An Roinn Airgeadais
Department of Finance
Oifig an Aire
Office of the Minister

FIN-MO-00219-2021

Mr. Sebastian Barnes
Chair
Irish Fiscal Advisory Council
Whitaker Square (ESRI Building)
Sir John Rogerson's Quay
Dublin 2
D02 K138

20th January 2021

Dear Sebastian

I refer to the Irish Fiscal Advisory Council's *Fiscal Assessment Report, December 2020* published on 1 December 2020.

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

Yours sincerely,

Paschal Donohoe

Paschal Donohoe T.D.
Minister for Finance

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Appendix

I would like to extend my appreciation to the Council for its work in producing the *Fiscal Assessment Report (FAR)* and for its continued contribution to the budgetary process.

As I set out in my letter to you in July 2020, budgetary policy is being formulated against the backdrop of exceptionally difficult circumstances and *Budget 2021* was no different. Looking ahead, budgetary policy will continue to play a key role in reducing the scarring effects of the pandemic on our economy and on our society.

I now propose to address the main issues highlighted by the Council in the *FAR*.

Chapter 1

I welcome the Council's conclusion that the increase in the debt-income ratio, as a result of the measures taken in response to the Covid-19 pandemic, is manageable. My view, which is in line with that of the vast majority of both domestic and international economists, is that allowing the debt-income ratio to increase is the most appropriate way to mitigate the economic fall-out from the pandemic. In this regard, it is also worth noting the steps taken in recent years to put the debt-income ratio on a downward trajectory during 'good times'.

I note the Council's recommendations for budgetary reform in Ireland, in particular by developing domestic debt targets, using a Rainy Day Fund to save temporary receipts and anchoring permanent spending growth to specific limits based on sustainable growth rates. Prior to the Covid-19 pandemic, my Department published a piece of analysis[1] which outlined several policy options aimed at ensuring the sustainability of the public finances; this included many of the elements proposed by the Council. While the pandemic has dramatically altered the fiscal landscape (in Ireland as elsewhere), I would tend to agree with the Council that budgetary policy should be anchored within a medium-term framework encompassing several important elements. As you will appreciate, my officials and I are giving a great deal of thought to this and work is progressing at a European level.

Chapter 2

I welcome the Council's endorsement of my Department's macroeconomic forecasts. I note that the Council is satisfied that my Department's approach conforms to that of other forecasting agencies both in the general approach and with respect to how Covid-19 impacts have been modelled and addressed.

Given the current uncertainties and risks at the time of *Budget 2021*, the Council assesses it prudent that my Department's forecasts for 2020 and 2021 were based on the absence of a widely available vaccine until at least 2022, and that trade between the UK and the EU would be based on WTO terms from January 2021.

[1] http://www.budget.gov.ie/Budgets/2020/Documents/Budget/Fiscal%20Vulnerabilities.pdf

Clearly, we now have additional, important information that will have a major bearing on the Irish economic performance this year. Firstly, while trade between Ireland and Britain will not be frictionless (with cumbersome paperwork, customs and regulatory checks at borders, etc.), this bilateral trade will not involve tariffs and quotas. All else equal, economic activity in Ireland this year will, accordingly, be stronger than initially assumed.

Secondly, the rollout of vaccination programmes for Covid-19 is an economic positive (and positive for other reasons also). While it will be the second or third quarter before a critical mass of inoculation is achieved given enormous logistical issues, there is now light at the end of the tunnel and *ceteris paribus* we can expect the economy to recover from the second half of the year.

Chapter 3

I welcome the Council's view that large-scale counter-cyclical budgetary support is warranted in the current circumstances. The pandemic has necessitated an unprecedented fiscal response. The Government has mobilised some €38 billion of supports via direct expenditures, changes in taxation and 'below the line' supports such as credit guarantees.[2] Although such large-scale State support has severe implications for the fiscal position, my view is that the alternative – to do less – would involve even larger costs, via deeper economic scarring effects. It is also important, I believe, to highlight the complementarity between monetary and fiscal policy in the euro area at present (very different to the last crisis).

I note the Council's view regarding contingency funding – namely the Covid Contingency Fund and the Recovery Fund in *Budget 2021*. By establishing contingency funds, the Government provides the fiscal headroom to pro-actively respond to the emerging economic situation, while ensuring such spending does not become part of the base (thereby becoming 'structural'). I agree with the Council's view that once the current crisis has passed, such expenditures will need to be withdrawn in an incremental and appropriate manner or, alternatively, financed by increases in revenue.

