Mr. Seamus Coffey
Chair,
Irish Fiscal Advisory Council
Whitaker Square (ESRI Building)
Sir John Rogerson's Quay
Dublin 2

17th January 2019

Dear Seamus,

I refer to the Irish Fiscal Advisory Council's *Fiscal Assessment Report, November 2018* published on 28th November 2018.

My response, set out in an appendix to this letter, follows the same format as that adopted in my previous replies to the *Fiscal Assessment Reports*. It is my intention to publish this letter on my Department's website.

Yours sincerely,

Paschal Donohoe

Paschal Donohoe TD
Minister for Finance and Public Expenditure and Reform

Appendix

Response of the Minister for Finance to the Fiscal Assessment Report, November 2018

Introduction

At the outset, I would like to thank the Irish Fiscal Advisory Council ('the Council') for its work and, more specifically, for the analysis set out in the recent *Fiscal Assessment Report* (FAR).

Before commenting on the individual chapters, I would like to briefly offer some perspective on the evolution of the public finances.

After a long and difficult journey, balance was finally restored to the public finances last year. My Department has estimated that the headline general government deficit has been eliminated, although we must await confirmation by the Central Statistics Office in March/April. The European Commission has projected that we will achieve our medium term (budgetary) objective this year, another important milestone.

As Minister for Finance, my overarching objective in the months and years ahead is to build upon the progress made so far. As you know, there are several elements to this. Firstly, I want to ensure a broad taxation base: low rates applied to a broad base is the most efficient means of financing the State while limiting distortions to economic activity. This was a key factor underlying my decision to remove the 9 per cent preferential VAT rate for many sectors in the recent budget. Moreover, it is my intention to publish in due course a set of proposals to reduce our reliance on corporation tax.

Secondly, the growth in public expenditure will be limited to the trend growth rate of the economy (notwithstanding measurement difficulties). While there has been some slippage during 2018 the bulk of this was due to higher health-related spending. In light of this there is ongoing engagement between officials in the Department of Public Expenditure and Reform and the Department of Health in relation to how we can best manage Health expenditure going forward to ensure that the provision of additional resources to the Health sector is matched with increased levels of accountability and transparency in expenditure matters.

Thirdly, windfall receipts have been and will continue to be used to reduce public indebtedness. For instance, the receipts from the disposal of AIB shares (€3.4 billion) have been used for debt reduction. All future receipts arising from the State reducing its involvement in the financial sector will be used to retire public debt.

Finally, cognisant of the risks facing our economy, I am establishing a Rainy Day Fund from this year. This will be capitalised by a €1.5 billion transfer from the Irish Strategic Investment Fund and by an annual contribution of €0.5 billion from the Exchequer.

I will now turn to some of the main issues highlighted in the FAR and address each chapter in turn.

Chapter 1 - Assessment of Fiscal Stance

I note the Council's assessment that the Irish economy is operating at close to potential and that the outlook remains broadly positive, an assessment that is similar to that of my own Department. I share the Council's views on risks facing the economy – mainly external in origin – and include the UK's impending exit from the European Union in March of this year. As you know, my Department documents the main domestic and external risks in its Spring and Autumn forecasts, and also includes an assessment of their likelihood and impact.

The highly uncertain external environment was a key factor underpinning my decision to target a balanced budget this year (with a surplus now being a distinct possibility) as well as the establishment of the Rainy Day Fund. Indeed, it is important to stress that a surplus of around ½ per cent of GDP would have been in prospect had the Government not decided to increase capital expenditure by around one-quarter this year. This latter decision was made in order to boost the productive capacity of the economy and to make it more resilient.

In relation to the Rainy Day Fund, I note that while the Council has welcomed this initiative it is somewhat critical of the decision to cap the Fund at €8 billion. I take a different view. In particular, I do not believe that it makes sense to accumulate an ever-larger fund whilst, at the same time, carrying a significant amount of debt. In the event of a serious downturn, one of the biggest threats relates to a possible spike in borrowing costs. It is important, therefore, to strike the right balance between building up buffers for future downturns on one hand and debt reduction on the other.

The Council highlights the role of low interest rates and strong corporation tax receipts in the recovery of the public finances. There can be no doubt that these favourable factors have played an important part. However, other factors, such as past and current policy measures, have also played a role.

In relation to corporation tax receipts, I am acutely aware of the doubling of these receipts in recent years. This, in part, reflects the increase in corporation profitability (in no small part due to the profit streams associated with intellectual property assets). It is worth pointing out that one-off corporation tax receipts amounting to €700 million have been excluded from the tax revenue projections for this year and, accordingly, do not feed into the expenditure base.

With regard to the fiscal rules, the European Commission has assessed *Budget 2019* as being compliant with the fiscal rules and I discussed this assessment with my euro area counterparts at the *Eurogroup* meeting in December.

I note the Council's assertion that Ireland's debt burden remains high since the financial crisis, an issue that has been consistently highlighted by my Department (including in its *Annual Debt Report*). Indeed, my focus is on debt reduction and to this end, I intend to continue to use windfall receipts from the resolution of the financial crisis, such as those generated from last year's sale of the State's share in AIB and the expected surpluses arising from NAMA in 2020 and 2021, to reduce this debt.

