



16 December 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 November 2016 *Fiscal Assessment Report* which was published on 30<sup>th</sup> November.

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 November 2016 *Fiscal Assessment Report***

### **Introduction**

At the outset, I welcome the Council's endorsement of the macroeconomic forecasts to 2017 and note the forecasts beyond 2017 are considered to fall within a "plausible range". I note that the Council concurs with my Department's assessment that the economy remains susceptible to domestic and international risks, as highlighted in Budget 2017. It is against this backdrop that the Government has reiterated its commitment to continue with the prudent fiscal policies it has successfully pursued over the past number of years. In practical terms this means that based on current assumptions the budget will be balanced in 2018.

The Fiscal Assessment Report (FAR) states the Council's view that there is evidence of only a marginal improvement in the public finances in 2016 and the forecasts do not fully comply with the rules pertaining under the Preventive Arm of the Stability and Growth Pact (SGP). It specifically indicates that excluding the technical one-off AIB transaction in 2015, the Expenditure Benchmark would not be complied with. Whilst noting the Council's opinion, I would highlight that the European Commission, which has overall responsibility for assessing compliance with the fiscal rules, in its recent assessment found Ireland complies with the expenditure benchmark in 2016 on an *ex-ante* basis.

In this regard, I welcome a key observation in the Report, that the Government's projected fiscal stance from 2017 onwards and its intention to comply with the EU fiscal rules is seen as consistent with the deficit and debt remaining on a downward path. I would also share the Council's assessment that provided the economy is growing at a sustainable pace, the use of available fiscal space as envisaged in the current forecasts would be consistent with prudent fiscal policy. In this regard, the Government's plan to establish the Rainy Day Fund in the year after achievement of the Medium Term Budgetary Objective will assist with this.

I note the Council's opinion that the combined package of measures announced by Government in 2016 / 2017 has gone beyond what is considered as prudent. As I have commented previously, in the context of a small open economy such as Ireland's, it can be

difficult to assess the suitability of the fiscal stance. Spare capacity still remains within the economy with unemployment still above equilibrium levels. Whilst endeavouring to provide targeted expenditure increases for public service improvements, Government remains committed to the implementation of prudent fiscal policies. In addition, capital investment in key physical and social infrastructure can help support growth and continued job creation.

I welcome the Council's acknowledgement that there has been an improvement in the medium term budgetary forecasts published by my Department. The *ex-post* budgetary projections represent a new innovation, which illustrate the utilisation of the estimated fiscal space over the medium term. This will serve to enhance the quality of future analysis and discussion around the budgetary framework.

Turning to expenditure issues, the Council's assessment of revisions to expenditure ceilings is based on an analysis of a period where the main focus of fiscal policy was meeting requirements under the Excessive Deficit Procedure (EDP). The over-achievement of these targets permitted revisions to Budget expenditure targets and expenditure ceilings, which allowed for key services to be maintained to the greatest extent possible.

This year represented an important shift in the context of fiscal policy, with Ireland successfully exiting the Excessive Deficit Procedure and moving into the 'Preventive Arm' of the Stability and Growth Pact. These rules play a key role in the domestic fiscal framework and are a key consideration in budgetary decision making. As set out in the Draft Budgetary Plan, the Expenditure Benchmark is met over 2016 and 2017, net of the higher EU budget contribution in 2017 which is driven by statistical revisions to Ireland's growth outturn for 2015. Budget 2017 targeted a structural effort of 0.8pp of GDP in 2017, with achievement of the MTO expected in 2018. While there are risks, expenditure will be managed in line with the requirements under the Stability and Growth Pact. It is also important to emphasise that the expenditure allocations for these years were also formulated with the objective of sharing the gains of the recovery with all members of society while reaching broad consensus on key social and economic priorities.

Looking ahead to 2018 and 2019, my colleague the Minister for Public Expenditure and Reform announced a spending review on Budget day to take place in advance of *Budget 2018*. Spending reviews previously played an important role in our efforts to reverse unsustainable expenditure growth. The purpose of future reviews will be to ensure that all expenditure is examined when Government is deciding on its spending priorities. Better information and stronger evaluations should also guide and inform those decisions. As we move to a different fiscal, economic and political context, we must reflect on the design of budgetary reforms introduced over the crisis period. As such, the Department of Public Expenditure and Reform will - in parallel to the spending review process - review options to reinforcing the role of three-year expenditure ceilings in restoring stability to Ireland's public finances and for sustaining this stability over the medium-term period. This is particularly relevant in light of the increased uncertainty that can impact on estimates of the structural balance and the risks faced by the Irish economy in the wake UK decision on EU membership and more general geo-political and economic uncertainty.

I concur with the Council's view that full implementation of the revised budgetary framework and reducing Ireland's debt levels should remain priorities. The Government's adoption of a 45 per cent of GDP debt ratio target demonstrates our commitment in this area. Considerable reforms have been implemented to Ireland's budgetary framework in recent years.

For the remainder of my response I would like to set out my views where they might differ from those of the Council. These are structured in such a way as to address the issues contained in each chapter of the FAR.

