An Roinn Airgeadais
Department of Finance

Fiscal Rules

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Overview

A. Fiscal rules: the basics and rationale

B. Current EU fiscal framework

C. Where to now? Proposals for reformed framework

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Rules and some economics jargon

Government's budget balance

- Total Receipts – Total Expenditure

Structural budget balance

- Economists adjust the budget balance to account for the business cycle
- In times of strong growth, taxes will be high and unemployment spending lower, so the structural balance attempts to identify the underlying position, i.e. if the economy was operating at potential

Output gap – gap between actual output and potential output

- basic idea – if an economy is growing too quickly (above potential), then we have a positive output gap…(usually associated with inflation)
- An unobservable variable – difficulties in estimating

Why do we have fiscal rules?

- Fiscal rules (also known as fiscal targets) are parameters set by governments to limit their own tax and spend excesses.

- Intended to tackle the problem of time inconsistency (similar to monetary policy)
  - Although governments may recognise that maintaining low levels of debt is desirable in the medium to long-term, they may have short-term incentives to run deficits in the present
  - Short-term incentives may act against the application of counter-cyclical fiscal policy during economic ‘good times’

- They are designed to help avoid the temptation to borrow more, leaving future generations to deal with the consequences.

Design of fiscal rules

- Rules typically aim to promote sound fiscal policies in the medium and long term while smoothing economic fluctuations in the short run.
- In reality, often a tension/trade-off between stabilisation and sustainability.
- The original design of the EU rules displayed a bias towards promoting sustainability.
- Design of the rules is important to ensure acceptance:
    - The rules will not be effective without political and public buy-in, e.g. Italy
- Kopits and Symansky (1998) suggest three criteria for assessing fiscal rules: clarity, adequacy and efficacy.

Irish Budgetary Framework

- As a member of the EU, Ireland is subject to the Stability and Growth Pact
  - Two arms: preventive and corrective

- Ireland is also a signatory to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union
  - *Budgetary aspects known as the “Fiscal Compact”*
  - *Largely mirrors preventive arm of SGP and debt rule*

- Budgetary and debt rules contained in the Fiscal Compact given effect in Irish law through the Fiscal Responsibility Act 2012

- FRA 2012 budgetary rule states that budget must be:
  - *In balance or in surplus as per the medium-term budgetary objective under SGP, or*
  - *Adjusting towards the medium-term budgetary objective.*

Why are EU fiscal rules necessary?

- EMU as unique model of economic integration
    - *Common monetary policy & decentralized fiscal policies*
- Common monetary policy
    - *Price stability*
    - *Macroeconomic stabilisation: dealing with common shocks*
- Fiscal policy at national level
    - *Sustainability: avoiding deficit bias*
    - *Macroeconomic stabilisation: dealing with idiosyncratic shocks*
- Common fiscal rules
    - *Overcoming (dis)incentives created by monetary union ('additional' fiscal bias)*
    - *Avoiding negative spillovers & overburdening monetary policy*

A rule-based framework: the Stability and Growth Pact

- Framework within which Member States make their budgetary decisions.
- Aims to ensure sound public finances
  - ***Avoidance of excessive deficits/debt***
  - ***Economic cooperation and surveillance.***
- Two arms, set up to be consistent:
  - *The preventive arm aims to ensure strong underlying public finances*
  - *The corrective arm (Excessive deficits procedure - EDP) corrects gross policy errors.*

Fiscal policy in the EMU
Who does what?

Member States	The European Commission	The Council of Ministers
• Decide on tax and spending levels – which drive borrowing and debt • But must be compatible with the rules: Stability and Growth Pact (SGP) • Fiscal Compact: National rules	• Implements the SGP: are Member States compliant with its provisions? • Prepares the analysis to guide the Council • 2-Pack: Opinions on Draft Budgetary Plans and Autonomous Commission Recommendations	• Take the decisions on the application of the SGP

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Preventive arm of the SGP
- overview -

Aim	Member States run prudent fiscal policies over the medium-run
Legal basis	Art. 121 TFEU, Regulation 1466/97
Objective	"Close to balance or in surplus"
Operationalisation	Medium-term budgetary objectives (MTO)
Requirement	At the MTO or on the path towards it
Assessment	Structural balance + expenditure growth
Process	European Semester; SPUs
Enforcement	Significant deviation procedure

Preventive Arm: two pillars

- The medium-term budgetary objective (MTO)
  - *Country-specific numerical value for the structural balance*

- The Expenditure Benchmark (EB): circumvent uncertainty surrounding the structural balance
  - *Expenditure rule that avoids explosive and unsustainable expenditure trends*

- Two pillars: change in the structural balance and the Expenditure Benchmark.
  - *Calibrated to be the same over time but sometimes capture different dynamics*

What are Member States requirements under the preventive arm?

