An Roinn Airgeadais
Department of Finance

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

17 July 2022

Dear Sebastian

I refer to the Irish Fiscal Advisory Council's Fiscal Assessment Report published on 31st May 2022.

My formal response to the Council is set out in the attached. 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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Formal response of the Minister for Finance, Paschal Donohoe T.D., to *Fiscal Assessment Report*, May 2022[1]

Introduction

At the outset, let me begin by thanking the Council for its work in producing the *Fiscal Assessment Report* (FAR) and its comprehensive analysis of the *Stability Programme Update 2022*. Before I turn to the FAR, I would like to provide some brief comments on the macro-fiscal context and the Government's budgetary strategy, which has been updated and set out in the *Summer Economic Statement*.

Economic activity has rebounded strongly following the ending of the pandemic and this has paid dividends in the labour market, where the level of employment is now at its highest ever. This, I believe, confirms that the various fiscal supports, put in place by Government over the two years of the pandemic, were successful in limiting the damage ('scarring') to the economy.

I would highlight that the exit from the pandemic, however, has not been entirely smooth. The rapid recovery in demand has run up against supply constraints, putting upward pressure on prices. The step-change in energy prices on foot of the Russian invasion of Ukraine has worsened the inflation situation and evidence is mounting that the momentum in the Irish economy is now slowing.

To address the higher cost of living, Government has already announced, and implemented, fiscal supports amounting to €2.4 billion, the equivalent of around 1 per cent of national income. The overarching objective of the forthcoming budget is to build upon this – to provide further support to households, including through measures targeted towards those who are least able to absorb recent price shifts while, at the same time, avoiding fanning the inflation flames.

As you are aware, the Government adapted its budgetary strategy in this year's *Summer Economic Statement* to take into account the much less benign inflationary environment, and especially the impact of higher energy prices on the most vulnerable groups.

Budget 2023 will provide for an overall package of €6.7 billion, composed of additional public spending amounting to €5.65 billion and taxation measures amounting to €1.05 billion. Core spending will now increase by 6.5 per cent next year. Government has calibrated this quantum in order to balance the need to protect core public services and avoid fiscal drag while ensuring that budgetary policy does not become part of the inflation problem.

I will now turn to some of the main points highlighted in the FAR.

Macroeconomic assessment

I note the Council's recent endorsement of my Department's short-term macroeconomic forecasts for the *Stability Programme Update 2022*.

Similar to my Department's outlook in spring, the Council has assessed that the downside risks to the economy over the medium-term have increased. In part this reflects the potential for higher levels of inflation to feed into second-round effects, leading to further price and wage increases. This in turn would have knock-on implications for Ireland's competitiveness and result in weaker demand for Irish

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[1] The *Irish Fiscal Advisory Council* publishes two Fiscal Assessment Reports each year. During the legislative scrutiny phase of the *Fiscal Responsibility Bill* 2012, which *inter alia* established the Council on a legislative basis, the Minister for Finance committed to formally responding to each of the Reports.

exports. I also wish to acknowledge the Council's view that, despite the deterioration in the economic outlook, there exists some potential for growth to be stronger over both the short-and medium-term.

Unfortunately, a number of the downside risks outlined in the *Stability Programme Update* have now come to pass. Inflation is running higher than expected, supply chain disruptions are more protracted, and growth prospects in Ireland's main trading partners have weakened. There is also a heightened risk of a complete withdrawal of Russian gas to continental Europe, which could trigger significantly higher gas prices in Ireland. Given the higher prices and mounting geopolitical uncertainty, the domestic economic outlook for the second half of this year and for next year is less benign than envisaged in the spring, while inflation has proven to be higher, broader and more persistent. A full suite of updated projections will be published in the autumn alongside *Budget 2023*.

Budgetary assessment

Short-term

Turning to budgetary policy, I welcome the Council's assessment that the Government's overall fiscal stance in the *Stability Programme Update* is conducive to prudent economic and budgetary management. In particular, the Council assess that the fiscal stance strikes an appropriate balance between managing the impact of higher inflation, avoiding cyclical imbalances, and supporting fiscal sustainability.

