Appendix –
Response of the Minister for Finance to:
Fiscal Assessment Report, June 2018

Introduction

Let me begin by welcoming the analysis by the Irish Fiscal Advisory Council ('the Council') set out in the *Fiscal Assessment Report* (FAR) of June 2018. In particular, I note the Council's acknowledgement that, in 2017, the Government achieved a key milestone by reaching the Medium-Term Objective (MTO) of a structurally balanced budget. The pursuit of sustainable fiscal policies over a decade is paying dividends but, clearly, there is more to be done.

The over-arching goal now is to build upon the progress made to date and to further enhance the sustainability of the public finances in Ireland. As set out in the *Summer Economic Statement* (SES), the Government is committed to adopting budgetary policies that support continued economic expansion and deliver steady, sustainable improvements in domestic living standards.

On the economic front, there is uncertainty regarding several near-term challenges. First and foremost is the uncertainty associated with the UK's exit from the European Union in March next year and the format the post-exit trading arrangements take. Secondly, there is a great deal of uncertainty regarding the outlook for the global economy at present, with heightening tensions regarding the multilateral, rules-based trading system. In this regard, I note that the risks highlighted by the Council are broadly in line with my own Department's risk assessment matrix, published as part of the *Stability Programme,* April 2018 Update.

In formulating budgetary policy, the Government remains cognisant of these risks. A key priority is to continue rebuilding the shock absorption capacity of the economy and the forthcoming Budget will provide for moderate increases in current expenditure in key priority areas, address infrastructural deficits and continue to reduce the debt-income ratio. In addition, the Government is establishing a 'Rainy Day Fund' and a draft bill will be published shortly with a view to early enactment. Finally, the Government is using windfall receipts to help reduce public net indebtedness.

Following the format of my previous responses to the Council, I will address some of the main issues highlighted in each chapter of the report.

Chapter 1 - Assessment of Fiscal Stance

I note the Council's view that a €3½ billion package would constitute a broadly appropriate budgetary stance for next year. This is in line with the €3.4 billion package that I have identified as appropriate at this stage of the economic cycle. I would highlight that a key theme of the SES is that budgetary policy will be formulated on the basis of what is right for the economy and not by rigid application of rules that would increase borrowing.

The Council acknowledges that "an appropriate policy for next year would be to increase government expenditure in line with the sustainable long term growth rate of the economy", but that any such additional expenditure "should be funded by additional tax increases or through re-allocations of existing spending". I share the Council's view that focusing on the right budgetary stance and being prepared to be more restrained than the fiscal rules allow is the correct approach for the Government to follow. Additionally, I concur with the Council's view that a full and literal application of the fiscal rules would involve the adoption of pro-cyclical policies not appropriate to our position in the economic cycle is an important one.

I want to stress that I am acutely aware of the excessively benign view of our level of public indebtedness when assessed against movements in Gross Domestic Product (GDP). My Department has emphasised other measures, most notably the debt-to-GNI* ratio, and will publish an update of its *Annual Report on Public Debt in Ireland* before the Budget. This report will highlight *inter alia* that the debt-to-GNI* ratio is in excess of 110 per cent and that reducing this must be a priority.

Within the overall budgetary package, I am prioritising those areas which boost the supply-side of our economy – those areas which enhance the capacity of our economy to grow sustainably over the medium and longer term. For instance, policy choices were made in *Project Ireland 2040* and the *National Development Plan* to substantially increase capital spending, which is appropriate given the serious infrastructural deficits at present.

I note the Council's suggestion that consideration be given to strengthening the design of the proposed Rainy Day Fund (RDF). However, we must balance this with operating within the Fiscal Framework provided for under the Stability and Growth Pact. I note also the Council's suggestion that the budgetary forecasting horizon should always be at least five years. In

relation to the latter, I recently confirmed to the Oireachtas Budget Oversight Committee, that my Department will extend its forecast horizon in the forthcoming Budget.

Chapter 2 – Endorsement and Assessment of the Macroeconomic Forecasts

I welcome the Council's endorsement of the SPU 2018 demand-side 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 systematic evidence of bias in recent forecast errors.