- Need to show compliance with the MTO:
  - ***Either remain at their MTO or adjust towards it: by a benchmark amount of 0.5% of GDP per year***
    - *More in good times and less in bad, more if debt above 60%*
    - *Waiver in exceptional circumstances or overall downturn*
    - *Also considering: structural reform clause, unusual event outside the control of the government, severe overall economic downturn*

Expenditure benchmark

- Expenditure grows in line with economy’s underlying growth potential
- Only expenditure trends can be **controlled** by govt over the medium term
- Discretionary revenue measures netted out
- Circumvent **uncertainty** surrounding the structural budget balance
- Strengthen automatic stabilisation
    - *Expenditure on a sustainable path*
    - *Revenues are allowed to fluctuate with the economic cycle*
    - *Unaffected by revenue windfalls*

Corrective arm of the SGP
- overview -

Aim	Correct gross policy errors
Legal basis	Art. 126 TFEU and Protocol 12, Regulation 1467/97
Objective	• Deficit: 3% of GDP • Debt: 60% of GDP or sufficiently diminishing and approaching 60% at a satisfactory pace
Assessment	Effective action methodology
Process	Excessive Deficit Procedure: Opening – Regular monitoring - Abrogation
Enforcement	Sanctions

Compliance with the deficit and debt criterion

Rule: General government deficit must be at/below 3% of GDP

Flexibility (when opening EDP): deficit close to 3% + deviation is temporary (and exceptional)

Rule: Debt < 60% of GDP or sufficiently diminishing and approaching 60% at a satisfactory pace

Distance to the 60% of GDP threshold has to decline over 3 preceding years at an average rate of 1/20th per year

Flexibility (when opening EDP): relevant factors are taken into consideration

The EDP in operation

Deficit-based EDPs = Debt-based EDPs

- No difference in formulating the Council recommendation
    - ***A deadline***
    - ***An adjustment path (annual deficit targets)***
    - ***Annual structural fiscal efforts (at least 0.5% of GDP)***
    - ***Annual limit to the growth rate of net primary expenditure (EB)***

- No difference in monitoring → assessment of effective action

- No difference in abrogation → deficit durably below 3% of GDP and compliance with forward-looking component of debt rule

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Impact of Covid-19:
General Escape Clause of SGP I

The SGP often criticised for being overly complex and rigid.

We can accept the first criticism but the response to the pandemic has highlighted the flexibility within the SGP.

Aside from EU support measures, a key initiative was the activation of the General Escape Clause of the SGP.

This was activated in March 2020 following a proposal from the Commission.

This means that Member States can temporarily deviate from the fiscal requirements that would normally be in place.

Impact of Covid-19:
General Escape Clause of SGP II

GEC applies until end-2023– no quantitative fiscal requirements in Member States' country-specific recommendation under European Semester.

With the help of the ECB, this has provided Member States with the space to do 'whatever it takes' to battle Covid-19 and mitigate the economic fall-out of public health restrictions

However, the SGP itself still in place and Member States can expect 'Excessive Deficit Procedures' in due course as the 3% deficit target is in the Treaty.

Major question regarding what follows the deactivation of the GEC in 2024 and beyond….

Reform of SGP: state of play

COM launched consultation on potential reform of governance framework in early 2020 but suspended with onset of Covid.

Review was relaunched in Oct 2020.

Public consultation closed at end-2021.

Commission Communication on orientations for a reform of the governance framework on published on November 9th.

Discussions taking place at a technical level in European committees.

COM to provide some guidance for 2024 ahead of Stability Programmes in April.

Commission Proposals on reforms to framework

Communication states….

Reformed framework should:

- tackle the prevailing challenges and contribute to making Europe more resilient, by sustaining strategic investment for years to come and by reducing high public debt ratios in a realistic, gradual and sustained manner.