I fully agree that that the Government has a delicate balancing act in protecting the economy and poorer households from higher prices, while avoiding adding to inflation through second-round effects. As I noted earlier, the Government adjusted the short-term budgetary strategy, on a once-off basis, in the *Summer Economic Statement* to take into account the elevated inflationary environment. This is in line with the Council's suggestion that the Government's expenditure rule could be temporarily modified to a limited extent when inflation deviates too far from trend. Through these changes and the targeted temporary non-core measures the Government seeks to balance the need to protect public services, protect vulnerable households and limit the risk of expenditure policy feeding into inflationary pressures.

I note the Council's view that the Government has some scope to introduce additional temporary measures this year to help address increases in the cost of living. Any further measures will build on the €2.4 billion in fiscal supports already announced by the Government and will focus on targeted measures, aimed at those most in need.

In designing the Government's response to the higher cost of living, it is important to recognise that the inflation shock is very different to the pandemic. In relation to the latter, borrowing costs were brought to exceptionally low levels. In contrast, the sharp increase in inflation, and the associated shift in the monetary policy stance, means that sovereign borrowing costs are now on a rising trajectory and Government is conscious of this.

I also agree that the fiscal position this year is likely to be better than projected in the spring. Tax revenue has surprised on the upside in the first half of the year and, as a result, a modest surplus is now possible for this year and next. However, I would stress that this would only arise because of the strength of corporation tax receipts.

Regarding the fiscal rules, I note the Council's conclusion that exceptional circumstances related to the pandemic prevailed last year and welcome the assessment that the Government would have been compliant with the domestic budgetary rule and the corresponding deficit threshold outlined in the *Stability and Growth Pact* regardless.

In relation to fiscal risks, the Council highlights that risks around the path for public finances are unusually wide, due to *inter alia* the war in Ukraine, Brexit and the impact of inflation on the domestic and global economy. These downside risks highlight the need for continued focus on ensuring our public finances continue on a sustainable path. The Government's Medium-Term Expenditure Framework has a key role to play in delivering on this objective.

Medium-term

Turning to the medium-term, I fully agree with the Council's view that many fiscal challenges lie ahead of us. These include financing an ageing population, climate change mitigation, the digital transition and the strong possibility of a fall in corporation tax receipts. These challenges underline the importance of rebuilding our fiscal buffers in the years ahead.

In relation to corporation tax, I note the Council's views on the need to reduce the overreliance on this tax head and the potential level of 'excess' receipts, that is the amount that cannot be explained by the growth rate of the domestic economy. The potential volatility and concentration risks in corporate tax receipts is something which my Department has drawn attention to since 2015.

While money is, of course fungible, the resilience of corporation tax receipts is facilitating the significant increase in productivity-enhancing public investment while, at the same, facilitating an expected surplus this year. However, the strong performance of corporation tax also increases the risk of relying on volatile and unpredictable receipts to fund permanent increases in expenditure. As such, I have asked my officials to examine the issue of 'excess' corporation tax more comprehensively in time for the Budget.

I also note the Council's view that the assumed path of government expenditure under the spending rule would allow little room for new measures and for challenges related to demographics, implementation of *Sláintecare* reforms, costs in transitioning to a low carbon economy and defence spending. It is important to highlight that considerable levels of funding will be provided under the medium-term expenditure framework, with core expenditure expected to reach €94½ billion by 2025.

Consideration of these allocations as a whole will be vital to ensure fiscal sustainability and delivery of key government priorities. Recent expenditure reforms including but not limited to IGEES, the spending review, the well-being framework and performance budgeting seek to shift the focus from incremental increases in expenditure to the overall budgetary allocations. This will allow consideration of value-for-money and efficiency in a broader sense and will feed into prioritisation going forward.

Conclusion

To conclude, let me once again thank the Council for its contribution to the budgetary process.

Government is doing what it can to cushion the blow of higher inflation. But Government must work within a changing environment where budget constraints and trade-offs are, once again, a reality.

No Government anywhere in the world can offset this and, instead, the role of Government is to redistribute the impact in order to ensure that those least able to cope are protected. This targeting of fiscal support has underpinned the Government's approach so far, and will continue to do so in *Budget 2023*.