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.

24 July 2015

Dear Professor McHale,

I refer to the Irish Fiscal Advisory Council's June 2015 Fiscal Assessment Report (FAR) which was published on Thursday the 4th of June 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

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Appendix – Response of the Minister for Finance to the June 2015 Fiscal Assessment Report published by the Irish Fiscal Advisory Council

Introduction

I welcome the publication of the Council's Fiscal Assessment Report (FAR), which produced some interesting pieces of analysis. Indeed, the FAR advocates a number of core principles to which I fully subscribe, including the need for a shift away from the perception of fiscal rules as something externally imposed on Ireland. My own view is that the fiscal rules will help reduce the risk of boom-bust cycles that have proved so costly in the past, and this is to be welcomed.

I am confident that the prudent fiscal strategy outlined for 2016 in the *Spring Economic Statement* (SES) will provide sufficient reassurance to market participants and others that Ireland is serious about complying with its obligations under the preventive arm of the Stability and Growth Pact (the Pact). As outlined in the SES, the available fiscal space will be used *inter alia* to boost labour supply by increasing the returns to employment. Combined with envisaged increases in public investment, this will help boost the productive capacity. As is the norm, the specific details will be set out in Budget 2016.

The FAR highlights a number of positive aspects including confirmation that my Department's macro-economic projections over the medium-term fall within an endorsable range.

There are a number of areas where I would not agree with the views put forward by the Council, most notably the assertion that the fiscal strategy does not comply *ex ante* with the requirements of the preventive arm of the Pact.

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

Chapter 1. Assessment of the Fiscal Stance

The Council acknowledges that the general government deficit for this year will be below the 3% of GDP ceiling, thereby leading to a correction of the 'excessive deficit' in a timely manner. Moreover, the Government is acutely aware of the need for fiscal policy to support sustainable growth over the medium term. Given the position in the economy cycle, a policy of minimum compliance was outlined in the SES and Stability Programme Update (SPU), and I note that the Council is support of this approach.

Having said that, the FAR states that a structural improvement of 0.6% of GDP should be pursued in Budget 2016. However, this does not take account of the uncertainties around the calculation of the structural balance, which the Council has identified in previous reports. With this uncertainty in mind, the SES and SPU are clear that the focus is on the Expenditure Benchmark pillar, as this provides a tangible nominal target on which fiscal plans can be based.

Moreover, the suggestion that the forward-looking aspect of the preventive arm of the Pact is not complied with is at odds with the assessment by the European Commission, which finds both sufficient progress towards the MTO and compliance with the expenditure benchmark. In relation to the former, the Commission's sees an improvement in the structural balance of 0.8% of GDP (on the basis of the Department's SPU projections).

The reason for this implied higher quantum of effort relates to a range of complex, technical factors, which my Department has detailed to the Council. On a broader point, however, the different figures further highlight the difficulties of framing policy decisions based on a fiscal anchor that is unobservable.

In relation to discretionary measures, I would disagree with the view of the Council that the inclusion of tax buoyancy arising from a budgetary package as a discretionary revenue measures goes against the spirit and letter of the expenditure benchmark.

The European Commission has stated repeatedly that the rationale behind the expenditure benchmark is to ensure that any increases in expenditure are properly financed, without leading to a weakening of the underlying fiscal position. This is, for me, the letter and spirit of the expenditure benchmark and I am of the opinion that excluding tax buoyancy would go against that spirit and would be inconsistent with the operation of the Stability and Growth Pact. For instance, the Budgetary Frameworks Directive requires Member States to ensure that fiscal planning is based on realistic macroeconomic and budgetary forecasts. It is, therefore, appropriate that we take the second round effects of budgetary measures into account when we forecast tax revenues because these are real effects with real impacts on revenue. In cases where proposed budgetary measures will reduce the burden on taxpayers, the second round effects will lead to real increases in tax revenue that partially reduce the costs of the proposed measures.

Furthermore, there is a need for a symmetric approach – if positive buoyancy was to be excluded, then it follows that negative buoyancy should also be excluded. In circumstances where tax increases with significant negative buoyancy effects were introduced to find additional expenditure, increasing expenditure by the projected gross yield and ignoring the losses due to negative buoyancy would lead to additional expenditure that is not being sustainably financed. I would also point out that both positive and negative second-round effects of policy measures have always been taken into account within my Department's fiscal forecasts.

I also agree that temporary revenue impacts should not be used to underpin long term expenditure commitments. However, I don't see how introducing a permanent change to the tax system (insofar as changes to rates are permanent) can be described as a temporary demand side effect. Regarding the fact that revenue buoyancy is not included in the formal description of the Expenditure Benchmark rule, it is important to note that there is no formal guidance as regards what is considered a discretionary revenue measure. Officials in my Department have been in contact with their counterparts in the European Commission seeking clarification on this issue in advance of Budget 2016.

The FAR outlines some weaknesses in the implementation of Ireland's new medium-term budgetary framework. It maintains that the medium-term public finance projections fail to provide a useful picture of the fiscal position after 2016. Furthermore, by not outlining 'envisaged policies', it maintains we fall short of requirements under the EU *Budgetary Frameworks Directive*.

I, on the other hand, view the medium term forecasts as credible and represent an improvement to previous no-policy change scenarios. Indeed, the post 2016 forecasts include a provision to account for demographic cost pressures, which will materialise in the future. The assumption of indexation of the income tax system as a means of preserving the real value of incomes adds to the realism of the forecast.

