



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

9 January 2015

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's November 2014 Fiscal Assessment Report (FAR) which was published on Tuesday the 15<sup>th</sup> of November last. I note that this report was subsequently discussed by the Joint Oireachtas Committee on Finance, Public Expenditure & Reform.

As with the previous Fiscal Assessment Report, I am responding by way of direct communication and my detailed response is in the appendix 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 publishing it on your website as well, should you wish to.

Yours sincerely,

Michael Noonan T.D.

Minister for Finance

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

Introduction

I welcome the Council's endorsement of the macroeconomic forecasts underpinning the Budget 2015 and the Council's assessment that "the fiscal stance adopted by the Government for 2015 is conducive to prudent economic and budgetary management."

I have structured my response to address the key points made in each of the chapters of the Fiscal Assessment Report (FAR).

Chapter 1. Assessment of the Fiscal Stance

Your acknowledgement that Ireland is likely to record a deficit for 2015 of less than the 3% of GDP ceiling is welcome, as is your conclusion that the fiscal stance is conducive to prudent economic and budgetary management.

The Council's acknowledgement of the benefits to fiscal sustainability of consolidation measures introduced to date is welcomed. The report also mentions some of the items, such as the potential negative impact on growth of consolidation, that need to be taken into account when considering the appropriate fiscal stance. I take note of the Council's view that Budget 2015 represented a 'missed opportunity' to frame fiscal policy in a way which would have accelerated the reduction of the deficit as well as debt levels.

However, I do not agree with the Council's position and I believe the fiscal stance adopted in the Budget is appropriate for Ireland at this point of the economic cycle. By targeting a general government deficit of 2.7% in 2015, lower than the requirements under the Stability and Growth Pact, the Government has sought to secure the recovery by providing a prudent buffer in the event of unanticipated developments and position the public finances on a steady downward path. The fiscal stance adopted also allowed for the introduction of a range of targeted initiatives on the tax and expenditure side to build consumer confidence, support job creation and to broaden and deepen the economic recovery that we are now experiencing.

I would like to reference the end-2014 deficit outturn. In Budget 2014, a deficit of 4.8% was targeted, providing a prudent buffer to the EDP limit of 5.1% of GDP. On the basis of end-year Exchequer data, it is expected that the general government deficit will be significantly below the original target and once again well within the EDP limit of 5.1% of GDP. Looking to 2015, the impressive performance of tax in 2014, with year-on-year growth of 9.2%, provides a degree of comfort that the tax forecast is achievable.

My response to your comments in Chapter 1 of the FAR regarding post-2015 tax and expenditure profiles is included in my response to Chapter 3 below.

#### Chapter 2. Assessment of Macroeconomic Forecasts

I note the Council's comprehensive text on the forecast endorsement process which concludes that the Department of Finance macroeconomic forecasts were within an endorsable range. The Council's analytical work on recent economic developments is also helpful.

I note the Council's views on the detail provided to underpin the reconciliation between the endorsed and final forecasts. It should be recalled that the Memorandum of Understanding (MoU) on forecast endorsement agreed between my Department and the Council contains an agreed protocol in this regard. The supply of information by my Department has adhered to this agreed protocol.

The FAR sets out the Council's views on suggested changes to the MoU on forecast endorsement. These will be taken into consideration in discussions on amending the MoU on forecasting in early 2015.

I appreciate the Council's focus on the issue of contract manufacturing and for bringing this issue to greater public prominence via the FAR. As the Council will be aware, as soon as this phenomenon became apparent in September's GDP numbers both the Department and the Council secretariat worked to reach a mutual understanding of the topic as this would be key to the forecast endorsement process. In terms of outputs, the Department drafted a box on contracted production at the request of the Council. This was included with the Budget's

Economic Review and Outlook. Specifically, the potential for the impact of contracted production to unwind or accelerate over the short term was highlighted.

More broadly, my officials are conscious of the impact of the presence of the multinational sector on Irish national accounts aggregates and how this complicates the forecasting process. Gaining a better understanding has been a central part of the Department's analytical focus over the last number of years.