Chapter 2 – Endorsement and Assessment of the Macroeconomic Forecasts

I welcome the Council's endorsement of my Department's macroeconomic forecasts for 2018 and 2019 that underpinned *Budget 2019*. I also note that the report welcomes my Department's publication of the alternative supply-side estimates and the use of other indicators in *Budget 2019* (e.g. modified domestic demand and modified current account), as important complements to other indicators of underlying economic activity. Methodological papers detailing the alternative supply-side estimates have now been published on the Department's website.

The Council highlights that the inclusion of these new series in my Department's publications provides a coherent basis for understanding the sustainability and quality of the economic growth forecasts. For example, my Department's forecasts show the output gap moving into positive territory in the near-term, with potential output growth moderating, and the modified current account moving into deficit. The Council notes that this presents an internally consistent view of the economy over the medium-term.

Finally, I welcome the Council's assertion that, in recent years, my Department's in-year forecasts and those made one-year ahead have all been relatively accurate.

Chapter 3 – Assessment of Budgetary Forecasts

I note the Council's focus on corporation tax receipts. These receipts have risen as a share of overall receipts and last year accounted for around 19 per cent (compared with a historical 'norm' that is closer to 14 per cent). This is a volatile source of revenue and highly concentrated. With this in mind, I share the concerns of the Council, and both my Department and myself have been vocal in signalling the risks associated with this. With this in mind, I intend to bring to Government (and subsequently publish) a set of proposals on how this over-reliance can be addressed.

In terms of the upside fiscal risk flagged by the Council (resulting from the State Aid case), this revenue has prudently not been factored into the forecasts, not least because it is still subject to a legal process and the exact quantum, if any, that could accrue to Ireland is unknown. Furthermore, as such a receipt would be a one-off in nature, it cannot and should not be used for recurring expenditure.

Turning to the expenditure side of the equation, gross voted expenditure is set to increase by 5.5 per cent in 2019. This continues the Government's strategy of incrementally enhancing the delivery of public services in a sustainable manner. In relation to investment, the Government has made the clear choice in *Project Ireland 2040* to prioritise increases in capital spending to address the infrastructural deficits which emerged during the recession.

I note the Council's assertion that the expenditure projections in the Budget lack credibility, with a significant amount of unallocated expenditure in the projections. The approach currently adopted in relation to Departmental expenditure amounts ('ceilings') is informed by the experience during the lead-up to the fiscal and economic crisis. Large and ultimately unsustainable increases in expenditure were implemented during the pre-crisis period. During this period, the process for agreeing final expenditure allocations had a number of stages where negotiations took place between the Department of Finance and line Departments. Price rises were semi-automatically applied to both pay and non-pay Departmental expenditure allocations early in the process and subsequent negotiations incrementally increased expenditure.

When preparing expenditure allocations beyond 2019, the ceilings are prepared on a prudent and contained basis, which maintains allocations across all spending areas and which takes account of demographic factors in the areas of Health, Social Protection and Education. In addition, the overall spending projections include a separate unallocated provision. This amount is distributed across Departments in the context of the annual budget process to reflect developments, for example, in public service pay and pension agreements.

This approach mitigates the risks inherent in re-stating expenditure ceilings applying inflationary increases as a new baseline (i.e. floor) for any new increased expenditure. A key objective of fiscal policy is that public expenditure is affordable both now and in the future. This necessitates an approach to expenditure management in which a systematic programme of expenditure reviews and efficiency-generating reforms is underway in each sector to ensure that priority initiatives can be supported and developed within the allocated ceiling.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I note that the Council points to the possibility of non-compliance with the fiscal rules in 2018 and 2019. Much of this reflects developments in the output gap. As highlighted in Budget 2019 and in earlier publications, it is very difficult to estimate the economic cycle in an Irish context.

Under the current European framework, calculation of progress towards the medium term objective requires an assessment of the economic cycle using the commonly agreed methodology, an approach which can provide counter-intuitive results for Ireland. To address this, my Department has produced alternative estimates of the output gap that better capture the true economic cycle in Ireland and I note that the Council has welcomed this innovation. While compliance with the fiscal rules will continue to be based on harmonised methodology for calculation of the output gap, the availability of this alternative series will help provide a better evidence base for policy formulation.

I would point out that estimates of the structural balance generated from both the commonly agreed methodology and my Department's alternative approach both suggest that Ireland will be compliant with the fiscal rules in 2018 and this year. Moreover, in its latest assessment, the European Commission has assessed Budget 2019 as being compliant with the fiscal rules.

On a minor point, I note that the Council considers that €0.7 billion of the corporation tax take in 2018 should be treated as a one-off. There are a number of issues with this. Firstly, it is important to reiterate that my Department's budgetary projections do not include this amount in the tax revenue projections for 2019 onwards (it is non-recurrent). Secondly, based on the Commission's principles for assessing one-offs,[1] these receipts would not be classified as one-off.

[1] As set out in *Public Finance Report 2015,* European Commission.

Conclusion

In conclusion, I would like to thank the Council for its assessment of *Budget 2019* and for its productive engagement with my Department during the budgetary process.