Key elements identified in Communication:

- improving national ownership
- simplifying the framework
- greater medium-term focus
- stronger and more coherent focus

Commission Proposals on reforms to framework

Cornerstone: medium-term fiscal-structural plans, proposed by each MS but on the basis of guidance (reference adjustment paths) provided by the Commission, and binding for 4 years

Aim: ensure that debt converges to prudent levels

- Period of fiscal adjustment, depending on the extent of debt challenges
- Adjustment path better tailored to the specific needs of Member States, with more realistic paths than under the current debt rule
- Reforms and investment commitments gain an extended adjustment period subject to clear criteria
- Use of net primary expenditure as operational indicator allows revenues, cyclical unemployment spending and debt servicing to fluctuate freely, providing a high degree of macro-stabilisation

Commission Proposals on reforms to framework

Differentiated requirements

One single operational indicator: country-specific net expenditure paths anchored on debt

The net expenditure path – for all Member States – should also be consistent with the budget deficit remaining **below 3%** of GDP over the medium-term

Risk categories are obtained with standard Commission DSA

Reference adjustment paths are calculated at the start of the process based on Commission DSA applied to debt and deficit 10 years after the end of the plan

Commission Proposals on reforms to framework

How would this work? Four step approach

COM presents a reference multi-annual expenditure path anchored on debt sustainability (DSA)

MS discuses with COM and subsequently submits its fiscal structural plan

COM provides an assessment of the plan (to be endorsed by Council)

MS implements plan and COM and Council monitors compliance with the endorsed fiscal-structural plan

Requirements- summary

	Substantial debt challenges	Moderate debt challenges	Low debt challenges
Default adjust. period	4 years Can be extended to 7 years together with reforms and investments	7 years Can be extended to 10 years together with reforms and investments	
Debt criterion	After (at most) 4 years, 10-year debt trajectory at unchanged policies on a plausibly and continuously declining path	After (at most) 7 years, debt trajectory at unchanged policies on a plausibly and continuously declining path	n/a
Debt criterion	After (at most) 4 years, deficit maintained below 3% of GDP over 10-year period at unchanged policies		After (at most) 7 years, deficit maintained below 3% of GDP over 10-year period at unchanged policies
Reference adjustment path provided?	Yes		No

Summary of proposals

Increased national ownership

- COM puts forward reference adjustment paths
- MS propose medium-term fiscal-structural plans
- Annual budgets will commit to follow the fiscal trajectory and ensure that debt will start converging to prudent levels within the adjustment period
- MS can request a longer adjustment period underpinned by reforms and investments
- Council endorsement of the plan
- Stronger role of national Fiscal Councils