## Chapter 1 – Assessment of the Fiscal Stance

In respect of its assessment of the economy, the FAR notes that distortions in the Irish National Accounts data make the assessment of headline and cyclical growth patterns more difficult and agree alternative indicators, such as employment and domestic demand, may provide a more reliable view of the underlying economic performance. This is reflected in the Economic and Fiscal Outlook published by my Department with *Budget 2017*. The FAR's identification of particular risks arising from impact of the UK vote to leave the EU and the consequent weakening of sterling reflect risks identified in the Economic and Fiscal Outlook.

The Council notes the important consideration that the public finances and debt sustainability play in determining the appropriate fiscal stance. I welcome the acknowledgement in the FAR that Ireland's debt position has improved, although risks remain elevated. Our debt-to-GDP ratio has improved by about a third from about 120 per cent in 2013 to an expected 76 per cent this year which, in turn, is some 15 percentage points below the euro area average.

Having said that, I share the Council's assessment that distortionary issues with Ireland's GDP render an over-reliance on the debt-to-GDP metric as inappropriate. Indeed, the Economic and Fiscal Outlook includes alternative debt metrics (interest to revenue and debt to revenue ratios) that illustrate a more objective assessment of our debt position. With this in mind, I recently announced a new target of 45 per cent of GDP to be achieved in the mid to late 2020s. This over-achievement of the 60 per cent Stability and Growth Pact target means we are providing a fiscal shock absorption capacity against unforeseen shocks. Furthermore, this target prudently does not factor in the proceeds from the sale of banking assets, which will be used to lower our outstanding debt even more.

Notwithstanding the reservations expressed by the Council about Ireland's projected compliance with the fiscal rules in 2016 and 2017, the European Commission in its assessment of the 2017 Draft Budgetary Plan, based upon its own forecasts, stated it to be "broadly compliant" with the provisions of the Stability and Growth Pact. This is the same conclusion as last year. Based on both the European Commission's and my Department's projections, we are on track to secure a balanced budget in structural terms by 2018, which now represents our fiscal anchor.

I note the Council maintains that the overall 2016-17 budgetary package goes beyond what is considered prudent. The Budget documentation outlines the basis on which the level of permissible fiscal space for 2017 increased beyond that signalled in the Summer Economic Statement (SES). Revisions by the CSO to the level of gross fixed capital formation, together with methodological revisions by the Revenue Commissioners affecting the cost of the full-year delivery of measures undertaken in *Budget 2016* meant that the level of fiscal space compliant with the expenditure benchmark in 2017 increased mechanically by some €200m. The overall strategy set out in *Budget 2017* is compliant with the benchmark over the period to 2021, and as a further buffer against adverse shocks, it provides for the resourcing of a Rainy Day (contingency) Fund from 2019 onwards to ensure a suitably prudent stance.

I welcome the view of the Council that progress has been made in the quality of my Department's published medium-term budgetary forecasts. I also note the Council's position that provided the economy continues to grow at a sustainable rate, the use of available fiscal space as envisaged in *Budget 2017* is consistent with prudent policy. It has been my long-stated position that the availability of fiscal space over the coming years will be contingent on potential growth. Indeed, this contingency is the very cornerstone on which EU and domestic rules are framed and applied in an Irish context.

I note the Council's view that a looser fiscal stance (even with the intention of promoting capital investment) would *not be warranted* given the cyclical position of the economy. However, this view seems to overlook the potential supply-side benefits of well-targeted, capital investment which enhances the overall productive capacity of the economy.

## Chapter 2 – Assessment and Endorsement of Macroeconomic Forecasts

I welcome the Council's endorsement of the Budget 2017 macroeconomic forecasts as being within a plausible range and also that the methodology conforms to good practice and the approach of other agencies. It must be recognised that these forecasts were prepared against the exceptional background of the 2015 National Accounts data – which posed challenges for all those dealing with economic analysis and forecasting. It is well recognised that the headline national accounts aggregate GDP and GNP have presented a misleading picture of Ireland's economic performance in 2015, and that these need to be supplemented by other indicators, notably personal consumption, employment and tax receipts. The Council's emphasis on this issue reflects the position set out by my Department in the Economic and Fiscal Outlook published with Budget 2017. On methodology, my Department is constantly reviewing its approach with a view to making continuous improvements. I should note in this context that my Department's forecasts are grounded on the annual national accounts data published by the CSO, while taking account of the information available, including from the quarterly data.

The focus on risks is appropriate in view of the heightened uncertainty in the international economic environment and from developments at home. This also reflects the concerns set out by my Department in the Economic and Fiscal Outlook, which noted that risks are firmly tilted to the downside. The Outlook also included an updated risk assessment matrix – which identifies similar issues to those raised by the Council and I have noted the Council's assessment of this matrix.