I note the views of the Council regarding the significant downside risks facing the Irish economy over the medium-term. In particular, the Council highlights the significant negative impact which the exit of a large foreign-owned multinational firm could have on corporation tax receipts and output. My Department also addressed the concentration of corporation tax receipts in its *Annual Taxation Report*, noting that it is possible a shock to the corporation tax base could have negative spill-over effects to other revenue streams.

The Council also views overheating as one of the principal risks facing the Irish economy, a view which I share. From a policy perspective, given the stage of the economic cycle, it is essential that budgetary policy 'leans against the wind' and does not contribute to overheating pressures; these are some of the key principles that will guide policy in the forthcoming Budget.

The Council welcomes the development of new estimates of the supply-side / output gap for the Irish economy by my Department. This work reflects the Department's commitment to the ongoing development of plausible supply-side estimates and a working paper will be published shortly describing the statistical approaches that have been applied. Furthermore, I can confirm that it remains the intention to incorporate these estimates into the headline tables of macroeconomic indicators of Budget and SPU publications in the future.

Chapter 3 – Assessment of Budgetary Forecasts

In terms of budgetary forecasts, I note the Council referenced its recently published '*Stand-Still Scenario note*'. Forecasting is an important element of public expenditure management; however, medium-term Budgetary planning requires other factors to be taken into account. One issue I would point out is that in proposing that price effects be applied to expenditure

ceilings, the Council does not address the risk that arises where the forecast inflation applied to the ceilings is higher than actual inflation over the forecast period.

Regarding public expenditure over the 2019 – 2021 period, the report states that allocated spending would be sufficient to maintain existing levels of service (ELS) and public investment plans, but would essentially leave 'little room' for other improvements or for discrete policy decisions. However, much of the increases included in the Council's stand-still scenario could be considered as discretionary policy decisions, rather than pure demographic or ELS costs. Expenditure ceilings, as set out in the Expenditure Report, are underpinned by analysis of demographic costs carried out by the Department of Public Expenditure and Reform (DPER), as set out in the paper by the Irish Government Economic and Evaluation Service (IGEES) *Budgetary Impact of Changing Demographics 2017 – 2027.*

The Council notes that its analysis does not take into account any possible efficiency gains or Government policy changes that could lead to expenditure savings. This is an area that DPER has put a lot of emphasis on, and I would like to highlight the Spending Review in this regard. The specific purpose of the Spending Review is to shift the emphasis away from the incremental increases in expenditure each year, by examining baseline Government expenditure as a whole. It is a process which seeks to drive efficiency in public expenditure and identify where it may be possible to reprioritise and reallocate within existing expenditure.

In July of this year, 27 papers were published as part of the second year of the Spending Review process, reflecting key strategic and priority areas of expenditure. One theme that emerged from the analyses was staffing and workforce planning, which is of key importance in the management of public expenditure. A number of papers have been produced in this area, both on an overall basis and on a sectoral basis, and I am confident that they will form an important part of the evidence base for budgetary decisions in this area.

Another theme that has emerged from the Spending Review process is sectoral expenditure drivers, with a number of papers examining key underlying drivers, while also looking at the potential sustainability of future costs. These papers are of particular value in light of the pressures we are facing in some key sectors, such as education and health and the expectations to meet these pressures with the incremental amounts available each year.

There are concerns raised in the report that the introduction of the Rainy Day Fund is not designed to operate as a counter-cyclical tool, given that contributions to the fund are expected to be flat over 2019–2021. As set out in the consultation paper, it was envisaged that the RDF would function as a defined purpose instrument addressing only specific shocks or events. Accordingly, the explicit commitment to contribute €500 million per annum relates only to the period out to 2021. However, as outlined recently, the intention is to build the fund up to a total of €8 billion over the medium term.

The Government recognises that increases in capital expenditure will need to be carefully managed as part of the overall fiscal stance in order to ensure it does not contribute to potential overheating of the economy. However, following years of low levels of investment in capital expenditure, a period of catch up growth is required. In the long-term, this investment will make the delivery of public services more efficient and support economic growth.