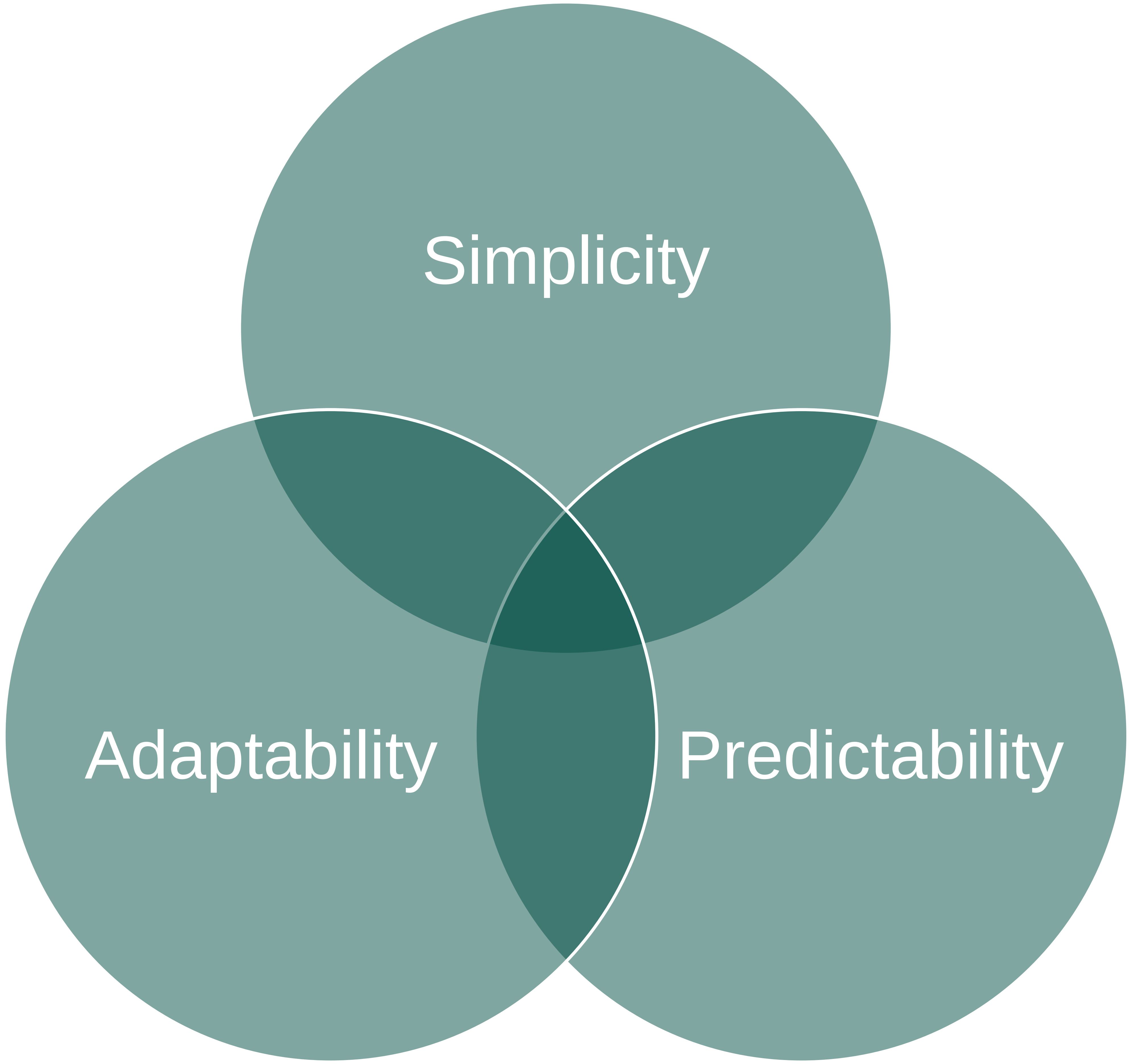
Simplification

- Net expenditure path anchored on debt sustainability and agreed by Council will be the single fiscal indicator
- Surveillance and enforcement will be risk-based
- Debt reduction benchmark, benchmark for reduction in structural balance, significant deviation procedure and matrix of requirements no longer exist

Enforcement

- Deficit-based EDP (3% of GDP threshold) maintained
- Debt-based EDP will be operationalised and strengthened, as a tool to ensure compliance with the agreed net expenditure path
- Financial sanctions toolbox will be enriched with smarter sanctions
- Macroeconomic conditionality will be maintained
- New tool for enforcing reforms and investment underpinning a longer adjustment period

Fiscal rules impossible trinity



SGP legislation: ECFIN website

http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm

European Economy - Occasional Papers

151 - Vade mecum on the Stability and Growth Pact

http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op151_en.htm

150 - Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact

http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op150_en.htm

Commission Communication on orientations for a reform of the EU economic governance framework

https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf

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Thanks for your attention

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ANNEX

The structural balance

Concept of **structural budget balance** – takes out the impact of the economic cycle (and one-offs)

