account for around two-thirds of the overall tax yield. In addition, it should also be noted that the share of corporation tax receipts provided by the "Top 10" tax paying companies has eased from 41 per cent in 2015 to 37 per cent in 2016, which is suggestive of widening profitability in other companies.

Turning to the spending side, the Council notes that a policy of "*in-year gross voted spending increases of €1 billion in 2016 and €0.7 billion in 2015, compared to budget-time projections... is especially risky when the source of the additional revenue is, to a large extent, Corporation Tax*". It should be noted, however, that expenditure grew by less than 3 per cent. This represents prudent fiscal management when viewed in the context of tax growth of 10 per cent in the same year. Furthermore, this increase took place following a period of significant expenditure consolidation and allowed for allocations to improve public services and support economic growth.

Chapter 4 – Assessment of Compliance with Fiscal Rules

In terms of compliance with the fiscal rules, the SPU sets out my Department's assessment of compliance with the two pillars of the preventive arm of the SGP. In relation to the structural balance, an improvement of 0.5 percentage points (pp) was recorded last year, which is considered to be broadly compliant. My Department's analysis also suggests compliance with the expenditure benchmark last year. In its *ex post* assessment of 2016, the European Commission found that Ireland's structural balance improved by 0.3 pp. Whilst below the recommended structural adjustment of 0.6 pp, it is not a significant deviation. While the Commission estimates that Ireland's spending breached the expenditure benchmark by 0.5 per cent of GDP last year, this is based only on a retrospective application of a technical change agreed in late-2016, an approach which I disagree with. My Department also assesses the public finances to be broadly in compliance with the fiscal rules for this year.

Finally, as I've outlined earlier, we are on-track to achieve a balanced budget in structural terms – the MTO – next year which has been the anchor for budgetary policy since exiting the excessive deficit in 2015. Achievement of the MTO represents an important milestone in ensuring the sustainability of the public finances.

I note also the Council's concern that details of one-off expenditure and revenue measures are omitted from the report. It should be noted that this information is publicly available and was provided to the Council as requested. Furthermore, my Department always complies with EU requirements in its publication of data in this regard. Equally, it is important to ensure that the balance is struck between providing comprehensive data whilst also ensuring that the information is accessible and usable. As always, my officials are available and willing to provide any further details which may be sought.

Conclusion

In conclusion, I would like to acknowledge the work done by the Council which is now an important part of Ireland's fiscal architecture.

Looking ahead, I would like to re-state my commitment, and that of the Government, to ensuring a sensible approach to the management of the public finances. Given the uncertain increasingly environment in which we operate, it is important that we achieve a balanced budget next year and continue to reduce public indebtedness.