Appendix –
Response of the Minister for Finance to:
Fiscal Assessment Report, November 2017

Introduction

To begin, let me say I welcome the publication by the Irish Fiscal Advisory Council (the Council) of the November 2017 *Fiscal Assessment Report* (FAR). In particular, I note the Council's acknowledgement that "*the Government followed through on their plans to keep net spending and tax plans within the available gross fiscal space for 2018 of around €1.7 billion*".

While interpreting macroeconomic data in Ireland is proving a challenge, a broad range of indicators point towards an economy that is growing robustly and full employment is now within sight. At the time of the Budget, output was projected to increase by 4.3 per cent this year and 3.5 per cent next year. On this basis, I note that the Council has assessed the fiscal stance adopted by the Government in Budget 2018 as "*conducive to prudent economic and budgetary management*". While the headline figure for the third quarter of this year was much stronger than anticipated this, as you will be aware, was artificially inflated by so-called 'contract manufacturing' which has little, if any, material impact on actual economic developments in Ireland. In these circumstances, I am sure you agree, the appropriateness of the fiscal stance is unchanged.

As noted in the FAR, the recent Budget provides for moderate increases in current expenditure together with a necessary increase in public investment to rates that are amongst the highest in the EU, whilst complying with the fiscal rules. This general assessment is also shared by the European Commission in its evaluation of the Governments 2018 Draft Budgetary Plan, which was deemed as 'broadly compliant' with the Stability and Growth Pact (SGP).

In summary, the Government remains committed to implementing appropriate budgetary policies that support demand, raise the capacity of the economy and ensure the public finances remain on a sustainable trajectory. I will now address some of the main issues highlighted in the report.

Chapter 1 - Assessment of Fiscal Stance

I share the Council's assessment that the fiscal stance for next year is "*conducive to prudent economic and budgetary management*". In formulating budgetary policy, the Government was conscious of the need to support economic activity, provide for moderate increases in current expenditure in key priority areas, address infrastructural deficits and continue to reduce the debt-ratio. All of this has been achieved within the context of compliance with the fiscal rules. I note, in this respect, the acknowledgement by the Council that the 2018 plans are consistent with the required adjustment in the structural balance and that the risk of a breach in the fiscal rules is relatively limited.

Turning to the 2019–2021 fiscal stance, I note the view of the Council regarding the challenges for budgetary policy over this period. I have repeatedly stressed (in Parliamentary Questions, for instance) that the debate needs to move beyond 'fiscal space' and towards 'fiscal stance', i.e. what is right for the economy rather than what is allowable from a purely legal perspective. As you will be aware, the economy is approaching full employment and I am cognisant of the need to avoid 'adding fuel to the fire'. It is my intention to return to this issue in the *Summer Economic Statement*.

I note the Council's suggestion that consideration be given to strengthening the design of the proposed Rainy Day Fund (RDF). The consultation paper, which is currently before the Oireachtas, seeks to scope out some of the design and operational modalities for this budgetary management tool. In providing for a RDF, I would also stress the purpose of the fund is to help absorb future shocks to the economy. I am acutely aware that we came into the last crisis with a debt ratio of around 25 per cent of GDP; it is now over 100 per cent of GNI* which means our capacity to absorb the inevitable shocks needs to be strengthened.

I note the Council's concern in relation to the potential risks of increased activity in the construction sector leading to an overheating in the wider economy. This is one of the main reasons why stamp duty on non-residential activity was increased in the Budget. It is important that this sub-sector – where there is significant additional capacity in the pipeline – does not crowd-out the residential sub-sector. The changes in the stamp duty regime should help ensure a re-balancing of construction activity towards new housing.

Chapter 2 – Endorsement and Assessment of the Macroeconomic Forecasts

I welcome the Council's endorsement of the Budget 2018 macroeconomic forecasts as being within a plausible range and also that the methodology conforms to good practice. I also note that the Council has found no evidence of bias in recent forecast errors.

The Council assess that the economy is operating at or slightly below its potential level. The report also notes that the EU-wide harmonised 'Commonly Agreed Methodology' (CAM) (which Ireland is legally bound to use in estimating potential output and calculating the structural balance) is unsuitable for Ireland. In this regard, I wish to restate my Department's commitment to develop alternative methodologies to estimate the economic cycle by the first quarter of 2018. It is envisaged that this work – which will be ongoing – will be published during 2018.

