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

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Professor Michael McMahon
Acting Chair
Irish Fiscal Advisory Council
Whitaker Square (ESRI Building)
Sir John Rogerson's Quay
Dublin 2

19 January 2024

Dear Michael,

I refer to the Irish Fiscal Advisory Council's *Fiscal Assessment Report* published on 7th December 2023.

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,

Michael McGrath TD
Minister for Finance

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Formal response of the Minister for Finance, Michael McGrath T.D., to *Fiscal Assessment Report*[1]

Introduction

At the outset, let me begin by thanking the Council for its work in producing the *Fiscal Assessment Report (FAR)* and its analysis of *Budget 2024*. Before I turn to the analysis set out in the FAR, I would like to provide some brief general comments on the economic and fiscal situation.

Despite large and unprecedented shocks in recent years, the domestic economy has proven to be remarkably resilient. Employment has increased strongly, with the unemployment rate now consistent with any reasonable definition of 'full employment'. Indeed, capacity constraints – labour, physical capital, raw materials – have become increasingly binding, a key factor behind the sharp pick-up in inflation over the past two years. Thankfully the inflation rate has now eased back, though I expect the journey back to price stability to be somewhat bumpy.

While the economic situation is relatively positive at present, the Government is conscious of significant challenges on the horizon. The tightening of monetary policy over the past year-and-a-half is a significant headwind, with higher financing costs acting as a break on both current and capital spending. Externally, growth has slowed in some of our main trading partners, while sector-specific factors are weighing on exports.

In relation to the public finances, an Exchequer surplus of €1.2 billion was recorded last year, with €4 billion transferred to the *National Reserve Fund*. My Department estimates a general government surplus of nearly €8 billion (c. 2¾ per cent of national income) last year; if windfall corporate taxes are excluded, an underlying deficit of around €3 billion (c. 1 per cent of national income) was recorded. In relation to these windfall receipts, legislation providing for the establishment of two new long-term investment vehicles – the *Future Ireland Fund* and the *Infrastructure, Climate and Nature Fund* – is currently being drafted.

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

Macroeconomic assessment

I note the Councils recent endorsement of my Department's macroeconomic forecast for *Budget 2024*. The central scenario involves more modest growth following the post-pandemic rebound in economic activity. Modified domestic demand is projected to increase by 2.2 per cent this year. Whilst Government supports and the easing in inflation will temporarily support growth in the first half of the year, the pace of growth thereafter is projected to moderate as the lagged effects of monetary policy tightening continue to weigh on consumer spending and investment. Risks to the near-term outlook are judged to be two-sided, though firmly tilted to the downside.

Incoming data confirm that, as expected, the rate of inflation has moderated, *inter alia* due to global energy price developments. While 'core' inflation has been somewhat more 'sticky', a closer alignment of demand and supply as the year progresses should result in more modest rates of underlying price pressures.

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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.

Budgetary assessment

Short-term

Turning to budgetary policy, I acknowledge that the Council is critical in some respects of Government's approach to *Budget 2024*, including the temporary departure from the 5 per cent expenditure rule.

The decision to increase net public expenditure beyond the 5 per cent rate set out in the Government's medium-term fiscal strategy was taken in a context where Government must respond to pressing issues such as the cost of living challenge and the need to address capacity constraints in the economy. My view is that *Budget 2024* struck the appropriate balance between giving Government the necessary flexibility to help with the challenges of today while maintaining our public finances on a sustainable pathway over the medium-term. As inflation eases, Government will return to the 5 per cent net expenditure rule when framing *Budget 2025*; this is consistent with the expenditure ceilings for 2025 and 2026 published as part of the *Budget 2024*.

I would also like to note that the European Commission has welcomed Ireland's budgetary plans, with Ireland being one of a relatively small number of euro area Member States to receive a positive assessment. Based on the Commission's estimates, Ireland's fiscal stance is in line with their recommendation to maintain a sound fiscal position in 2024. I also note that the ESRI has assessed that *Budget 2024* will insulate most households from the impact of inflation.

I note the Council's estimates that less than one-third of the temporary cost of living measures for households in *Budget 2024* are targeted. However, these measures should be viewed alongside the suite of permanent measures introduced, which also provide assistance to those most vulnerable: analysis by my Department indicates that the overall distributional impact of *Budget 2024* was progressive, with lower income deciles experiencing the largest gains from both the one-off (temporary) cost of living package and the core (permanent) *Budget 2024* measures as published in Part I.2 of the Budget Expenditure Report.

Fiscal Rules

I note the Council's assessment that "exceptional circumstances" will no longer apply as of 2024. This is in line with the European Commission's assessment and its reasoning for de-activating the *General Escape Clause* at end-2023, which has been in place since the beginning of the Covid-19 pandemic. As such, Ireland will once again be subject to the annual fiscal requirements from the *Stability and Growth Pact*. In this regard, I welcome the Council's analysis that Ireland is on track to comply with the existing set of domestic and EU fiscal rules.

