Professor John McHale

Chair

Irish Fiscal Advisory Council

Whitaker Square (ESRI Building)

Sir John Rogerson's Quay

Dublin 2

27th January 2016

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's November 2015 *Fiscal Assessment Report* which was published on 26th November. I note the report was discussed on December 3rd by the Joint Oireachtas Committee on Finance, Public Expenditure and Reform.

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

Michael Noonan T.D.

Minister for Finance

Appendix – Response of the Minister for Finance to the November 2015 *Fiscal Assessment Report*

Introduction

At the outset, let me say that I welcome the publication of the Irish Fiscal Advisory Council's Fiscal Assessment Report (FAR) and the analysis therein. Under the improved budgetary architecture, the Council has an important role in assessing and commenting on the Governments fiscal forecasts and on the fiscal stance, as well as assessing compliance with the fiscal rules.

I note, in particular, the Council's central observation that the fiscal stance for this year, as set out in Budget 2016, is consistent with both the deficit and debt remaining on a downward trajectory and complies with the requirements of the preventive arm of the Stability and Growth Pact (SGP), which is seen as prudent policy. Reducing the deficit significantly below 3 per cent of GDP last year represents a key milestone and highlights the Governments commitment to prudent budgetary policies.

It is important to stress that it is always difficult to assess the appropriateness of the fiscal stance in an open economy such as Ireland. Having said that, I see the fiscal stance for this year as being appropriate given the cyclical position of the economy. Clearly there remains slack in the economy (with, for instance, an unemployment rate of just under 9 per cent) and it is appropriate that budgetary policy helps to reduce, and eventually eliminate, this slack. I would also highlight the supply-side impact of many of the budgetary measures – the reduction in taxation on labour, the childcare package and changes to Family Income Supplement, for instance, will likely will have a favourable impact upon labour force participation, enhancing the capacity of the economy to grow *inter alia* by eliminating skills shortages.

I want to highlight that the Government's budgetary strategy is being implemented while simultaneously reducing the public debt ratio at a fast pace. For instance, the increase in gross voted expenditure forecast between 2014 and 2016 is expected to be approximately 4 per cent whilst, over the same period, the growth in taxation revenue (including PRSI) is projected at 14 per cent. Accordingly, and in conjunction with strong output growth, the debt-to-GDP ratio is now on a firm downward trajectory.

Furthermore, the forecast for the debt ratio over the medium term does not take account of factors such as the State's shareholdings in AIB, Bank of Ireland and PTSB, the current value of which is estimated at €18 billion (around 9 per cent of GDP). It is my intention that the proceeds from the sale of these assets, as they arise, will be used to further reduce the debt burden. I want to stress that I share the Council's view that, given the wide range of uncertainty surrounding the economic outlook at present, continuing to reduce public debt to safer levels must remain a key policy priority for the foreseeable future. In this context, the Budgetary Strategy pursued since 2011 has seen the debt-to-GDP ratio fall below 100 per cent in 2015 and will fall to just over 90 per cent this year, broadly in line with the European average.

As you will be aware, at the *Eurogroup* meeting in November Ireland's Draft Budgetary Plan was discussed (alongside the Plans for other euro area Member States). The European Commission has assessed the Budget for 2016 to be 'broadly compliant' with the requirements for 2016 under the SGP. I am confident that the prudent fiscal policy adopted by the Government over recent years, which has ensured a correction of the excessive deficit in a timely and durable manner, will continue to ensure that our obligations under the preventive arm of the SGP are also met.

I would like to endorse several of the principles advocated in the FAR including the important role that Ireland's national budgetary framework – including budgetary rules and independent fiscal institutions – plays in guiding our fiscal policy. I believe the enhanced framework will be especially important in anchoring fiscal policy as we migrate from the corrective to the preventive arm of the SGP.

Equally, I would like to elaborate on some issues where my views might differ from those of the Council as set out in the FAR. In setting out this document I have structured my response to address the key points made in each of the chapters of the FAR.