The Council also raises the issue of the sustainability of Corporation Tax receipts, an issue with which I am deeply engaged. Towards the end of 2019 I announced new budgetary targets (such as a debt-to-GNI* target) to help mitigate this vulnerability; while the pandemic has changed the fiscal landscape, I can assure the Council that the Government will set out a pathway towards a balanced budget in the *Stability Programme Update*, which will be published in the spring.

Turning to spending, the overall Government Expenditure Ceiling of €87.8 billion for 2021, taken alongside the overall spending of €85.3 billion for 2020, reflects a package of measures that is unprecedented in size and scale and shows the Government's commitment to supporting people, businesses and the broader economy during this crisis. This approach is targeted at ensuring that our key public services are in a position to respond effectively, while providing

[2] https://www.gov.ie/en/publication/84a0c-taking-stock-the-fiscal-response-to-covid-19/

the support to businesses and workers who have been devastated by the pandemic. The measures are costly but it is clear that cost of inaction would have been far greater and could have led to longer term damage to the economy.

The exceptional supports of almost €12 billion in 2021 have been separately identified from spending on core expenditure programmes (Core Expenditure) and will be unwound in an incremental and responsible way as the impact of the virus recedes. This ensures that Covid related expenditures do not enter the permanent expenditure base.

I note the Council's view that the increase on core expenditure of €5.4 billion or 7.7% must be funded in a sustainable manner. This overall increase is driven by policy decisions to allocate additional resources in particular to health, housing and the public capital programme.

As set out in Expenditure Report 2021, core current expenditure is to increase by 6.2% in 2021. The additional allocation of core funding for Health of €1.9 billion (10.7%) includes investment in the permanent capacity of our Health system. An upgraded Health system, with accelerated progress in implementing Sláintecare, is also an investment in our economy and our society. Spending on the Department of Housing's core current expenditure programmes increases by 10.5%, reflecting the Government's priority in this area. Excluding these two key priority areas, spending growth of 4% across the rest of Government continues the approach of providing for steady incremental improvements in public services.

In relation to spending reviews, they have been an important component of the public expenditure management framework since the global financial crisis (GFC) both here and in other countries. Beginning in 2009, there have been five spending review cycles in Ireland.

As the effects of the crisis faded, the objective and scope of spending reviews have changed. Countries are not necessarily using them solely to decrease public expenditure, but also to assess the efficiency and effectiveness of expenditure allocations. Many spending review papers use available data to highlight important questions regarding rationale, efficiency, effectiveness and the sustainability of expenditure, including in key policy areas such as health, housing and climate change. While explicit expenditure savings do not form part of the current series of publications, this does not mean that the key findings of these papers are not relevant and actionable with regard to improving how public expenditure is allocated across or within Departments.

However, it is also important to acknowledge that the output generated as part of the spending review process is varied. While some Departments are further along the journey to embed analysis as part of their decision-making processes, others are at an earlier stage. IGESS has played an important role in helping to support Departments in this regard and it is worth noting that since 2017 over 100 papers have been published papers as part of the spending review process.

Finally, the Council has again requested more detail on non-Exchequer expenditure. I understand my officials have been engaging frequently with the secretariat and have provided more detailed information than was available in previous years. However, given the nature of much of these data, there are legitimate concerns around confidentiality and commercial sensitivity; there is a balance to be struck.

Chapter 4

In terms of the fiscal rules and the in-year assessment for 2020, it is beyond doubt that the general government deficit for last year exceed the 3 per cent deficit limit in the *Stability and Growth Pact* (SGP). Although an *Excessive Deficit Procedure* (EDP) has not yet been launched, Ireland could still be subject to the corrective arm of the SGP once the escape clause ceases to be in place. However, it is likely that exceptional circumstances will continue to exist into this year and the general escape clause will remain in place. I note that the Council assesses this to be appropriate given persistent Covid-19 pressures.

The general government deficit is forecast to improve (compared to Budget 2021 forecasts) by 0.5 percentage points, to 5.7 per cent of GDP in 2021. The more important aspect is the structural deficit – that part of the deficit that is unrelated to the economic cycle – although it is exceptionally difficult to quantify at the moment. My Department will include an estimate of this in the forthcoming *Stability Programme Update*.

Conclusion

In conclusion, let me once again thank the Council for its contribution to the budgetary process. We are truly living in exceptional times and the Government is committed to providing the necessary budgetary support so that our economy – and indeed our wider society – emerge from this pandemic with as little damage as possible.