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

17th July 2019

Our Ref: FIN-MO-01945-2019

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

Dear Seamus

I refer to the Irish Fiscal Advisory Council's *Fiscal Assessment Report,* published on 11th June 2019.

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 TD
Minister for Finance and Public Expenditure and Reform

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Appendix

Response of the Minister for Finance to the Fiscal Assessment Report, June 2019

Introduction

Firstly, let me begin by once again acknowledging the important role that the Irish Fiscal Advisory Council ('the Council') plays in our annual budgetary process. In particular, I would like to thank the Council for its work on this most recent *Fiscal Assessment Report ('FAR')*, as published on 11th June 2019.

As in my previous replies, I will address the main issues highlighted in the *FAR* under each chapter.

Chapter 1 – Assessment of Fiscal Stance

I note that, for the first time in over a decade, the public finances returned to surplus last year. Employment has reached its highest ever level, with approximately 2.3 million people at work. The *Stability Programme Update (SPU) 2019* projects growth of 3.9 per cent of GDP this year as well as a budgetary surplus of 0.2 per cent of GDP. The Government has made significant progress in terms of placing the public finances on a more sustainable path and has helped position the economy to deal with the challenges which lie ahead.

In terms of short-term economic prospects, I strongly agree with the Council's view regarding the unusually high level of uncertainty at present, not least due to the rising possibility of a disorderly Brexit later this year. At the same time, I am conscious that the economy is now operating at close to full capacity with risks of overheating.

In the *Summer Economic Statement 2019 (SES)*, I set out the budgetary strategy, which involves two possible scenarios both involving a budgetary package of €2.8 billion. This, I believe, is the appropriate approach to addressing the uncertainty associated with Brexit and to managing the economy and public finances.

The Government is committed to ensuring that we have capacity to deal with any adverse economic shock that may emerge. From a budgetary perspective, we are targeting an increase in the headline surplus and we are using windfall receipts from the financial sector to retire public debt. In addition, the *Rainy Day Fund* has now been established and will have accumulated €2 billion of financial assets by end-year.

Chapter 2 – Endorsement and Assessment of the Macroeconomic Forecasts

I welcome the Council's endorsement of my Department's macroeconomic forecasts as contained in the *SPU*. I note the Council welcomes my Department's publication of forecasts for underlying measures of economic activity – controlling for statistical distortions related to multinational enterprises – which is in line with the Council's recommendations.

In relation to supply-side estimates – which are so important for assessing the cyclical position of the economy – my officials have allocated significant efforts to improving the methodology. In this context, I note that the Council has once again welcomed the alternative methodology now used by my Department.

Finally, I welcome the Council's assertion that my Department has produced reasonably accurate short-term (in-year and year-ahead) forecasts of key aggregates, including forecasts of underlying domestic demand.

Chapter 3 – Assessment of Budgetary Forecasts

I note the Council's focus on corporation tax receipts and the increasing share of these receipts in overall taxation. I have stated on many occasions that I am not complacent to the risk to the public finances from this revenue stream. For this year, a modest decline in receipts from this revenue stream is included in my Department's projections.

More fundamentally, as highlighted in the SES, I have requested my officials to assess the sustainability of corporation tax receipts, particularly in light of multilateral changes that are likely on foot of the OECD's work in this area. This sustainability analysis will be published by March next year.

Turning to the expenditure side of the forecasts, I would begin by noting that *SPU 2019* set out current expenditure forecasts based on an annual increase of 2.5 per cent. The Departmental Capital ceilings out to 2022 have also been set out in the *National Development Plan*. This approach is consistent with recent fiscal strategies first set out in the *Summer Economic Statement 2016* and reflects the *Programme for Government* commitment to ensure a ratio of at least 2:1 in favour of expenditure increases over tax cuts.

In setting out its budgetary priorities for 2017, 2018 and 2019, the Government made decisions to allocate further funding towards current expenditure beyond the commitments outlined in the preceding *SPU* and *SES* for each year. This decision was predominantly facilitated by the budgetary policy choice not to avail of the full fiscal space available for tax measures in the last two years and the introduction of revenue raising measures.

Furthermore, in terms of the Council's specific assertion that the expenditure forecasts lack credibility, I would point out that the sensible approach currently adopted in relation to Departmental expenditure ceilings is informed by the experience in the lead-up to the crisis. Large and ultimately unsustainable increases in expenditure were implemented during the pre-crisis period. This demonstrated the real risks inherent in setting as a new baseline (i.e. floor) for any new increased expenditure by restating expenditure amounts ('ceilings') and applying inflationary increases.

A key objective of fiscal policy is ensuring 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 in a sustainable manner.

Finally, I acknowledge the Council's concerns in relation to overspending issues in the Department of Health (DoH) and, in particular, that these are driving the recent increases in general current expenditure. Indeed, in-year slippage in 2018 resulted in a supplementary estimate of €645 million for DoH.

In annual terms, the increase in gross current funding for the DoH in 2019 is 5.8 per cent. This brings the total current allocation to €16.4 billion. The provision of this level of resources must, of course, be accompanied by increased levels of accountability by senior management in the HSE. In light of this, a Health Budget Oversight Group has been established between D/PER, DoH and the HSE. The group is tasked with monitoring monthly expenditure against service line profiles and to highlight deviations at an early stage and ensure remedial action is taken to ensure expenditure returns to profile.

Chapter 4 – Assessment of Compliance with Fiscal Rules

I note the Council's new 'principles-based approach' to assessing Ireland's compliance with the fiscal rules.

As I highlighted in the *SES,* the current fiscal rules are clearly inappropriate for the Irish economy at this point in the economic cycle; we need to tailor these to better reflect the idiosyncrasies of the Irish economy. My Department will shortly publish an analysis setting out the shortcomings of the rules and outline proposals for improvements. My intention is to give consideration to some of these and to make recommendations to Government in the autumn.

I note the Council's assessment which finds that the Medium-Term Objective (MTO) of a structural balance of -0.5 per cent of GDP was achieved in 2018. While I welcome the Council's assessment of compliance with the debt rule, I also share its concerns regarding the use of GDP as a denominator. In this regard, I would like to highlight my Department's forthcoming (third) *Annual Report on Public Debt* which will provide a comprehensive overview on recent and likely future developments in government debt.

Conclusion

In conclusion, I would like to thank the Council for its assessment of *SPU 2019* and its helpful engagement with my Department on an ongoing basis. I would also like to reaffirm this Government's commitment to ensuring sustainable fiscal policy and a budgetary strategy that protects domestic living standards for all citizens.