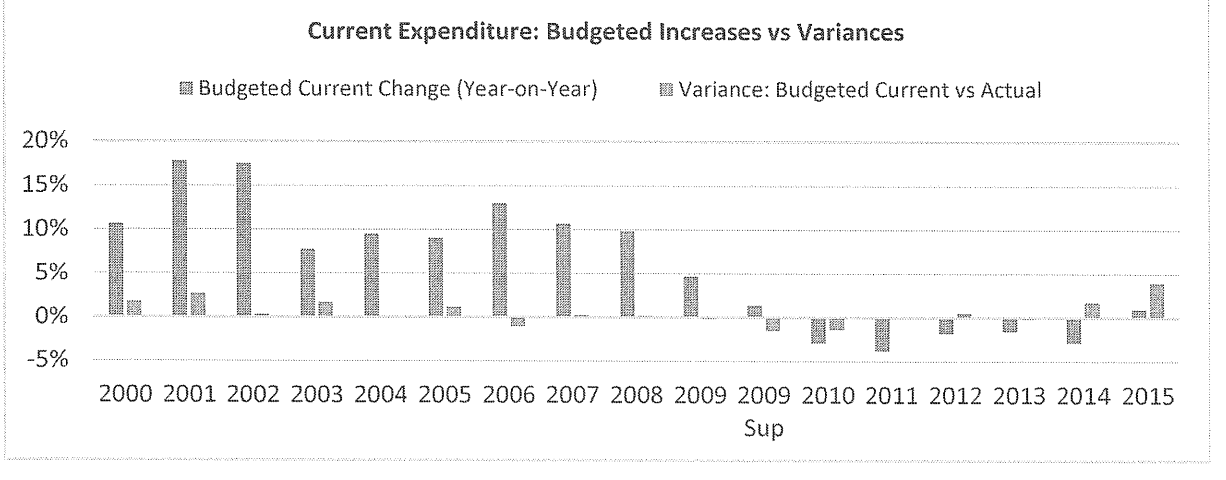
Chapter 1 – Assessment of the Fiscal Stance

In relation to 2015, the Council suggests that a large proportion of the higher-than-forecast tax revenues have been used to accommodate additional expenditure rather than to lower the deficit. When compared with the assumptions underpinning Budget 2015, taxation receipts for last year were €3.3 billion ahead of initial expectations, largely on foot of stronger-than-assumed nominal economic growth. Well over half of these additional receipts were prudently used for deficit reduction, with the remainder being used to finance priority areas of expenditure, such as healthcare provision, where capacity constraints are clearly evident. Indeed, it is now estimated that *ceteris paribus* the 2015 general government deficit will be about 1½ per cent of GDP, which is comfortably below the Budget day forecast of 2.1 per cent of GDP (and the 2.7 per cent target set out in Budget 2015). This will see Ireland correct the excessive deficit in a timely manner. *Ceteris paribus* the carry-through would imply that the headline deficit in 2016 will be around ¾ per cent of GDP although, of course, it is the change in the structural balance that is the relevant metric from this year onwards. The Exchequer also benefitted from the redemption of AIB preference shares at end-2016, with the proceeds being used to further reduce public debt.

In relation to 2016, the Government is targeting an improvement in the structural deficit of 0.8 per cent of GDP – in excess of the 0.6 per cent requirement of both the SGP and the recommendations of the European Council last July. Notwithstanding the acknowledged difficulties in measuring this key fiscal anchor, the trajectory outlined in Budget 2016 will see Ireland achieve a balanced budget in structural terms by 2018-2019.

Turning to expenditure developments, taking into account the increases included for 2016 in the Budget 2016 estimates, the increase in gross voted expenditure between 2014 and 2016 is projected at just 4.2 per cent (an average of 2.1 per cent per annum).

The Chart below, which mirrors the period covered in Figure 3.1 of the FAR, illustrates the need to assess the variance in 2016 in the context of the very high and ultimately unsustainable levels of expenditure growth announced at Budget time over the period preceding the onset of the fiscal crisis as well as the 14 per cent reduction in gross voted expenditure over the 2009-2014 period. During this latter period, while expenditure was being reduced, demographic and other cost pressures arising from increased demand for services still had to be met.