Medium-term

Turning to the medium-term, I welcome the Council's assessment that the path for public debt is sustainable. However, I also recognise the Council is critical of a number of aspects of Government's fiscal projections for the coming years, which I will address in turn.

: *transparency*

I disagree with the Council's assessment of lack of transparency. I would note that both my Department and the Department of Public Expenditure, NDP Delivery and Reform (DPENDPDR) publish a range of reports throughout the year detailing the setting of policy and monitoring of expenditure. These include the monthly Fiscal Monitor, Summer Economic Statement, Mid-Year Expenditure Report, Expenditure Report, Revised Estimates, Performance Report and Spending Review papers.

: classification of expenditure

The classification of core and non-core expenditure has been an important element of the setting of budgetary policy since 2020. Non-core expenditure allows for flexibility to respond to external shocks, such as the impact of the war in Ukraine, while core expenditure for day-to-day investment in public services and infrastructure is protected. It is important to note that non-core expenditure is reducing over time, and will fall to €4.5 billion in 2024, down from €15.4 billion in 2020.

: public expenditure projections

I would highlight that the Councils definition and calculation of stand-still costs varies considerably from the DPENDPDR assessment of costs for Existing Levels of Service (ELS). The Council applies automatic indexation, which is not current Government policy and make no allowances for productivity improvements or efficiency gains. Furthermore, while ELS is a significant element of the Budget package, it does not represent new policy decisions. The SES set out an indicative ELS requirement of €2.3 billion for 2024, but this was revised downward to €1.8 billion following detailed engagement during the Estimates process. The ELS allocation by DPENDPDR is published in the Expenditure Report 2024. Additionally, provision was made in new measures for costs of a future public sector pay agreement. The Revised Estimates for 2024 sets out technical allocations, within the Government Expenditure Ceiling, to each Department in respect of future costs of a public sector pay agreement. While not prejudging the outcomes of negotiations with public service unions currently underway, this will ensure Votes have funding in place for 2024 to meet the costs which would arise should an agreement be reached.

: health expenditure

Budget 2024 continues the significant investment in the health sector with a total 2024 allocation of €22.5 billion. This represents an increase of almost 50 per cent on the amount allocated to Health pre-pandemic in 2019. This allocation recognises that the health service continues to experience a challenging and complex service environment in the aftermath of the pandemic.

Corporation tax and the long-term investment vehicles

I note the Council's assessment that concentration in the corporate tax base is increasing. I have said on many occasions that these windfall receipts are not sustainable and are not a suitable basis on which to build permanent spending commitments, and this underpins the Government's policy of establishing longer-term savings vehicles. I have also highlighted that changes to the international tax regime under the OECD BEPS process are likely to have a negative impact on future revenues.

In terms of these global tax reforms, I note the Council's estimates of the potential fiscal impact of Pillar Two, which provides for the implementation of the 15 per cent minimum effective tax rate applicable to companies with an annual turnover in excess of €750 million in at least two of the previous four years (while these have now taken effect for companies, the first payments are not expected until 2026).

It is important to emphasise that Pillar Two is just one part of the OECD international agreement. The combined impact of both Pillar One and Two is likely to result in a net reduction in Irish corporate tax receipts. From the outset, my Department has cautioned that projections must take into account the revenue impact of both Pillars, including Pillar One which provides for an allocation of profits to market

jurisdictions. The fiscal impact of Pillar two will be influenced by a number of factors, including cross-pillar interaction, the timing and optionality of countries implementation choices as well as firm specific volatility and potential behavioural changes. It will take some time before the full impact on corporate tax revenues materialises.

While work continues at the OECD on the finalisation of the Two-Pillar Solution, the potential overall cost is estimated to be €2 billion per annum relative to baseline. My officials, together with those of the Revenue Commissioners, will continue to work on assessing the long-term impact of the two Pillar solution, with a view to updating the projected fiscal impact as part of the Stability Programme, April 2024 Update.

As noted in the FAR, Government has announced the establishment of the *Future Ireland Fund* and the *Infrastructure, Climate and Nature* Fund, to enable us to make use of these "windfall" corporation tax receipts to provide resources for future fiscal challenges. I welcome the Council's endorsement of the *Future Ireland Fund* as an important milestone. I note the Council's comments in relation to the link between GDP and the rates of contributions to the *Future Ireland Fund*, while also noting that there are challenges associated with each of the different bases. By using GDP, this will incorporate the multinationals who are generating the "windfall" corporate tax receipts.

I also note the Council's comments in relation to the *Infrastructure, Climate and Nature Fund*. Appropriate terms and conditions will be included in the establishing legislation to ensure that it can meet its dual purposes of countercyclical investment and the support of relevant climate and nature goals effectively.

Conclusion

To conclude, the Council provides an important role in critiquing budgetary policy. It is important that group-think is avoided and that budgetary policies are debated in a constructive, evidence-based manner.

In framing policy, Government must strike a delicate balance between the pressures of today – assisting with the cost of living, preventing fiscal drag, continuing to invest in our public services and boosting productive capacity -- and our long-term ability to respond to future challenges.

I believe that *Budget 2024* strikes that balance.