On the supply side, the Council suggests that the outlook for potential growth has improved by more than appears warranted given a relatively unchanged medium term outlook for aggregate demand. It is stated that 'in contrast to [stronger] potential GDP forecasts, real GDP forecasts for the medium-term are essentially unchanged'. My Department's estimates of supply-side potential are mechanical calculations based on the required harmonised methodology and use Budget 2015 demand-side estimates out to 2018. In this regard both the supply and demand side outlook are entirely consistent. The slight upward revision in potential output over the medium term (relative to estimates made at the time of the 2014 SPU) is due to a number of technical factors which increase contribution from each of labour, capital and total factor productivity.

The FAR calls for a more substantive discussion of external risks in the Budget. In line with recommendations made by the Fiscal Transparency Assessment Report, my Department has improved its reporting of risk analysis, both directly in the Budget documentation and also in terms of its contribution to the over-arching National Risk Assessment document published this year. Whilst external risks are closely monitored by my officials, given the sensitive and often self-fulfilling nature of annotating such risks, the existing high-level approach taken in these documents is considered sufficient, and is in line with the approach used by other forecasting institutions (IMF, European Commission, OECD).

### Chapter 3. Assessment of the Budgetary Forecasts

I note the Council's view that the over-performance of revenues in 2014 is due primarily to an improvement in the underlying performance of economic activity and not to one-off or temporary factors. The forecasts underpinning Budget 2015 assume a continuation of this improvement into next year.

With regard to your assertion that the post-2015 revenue forecasts do not reflect the Government's intention to reduce the tax burden in coming years, I would strongly make the point that our approach is correct. We consider that Budgetary arithmetic can only reflect existing legislative provisions and specific policy announcements that are going to be legislated for in the coming year. Budget forecasts cannot be based on general policy intentions, such as that to reduce the level of income tax in the future. Specific policy decisions will be taken on an annual basis taking account of the economic and fiscal situation prevailing at the time and of the available fiscal space that is compatible with continued compliance with rules set out in our fiscal framework. Once specific decisions have been taken to be included in proposed legislation, then forecasts for future years can take account of them.

The FAR notes that the expenditure profile in Budget 2015 was based on holding Voted Expenditure constant. However, I would point out that the relevant section in Budget 2015 explained that a technical assumption was made to hold the expenditure profile constant because there remain a number of outstanding issues around the interpretation and implementation of the fiscal rules and I will revert to these points in the next section.

I welcome the detailed analysis on the tax forecasts in respect of the 'big four' taxheads. Analysis of the applicability and accuracy of the tax elasticities is undertaken regularly in my Department and any efforts which help to explain where variances arise are to be welcomed.

With regard to the accuracy of the non-tax revenue forecasts, I would point out that my Department are the recipients rather than producers of such estimates. For example, the Central Bank provides the estimate of Central Bank surplus to be remitted to the Exchequer in the coming Budget year. This is based on the Central Bank surplus income in the current year, as forecast by around the end of September.

As referenced in the FAR, my Department excluded the portion of the Central Bank surplus that relates to the capital gains from the Promissory Note transaction from the 2015 deficit calculations. So while this excluded portion does not improve the general government deficit, I think it is important to emphasise that there are benefits for the public finances more generally. The Exchequer Borrowing Requirement is lowered which, all other things being equal, means that the debt is reduced by €0.35bn in 2014. While the statistical treatment of

these profits is not definitive at this point, it is the most prudent approach to take on this issue at the moment. The statistical treatment will be clarified in advance of the Stability Programme Update in April.

The Report states that without the impact of the ESA 2010 statistical changes, the deficit ceiling for 2015 would have been exceeded. I would point out that the Government is committed to achieving the fiscal targets and exiting the excessive deficit on schedule. This has been the overarching goal of fiscal policy over the last number of years. Decisions on the measures introduced in Budget 2015 were made in light of the full range of data available, including the impact of the statistical changes.

I agree with the Council's opinion that balance sheet risks have diminished considerably over the last number of years. In this regard, the success of NAMA in repaying senior debt owing to the State should be noted. Indeed, in early December, NAMA redeemed a further €1bn of senior debt.