Addressing the question of Corporation Tax receipts - which comprises 14 per cent of total tax revenue - the Revenue Commissioners have formally indicated that the extra revenues are due to improved trading conditions and they expect much of these additional monies will reoccur in 2016. Whilst corporation tax receipts increased by 49 per cent year-on-year in 2015, the continued strong performance in the final quarter of 2015 means that Budget 2016 projects a lower level of corporation tax receipts for this year than last year's outturn. This is not to say that a fall-off in receipts is expected but serves to highlight the prudent nature of the 2016 forecasts. Accordingly, I am satisfied the corporation tax revenues element upon which the budget is based are both justifiable and soundly based. In any event, Ireland is now subject to the expenditure benchmark. This will provide the basis for the determination of sustainable fiscal policy and provide an overarching framework for expenditure policy, which will be financed on a sustainable basis and safeguarded from cyclical revenues.

Chapter 2 – Assessment and Endorsement of Macroeconomic Forecasts

I note the Council's comprehensive text on the forecast endorsement process which concludes that the Department of Finance macroeconomic forecasts are within an endorsable range. The Council's additional contribution on the distribution of economic risks is also helpful, and consistent with the views my Department set out in its risk analysis section of Budget 2016 documentation. Indeed, I welcome the Councils statement that the Department's view of the balance of risks represents an important input into discussions around the macroeconomic and fiscal outlook. Likewise, I regard the Council's risk assessment matrix as a particularly useful analytical tool which complements the work of my own Department in considering and analysing economic risks.

I understand that during consultations with the IFAC Secretariat and Council, my Department had based its 2016 projection on a budgetary package amounting to around €1.2 billion, as the precise measures in Budget 2016 had not been finalised at the time of the endorsement process. A full reconciliation of the impact of the final €1.5 billion package was provided to the Council at the time of the Budget, in line with the Memorandum of Understanding.

I note the comments by the Council regarding the clarity of communication by my Department in respect of fiscal assumptions for 2015, and in particular the use of supplementary expenditure measures in the 2015 macroeconomic forecasts. In this regard, I welcome the post-Budget consultations between my officials and the IFAC secretariat, with a view to updating the Memorandum of Understanding.

I share the Council's view that, contrary to figures suggested by the commonly agreed methodology (CAM), there are few actual signs of over-heating apparent in the economy at present. This is borne out by the absence of real wage pressures, together with a strengthening of the current account of the balance of payments. Notwithstanding this, we will remain vigilant to the emergence of imbalances. In this regard, provisions under the European Semester – such as monitoring under the Macro Imbalances Procedure – will be supportive. Unlike in the past, we will not rely solely on high-level aggregates which can often conceal underlying trends. To this end, my Department is also developing a modular toolkit of indicators similar to that proposed by the Council.

Chapter 3- Assessment of Budgetary Forecasts

I would like to echo the Council's underlying message that prudent fiscal management is necessary in the preparation of the budgetary forecasts. As outlined above, underpinning our recent budgetary policy has been a projected 14 per cent growth in taxation revenue between 2014 and 2016 relative to a corresponding increase in expenditure of just 4 per cent over the same period. This prudent policy position has, and will continue to facilitate a reduction in both our deficit and debt.

I would also agree with the Council that caution be exercised in relation to the impact of the strongly-performing corporation tax receipts on the public finance estimates. Accordingly, this issue is formally recognised in Budget 2016 in the 'Statement of Risks' section of the budgetary documentation. My Department liaises closely with the Revenue Commissioners in monitoring developments in this area, and discussions are ongoing regarding enhancing the forecast methodology. While around 60 per cent of the stronger-than-expected revenues are from a small number of large multinational companies, the Revenue Commissioners advise that corporation tax payments increased in all company size categories primarily due to an increase in the number of companies paying tax. The Revenue Commissioners further advise from their engagement with companies that the increase is primarily attributable to improved trading conditions. As I have already stated, the Revenue Commissioners have informed me that it appears the vast majority of the increase in corporation tax payments are not cyclical in nature. The corporation tax revenue base for 2016 and beyond is based upon this prudent analysis.