I note that the Council also assesses that risks are broadly balanced with substantial upside and downside risks to growth over the short-term – this is in line with my own Department's assessment as published in the risk matrix (included in the budgetary documentation). I share the Council's assessment regarding the housing market where, clearly, the issue is one of supply. In this regard, the Government in Budget 2018 introduced a number of measures to boost supply, which are above and beyond those already introduced as part of *Rebuilding Ireland*. In their totality, these initiatives should increase the supply of both private and social residential properties.

Turning to the one of the most important issues facing the Irish economy – namely Brexit – the likely impact and its timing are obviously highly uncertain. My Department has prudently incorporated a Brexit-related impact in its projections from 2019 onwards; having said that, depending on the transition arrangements (if any), the impact could be less / more severe. My own view is that the best and most immediate policy under the Government's control to counter the likely negative economic impacts of Brexit is to continue to prudently manage the public finances. Over the longer term, we must continue to diversify our export base, a process that has been underway for some time now.

Chapter 3 – Assessment of Budgetary Forecasts

The Council notes that increased spending in Budget 2018, relative to earlier forecasts, is being financed by a number of discretionary revenue-raising measures (DRM's). The FAR queries whether such measures will continue to have long-term yields which equal those expected in 2018. In terms of the analysis conducted on the stamp duty rate increase for non-residential property, *Budget 2018* includes a 4 per cent adjustment to the rate of stamp duty on non-residential property. The projected 2018 yield of €376 million is based on estimates in Revenue's Pre-Budget Ready Reckoner which are considered both conservative and prudent. Revenue data clearly show that the levels of commercial and other non-residential property transactions significantly exceed that which has been estimated by some commentators.

In terms of the medium term General Government balance, the Council questions whether the projections overstate the budget balance as they are predicated on the basis of unused fiscal space. The FAR argues this may be based on "*unrealistically low forecasts for certain areas of spending"* due to the non-incorporation of the unallocated fiscal space margin. Previously it has been government policy to use all of the available fiscal space. However, as potential growth rates have picked up there is now an additional unused margin. This represents the Government's current public finance policy position which will be reviewed in line with the evolving fiscal stance.

The FAR examines the change to the USC introduced as part of *Budget 2017* as well as some revenue raising measures introduced with *Budget 2018.* The Council argues that "*receipts to date in 2017 have been weaker than expected, even after including the expected impact of the USC cut*." I would point out that the USC is still a relatively new tax and has been subject to much subsequent change in the bands and rates and, as such, is more difficult to forecast. It is also worth noting that notwithstanding the significant deviation in February this year, provisional overall USC receipts at end-November are now on profile.

In terms of expenditure, I note the Council's assessment that this is forecast to increase at a moderate pace over the 2019–2021 period. I note also the Council's assertion that these projections are consistent with over-compliance with the fiscal rules, with general government revenue projected to grow by 3.9 per cent on average over the same time-frame.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I welcome the Council's assessment that Ireland is compliant with the EU fiscal rules. The FAR indicates the improvement in our structural balance next year is projected at 0.6 percentage points (pp) of GDP, in line with our obligations under the fiscal rules and we are 'broadly compliant' with the expenditure benchmark.

I note the Council's concern that, in terms of the Expenditure Benchmark, "*assessing compliance with the rule using the Commission's data would show considerably larger estimated breaches*". However, the Commission has informed my Department that non-indexation is taken into account in the event of an 'overall assessment'.

I note the Council suggests that the proposed RDF may impact upon future assessments of Ireland's compliance with the fiscal rules, and that this may require further dialogue at a

European level. These are issues on which my officials will engage with the Commission in the months and years ahead.

Conclusion

To conclude, I want to thank the Council for its work in producing this detailed assessment of *Budget 2018*. We have shared goals of ensuring that, in the short-run, budgetary policy provides sufficient counter-cyclical support and, in the long run, the public finances remain on a sustainable path.

The Council is now an integral part of the reformed budgetary framework and I value your contributions.