In relation to the risks associated with corporation taxes, I am fully aware of the concentration issue and the Department of Finance, along with the Office of the Revenue Commissioners, has highlighted this concern on many occasions, including in last year's Budget, the *Stability Programme Update* and in the *Annual Taxation Report 2018*. However, as a country that has been consistently successful in attracting leading multi-nationals to base their operations here and given our level of integration with the global economy, it is not altogether surprising that our corporation tax base has become concentrated. Corporation tax receipts account for about 16 per cent of our overall tax receipts at present. For comparison purposes, I would highlight that income tax and VAT – when combined – account for about 66 per cent of our overall receipts. Nonetheless, in order to mitigate these risks, it is proposed to supplement the €1.5 billion capitalisation of the RDF (from the Irish Strategic Investment Fund) by setting aside some of the historically high levels of corporation tax, with a €0.5 billion contribution from the Exchequer account to the Rainy Day Fund in 2019.

Turning to Stamp Duty, the FAR outlines that this tax sub-head is "cumulatively below expectations in 2018 to end-April by 9.8 per cent, raising questions about the estimated yield from the higher rate of stamp duty introduced in Budget 2018". I would point out that, in the period to end-July, the cumulative gap has been narrowed somewhat, with receipts now 6.4 per cent below their target and up 32.5 per cent in year-on-year terms. Furthermore, the Office of

the Revenue Commissioners has advised that provisional data for the first 7 months of 2018 indicate that €345 million was collected in relation to Stamp Duty on property transactions (both residential and non-residential property). This compares with €184 million in the same period of 2017.

Receipts of Stamp Duty on property are volatile on a monthly basis. Furthermore, I would highlight that elements of stamp duty receipts are non-linear, with over three quarters of this heading based on property and share transactions, which themselves can be 'lumpy' in nature. It should also be noted that, in preparing the yield costing for the Budget 2018 commercial stamp duty measures, the base was prudently adjusted for previous large 2016 transactions. In summary, therefore, it remains likely at this stage that receipts from non-residential Stamp Duty at end-year will be broadly in line with projections.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I welcome the Council's assessment that over the medium term horizon (2019 – 2021), the Governments budgetary plans are compliant with the fiscal rules. As I stated earlier, I also welcome the Council's acknowledgement that the Government achieved the MTO last year. In its assessment of our compliance with the rules, the European Commission concurred with this view, assessed a structural deficit of 0.1 per cent of GDP in 2017.

I note, however, that the Council has indicated that there is a possibility of deviation from the MTO in 2018. This mainly reflects developments in the output gap (rather than the headline balance); the figures for actual GDP are increasingly misaligned with actual economic developments, making assessment of the economic cycle even more difficult than normal. One consequence of this is that the structural deficit is now projected to be 0.9 per cent of GDP for this year. I would point out, however, that both the Department of Finance and the European Commission project a structural deficit of 0.4 per cent of GDP for 2019.

Section 4.5 of the report refers to annual revisions to expenditure ceilings as a pattern of 'pro-cyclical adjustments'. Given that there have been moderate, sustainable levels of increases in expenditure in the years since the crisis, it is not clear why these adjustments have been classified in this way. As the Commission sets out recommended growth rates, which are

amended and updated from one report to the next, it is to be expected that three-year expenditure ceilings must be revised when necessary.

The Council outlines a proposal by the European Commission aimed at supporting medium-term planning, by improving the medium-term focus of the fiscal rules, in particular in relation to the medium-term expenditure growth path. It is suggested that the path for expenditure growth would be set at the beginning of a new Government's term, and would last for its entirety. This time-frame would appear to be too long and could generate the risk of setting inappropriate levels of expenditure growth for five years into the future.

Conclusion

To conclude, I want to thank the Council for its assessment of the *Stability Programme,* April 2018 Update and for its continued input into the reformed budgetary process. I would like also to reaffirm this government's commitment to ensuring that our public finances remain on a sustainable path into the future.