Turning to expenditure developments, the Ministerial Expenditure Ceilings for the period to 2018 set out in the Expenditure Report 2016, take into account a range of expected expenditure developments including demographic pressures in Health, Education and Social Protection, the carry-over impact of certain Budget 2016 measures, expected lower numbers on the Live Register and the revised capital envelope set out in the Capital Plan. The Comprehensive Expenditure Report 2012-2014 introduced key reforms to the budgetary architecture aimed at enhancing public expenditure management in Ireland. These reforms were informed by the core principle that a more open and transparent process allowing for clearer accountability and oversight to support better decision making and value for money, and ensure that public funds are used efficiently to deliver effective services for citizens, was required.

The introduction of multi-annual expenditure ceilings was one element of these reforms. These three-year ceilings provide greater clarity about the resources available to Departments over this period; facilitate a more strategic approach to resource allocation by emphasising prioritisation of key services and are set to ensure compliance with our SGP obligations. Similarly, compliance with our SGP obligations is the strating point for any revision of the ceilings. However, it needs to be emphasised that an effective public expenditure framework has several key elements. In addition to multi-annual ceilings these include:-

- Regular Comprehensive Reviews of Expenditure that take into account whether or not the programmes are delivering changes in government policy priorities and proposals for new expenditure programmes;
- Reviews of expenditure being informed by relevant evaluations of the effectiveness and efficiency of programmes through adoption of the Public Spending Code and utilisation of the Irish Government Economic and Evaluation Service;
- Performance Budgeting with a focus on the impact upon public services; and
- Greater engagement with the Oireachtas through a whole-of-year budgetary process and with society through a National Economic Dialogue.

These reforms have proven successful in facilitating the implementation of the expenditure adjustments required to ensure the sustainability of the public finances. The reforms will play an equally important role in the years ahead and, in line with IFAC's assessment of their effectiveness, will further improve budgetary management in Ireland.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I note the Council's findings that the planned fiscal stance in 2015 and 2016 meets requirements of both the domestic rules and SGP requirements, and that the stance in 2016 is consistent with prudent policy direction. It is the Government's intention to comply with the fiscal rules so as to ensure the public finances remain on a sustainable path.

On the issue of required pace of adjustment under the SGP rules, the FAR is critical that 'freezing of minimum fiscal adjustment requirements has yet to be published [by the Commission] despite being key to establishing the fiscal parameters to Budget 2016'. It is my understanding that these documents are provided by the Commission to all Independent Fiscal Institutions in the EU on a horizontal basis. However, in order to remove any uncertainty, I am open to setting up a process whereby my officials can provide relevant documents on a bilateral basis, subject to agreement with the European Commission.

On the matter of future spending pressures, I welcome emphasis by the Council that, on the basis of existing estimates, any further expenditure overrun in health in 2016 would lead to a potentially significant deviation under the expenditure benchmark (unless offset elsewhere). This is consistent with my own views and those recently outlined by the European Commission. In order to ensure continued fiscal prudence, overruns of this nature will not be allowed to materialise in 2016.

The FAR is critical of within-year spending increases of the nature foreseen in 2015. Whilst it acknowledges these increases are not inconsistent with the rules, the Council maintains that this loosening undermines domestic expenditure ceilings. Whilst it is true that continuous or repeated within-year raising of ceilings challenges the effective implementation of expenditure allocation, this can and will no longer be the case from 2016 under the provisions of the preventive arm to which we must abide.

I agree that despite its complexity and imperfection in certain areas, a strong budgetary framework is a valuable structure to guide the design of Irish fiscal policy. I very much share the position of the Council that simplifying the European fiscal governance framework would be of considerable benefit, both in Ireland and elsewhere. In addition, measures which improve the predictability of budgetary planning process and clarify the link between resource allocation and government policy/priorities, will undeniably guard against short-term incremental budgeting and are to be welcomed.

Conclusion

In conclusion, I want to thank the Council for its continued input into the budgetary process in Ireland. Correcting the excessive deficit last year – by a wide margin – has been an important milestone for budgetary policy in Ireland. The public accounts are now in a much healthier position, as we embark on the challenges posed by the preventive arm. In this context, I am confident that the path chosen for budgetary policy in 2016 is an appropriate one, balancing the competing needs of macroeconomic stabilisation, rewarding work and enterprise, targeting resources to key priority areas while at the same time continuing the process of gradually eliminating the structural deficit and bringing public debt to lower, safer levels.