On the basis of current estimates, the SES and SPU confirmed that a quantum of fiscal space broadly similar to that in 2016 would be available each year from 2017 onwards. However, while Government has stated elsewhere its intention to reduce the marginal rate of tax and new expenditure priorities, the production of fiscal forecasts reflecting policy beyond 2016 requires specific decisions on the allocation of fiscal space for each year. Given the uncertainty regarding the evolution of the headline and structural deficits (the latter reflecting measurement issues), it is appropriate to make these specific decisions on an incremental, year-to-year basis when more information is available.

The FAR suggests that deficit and debt trajectory as outlined in the SPU is unreflective of what will likely be the case; this is a reasonable point. However, setting out full projections on the basis of unsupported technical assumptions would also have been misleading. On balance, however, the Council makes a reasonable point, and together with the need to meet the requirements of the budgetary frameworks directive, this is something that I will look at improving in future publications.

Chapter 2: Assessment and Endorsement of Macroeconomic Forecasts

I welcome the Council's endorsement of the SPU 2015 macroeconomic forecasts to 2020.

The FAR proposes that an alternative model of potential output be used to inform the assessment of the fiscal stance. This proposal is not consistent with EU legal requirements that require fiscal policy to be framed on the basis of the harmonised methodology for compiling estimates of the structural balance. Such an approach would also generate confusion.

Notwithstanding these limitations, for the purposes of expanding our analytical toolkit to better underpin our medium-term macroeconomic outlook, my Department has already devoted additional resources to developing complementary models of the supply-side of the economy and work will continue in this regard. My officials are also actively engaging with the ESRI on these issues in the context of advances of the COSMO macro-modelling project.

The FAR is also critical of upward revisions in the rate of potential output growth between the Council-endorsed figures and the subsequently published SPU projections. I wish to emphasise that my Department's medium-term views of the supply-side are not tempered by a single year budgetary package. Rather, such relatively minor revisions in supply-side figures between vintages merely attests to the instability of the harmonised methodology.

Chapter 3: Assessment of Budgetary Forecasts

The Council noted that the provision of indicative fiscal space for the forthcoming Budget was a welcome development in terms of fiscal transparency. This reflects a Government decision to provide more certainty on the future direction of fiscal policy. The provision of this indicative fiscal space is also a crucial element for discussion at the forthcoming *National Economic Dialogue*.

I welcome the Council's view that the 2015 deficit forecast contained in the SPU is achievable. I would also echo the Council's comments on the improved tax performance primarily relating to corporation tax and agree that caution should be exercised given the volatility associated with this tax-head.

With regard to risks to the public balance sheet, the SPU outlined that contingent liabilities continue to decline, and this is acknowledged in the FAR. The FAR states that the SPU projections do not explicitly contain potential upsides, which have a reasonable probability of being realised, for example, a positive dividend from NAMA. I think that this is the correct and prudent approach given the dangers associated with the inclusion of speculative estimates. However, it may be worthwhile to reference some potential upsides qualitatively in future commentary.

The Report is critical of the provision made within the fiscal projections to accommodate demographic and other spending pressures. From 2016 onwards, expenditure projections include provision for €300m per annum to cover costs relating to demographics in the areas of health, education and social welfare. In addition, as outlined in the Spring Economic Statement, the unemployment rate is forecast to fall from 11.3% in 2014 to 6.9% in 2020. This improved employment position will lead to reductions in certain live register related expenditure that will release additional funds to meet demographic pressures and spending measures.

Chapter 4: Assessment of Compliance with Fiscal Rules

The Council comments that 'the excessive deficit appears to be undergoing correction in a sustainable manner'. This is to be welcomed and is reflective of the prudent fiscal and economic strategies undertaken by this Government.

As I outlined earlier, the Report is critical that the SPU sets out a budgetary plan which does not comply *ex-ante* with the fiscal rules in 2016. Whilst the FAR is quick to highlight that the pace of implied structural adjustment is non-compliant with domestic and European rules, no mention is made of the resultant internal inconsistency evident within the rules. The SPU clearly demonstrates that availing of the fiscal space permitted under the expenditure benchmark in 2016 leads to a counter-intuitive situation, whereby the corresponding pace of structural adjustment is lower than the minimum improvement of greater than 0.5pp required in 2016. This point is deserving of greater focus, which serves to highlight the extremely complex and, at times, inconsistent nature of the rules. Whilst the expenditure benchmark pillar is, in theory, designed to support a minimum threshold of structural adjustment, in practice the instability of the harmonised methodology can lead to internally inconsistent outcomes. In anticipation of this occurrence, I note that both the Council and the European Commission have stated their intention to analyse the drivers of deviations leading to conflicting signals across the two pillars.

The anomaly, identified separately by both my Department and the Council, in the expenditure benchmark has been resolved by the Commission and my officials. While the Council advocated for an annual update in the determinants of the expenditure benchmark, the FAR criticises the implied weakening in the anchoring property formerly performed by multi-annual expenditure ceilings, citing a reduction in predictability of medium-term budgetary plans. This tension illustrates the inevitable trade-off between spending rules that permit some degree of welcome responsiveness to improved growth potential of the economy, and the preference for stability achieved through fixed expenditure ceilings set a number of years previously. This further highlights the complexity of having dual spending anchors operating together (i.e ceilings and a benchmark).

Finally, I note that the Fiscal Council states that there is 'a considerable risk of non-compliance with the Expenditure Benchmark' on the basis of the SPU projections. I would point out, however, that the SPU 2016 projections show broad compliance with the benchmark even excluding the second-round buoyancy impacts. As mentioned earlier, officials in my Department are engaging with their counterparts in Europe to reach a conclusion on the buoyancy issue in advance of Budget 2016.