### Chapter 3- Assessment of Budgetary Forecasts

Turning to the assessment of the budgetary forecasts, the public finances continued to show clear signs of improvement during 2016. From a fiscal position, a concrete manifestation of the improving budgetary position was the formal abrogation by Council of the Excessive Deficit Procedure this summer, with the excessive deficit deemed to have being corrected in a durable manner. All the key public finance forecasts in Budget 2017 continue to move in the right direction with a balanced budget in 2018 better positioning us to deal with external shocks and challenges.

I acknowledge the Council's central point in relation to the Exchequer tax receipts that potential risks exist in relation to corporation tax. In Budget 2017, with specific respect to the fiscal forecasts, formal recognition is given to the potential concentration risks that exist in relation to this tax heading. While corporation tax receipts are expected to account for c. 16 per cent of the overall tax yield this year, my Department is of the view that this is within standard norms. In addition, I note the European Commission's most recent forecast has considered the growth in corporation tax receipts and states it to be a "level shift which is assumed not to revert over the forecast horizon". However, this is an issue that my Department will continue to monitor closely in conjunction with the Revenue Commissioners. Finally, I would point out my Department's corporation tax forecasts for 2017 and outer years are conservative and incorporate the most up-to-date company and sector specific data furnished to the Office of the Revenue Commissioners by client companies. Furthermore, compliance with the Expenditure Benchmark will minimise the possibility that spending is financed by one-off /temporary tax receipts.

Looking at the aggregate tax performance, based on the recent end-November Exchequer Returns, we are currently on track to achieve our Budget 2017 forecast of €48.1 billion in respect of 2016. The position at end-November was that approximately 93 per cent of our overall targeted tax receipts had been collected, which is very much in line with expectations.



## Chapter 4 – Assessment of Compliance with Fiscal Rules

This year, following the correction of the excessive deficit, our public finances are now subject to assessment under the preventive arm of the Stability and Growth Pact. I welcome the comprehensive work the Council has undertaken in relation to assessing Ireland's compliance with the EU fiscal rules. I fully concur with the Council's overall view that the focus should now be to prevent fiscal policy from entering unsustainable territory. This approach has been the hallmark of this Government's stewardship of the public finances.

In relation to 2016, the FAR indicates that on an *ex ante* basis it is expected the structural balance pillar is not met this year. While this outlook is reflected in both my Department's and European Commissions projections, it should be noted that this does not jeopardise our overall compliance with the EU budget rules. Furthermore, the forecast deviation on the structural balance for this year needs to be placed in context, with all the published assessments indicating that this breach is not classified as 'significant'.

The FAR points to compliance with the expenditure benchmark in 2016 as relying on a one-off financial transaction in 2015. However, it also observes that under this measure there is no provision to take account of spending related one-offs, with the result that compliance with the expenditure benchmark in 2016 is assured.

The Council takes issue with the fact that the pace of budgetary adjustment has softened considerably in 2016. However, I would caution that some 0.2 percentage points has been knocked off the pace of structural budgetary adjustment in 2016 on account of revisions to the output gap. As the Council is aware, the instability affecting these harmonised estimates is particularly elevated in the context of recent National Accounts revisions. The Council is strongly of the view that my Department's *ex-ante* macro-fiscal forecasts should show full compliance with the rules in all years. The Budget document makes clear, however, that the basis for the envisaged breach on the expenditure benchmark in 2017 relates solely to an upward revision to Ireland's EU budget contribution uniquely on account of the statistical revisions announced in the context of the July 2016 National Accounts. As a result, this higher

level of spending cannot be considered to add to the emergence of overheating within the economy.

I note the Council's acknowledgement of the substantial work undertaken by my Department to come forward with a range of plausible, technically robust alterations to address the issue which revisions to the National Accounts posed for the estimation of the cyclical position of the economy on which application of the fiscal rules hinges. My Department will continue its leading role in further developing both existing and alternative methodologies to measure the cyclical position of the Irish economy. I note that my Department's significant work in this respect was discussed with the Council and made public in the context of the recent endorsement exercise.

In terms of overall compliance with the rules, for this year the European Commission's own projections and separately those of my Department indicate that Ireland is comfortably in compliance with the expenditure benchmark. Accordingly, no compliance issues are anticipated in relation to the fiscal rules for this year when the overall assessment is applied by the European Commission. For 2017, both the Commission and Department forecast compliance as our structural balance improvement exceeds the minimum 0.6 per cent requirement. Overall, I am reassured to note that the European Commission, which has ultimate responsibility for assessing overall compliance with the fiscal rules, has indicated our 2017 Draft Budgetary Plan is "broadly compliant" with the provisions of the SGP.

## **Conclusion**

By way of conclusion, I wish to express my gratitude to the Irish Fiscal Advisory Council for its positive contribution and engagement with the annual budgetary process. Looking ahead, the Government will maintain its focus on prudent management of the public finances and ensure we do not jeopardise our hard won budgetary gains, particularly in light of emerging challenges arising from specific external developments such as Brexit or domestic pressures. In this regard the new lower debt target of 45 per cent of GDP will help provide an additional fiscal 'shock absorber' capacity for the public finances and help cushion the impact external pressures over the medium term horizon.