With regard to the treatment of water charges, savings to the Exchequer should accrue over the longer term. In the more immediate future, the increased investment by Irish Water in terms of installation of water meters and infrastructure will mean that expenditure will exceed revenue for the coming years. The gap between the two will be made up of equity and borrowings. While formulation of the recently announced structure and charging system of Irish Water took account of the requirements of the Market Corporation Test, the decision regarding whether it is on balance-sheet or not remains with the CSO in the context of the EDP Returns due to be made at the end of March 2015. Eurostat is also likely to review the matter.

#### Chapter 4: Assessment of compliance with Fiscal Rules

With regard to the Expenditure Benchmark, notwithstanding the specific issues that Ireland has sought clarification and discussion on from the European Commission regarding application of the methodology, I am of the view that this will be a key tool in underpinning the long term sustainability of the public finances. In this regard, I welcome the Council's statement that the European and domestic budgetary framework can play a vital role in

ensuring the sustainability of the public finances over the medium term. I also agree that there needs to be a greater awareness of the implications of the fiscal rules on budgetary policy and I will endeavour to help with this.

I note that the Council estimate that Ireland would have breached the expenditure benchmark in 2015. I would stress again that this is a notional ceiling as Ireland is not subject to the preventive arm of the Stability and Growth Pact until 2016. This knowledge was central to the drafting of Budget 2015.

As the Council mentions, the reference rate, based on potential growth rates, will not be provided by the Commission until late 2015 at the earliest. On the basis of the most recent estimates provided by the Commission, my Department estimate the reference rate will be 1.6% for the 2017-2019 period. However, it should be noted that the 2014 to 2016 reference rates were issued in March 2013. Were the same timing to apply to the 2017 to 2019 iteration, then it would be early 2016 before the reference rate was available. Irrespective of when the reference rate is determined the value of the reference rate is likely to change from the indicative 1.6 % figure.

The likely convergence margin for 2017 to 2019, which will be issued with the reference rate and must be applied until the MTO has been achieved, is also uncertain at this point. Aside from the impact of any decision on the minimum required annual improvement in the structural balance, referred to below, there is uncertainty as to the precise reference year(s) that will be used in the calculation. This too will have a bearing on permitted spending parameters.

Furthermore, as you are aware, the GDP deflator that is used in the expenditure benchmark calculation is generated by the European Commission. As their forecasts only go to 2016 at this point and apply a linear path back towards a GDP deflator of 2% by 2019 (a technical assumption), further uncertainties remain around these estimates,

It was in light of these numerous uncertainties, which are largely acknowledged in the text of the FAR, that the decision was taken to use a technical assumption that Voted Expenditure would remain flat in the coming years.

However, I agree with your overall conclusion that there is limited room for manoeuvre if the Budgetary Rule and the Expenditure Benchmark are to be respected. I am aware of the implications of the Expenditure Benchmark for the public finances and the limitations it puts on expenditure growth. Adherence to fiscal rules will be the defining anchor for budgetary policy in the coming years.

As referenced in previous correspondence, the deadline for achieving Ireland's Medium Term Budgetary Objective (MTO) of a balanced budget in structural terms is no longer 2018. What is important is the required annual improvement in the structural adjustment. Nonetheless, the FAR states that "it appears that this target remains" and goes on to conclude that requires a large structural cumulative adjustment of over 2½% of GDP between 2016 and 2018. Budget 2015 indicates a position of structural balance is reached in 2018. Rather than a target, it reflects a function of technical factors. These principally relate to the path of the output gap under the harmonised methodology and technical estimates of the profile for headline budget balance, rather than a specified path of further structural reform effort.

As Ireland is not at its MTO, an improvement of at least 0.5% of GDP in the structural balance per annum is required. The Fiscal Council should note that clarification has been sought and discussions are ongoing with the European Commission on rounding as to what exact quantum this implies. I will update the Fiscal Council once clarity around this issue is available.

Finally, reference is made on page 59 to 'accounting stratagems' around the measuring of temporary measures for the purposes of structural deficit estimates. We agree strongly on the need for greater transparency and clarity on the part of both the Commission and Department on what constitutes a temporary measure for the purposes of estimating the structural budgetary position. My officials are actively engaging with counterparts in the Commission to ensure consistency of approach on this matter.