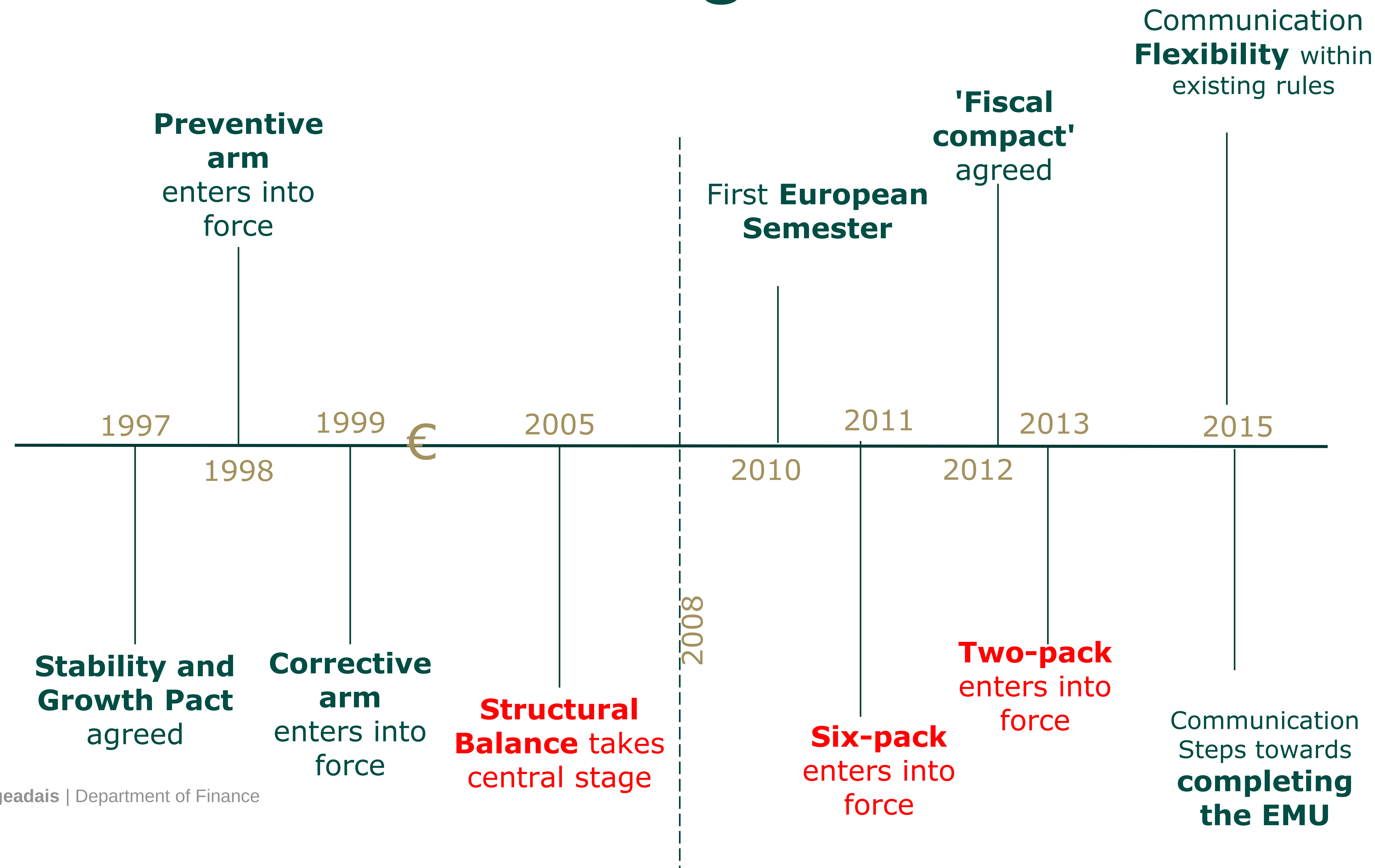
$$SB = \underbrace{\frac{BB}{Y} - \varepsilon.Output\ Gap}_{\text{Cyclically adjusted budget balance (CAB)}} - oneoffs$$

IF ΔSB > 0 => Fiscal position is improving

IF ΔSB < 0 => Fiscal position is deteriorating

Also used as operational indicator in corrective arm

Timeline of changes and reforms



Six-pack	
Regulation No 1176/2011	*"on the prevention and correction of macroeconomic imbalances":* Lays out the details of the **macroeconomic imbalance surveillance procedure**
Regulation No 1174/2011	"*on enforcement measures to correct excessive macroeconomic imbalances in the euro area*": Possible **sanctions on other corrective procedures under the MIP** for EA MS
Regulation No 1175/2011	"*amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies*": Strengthening of the preventive arm through **expenditure benchmark and significant deviation procedure**
Regulation No 1177/2011	"*amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure*": **debt reduction benchmark**, **'comply-or-explain' principle for the Council**
Regulation No 1173/2011	"*on the effective enforcement of budgetary surveillance in the euro area*": details **possible sanctions under the preventive/corrective arm of SGP**
Directive 2011/85	"*on requirements for budgetary frameworks of the Member States*": specific requirements w.r.t **unbiased forecasts and independent fiscal institutions**
Two-pack	
Regulation No 473/2013	"*on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*": **programme support and surveillance** for EA MS under financial stress
Regulation No 472/2013	"*on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability*": **common budgetary timeline** for the EA (assessment of draft budgetary plans)

The components of the expenditure benchmark

Total government expenditure **excluding**:

$g_t < g_t^R$

- Interest expenditure
- Cyclical component of unemployment benefits
- Expenditure matched by EU funds

Furthermore:

- Discretionary revenue measures are netted out
- *Nationally-financed* GFKF is smoothed over four years

Potential growth based on 10 year range (t-5 to t+4 in setting growth rate for t+1)

The debt criterion

Distance with respect to the 60% of GDP reference value has declined over 3 preceding years at an average rate of 1/20th per year

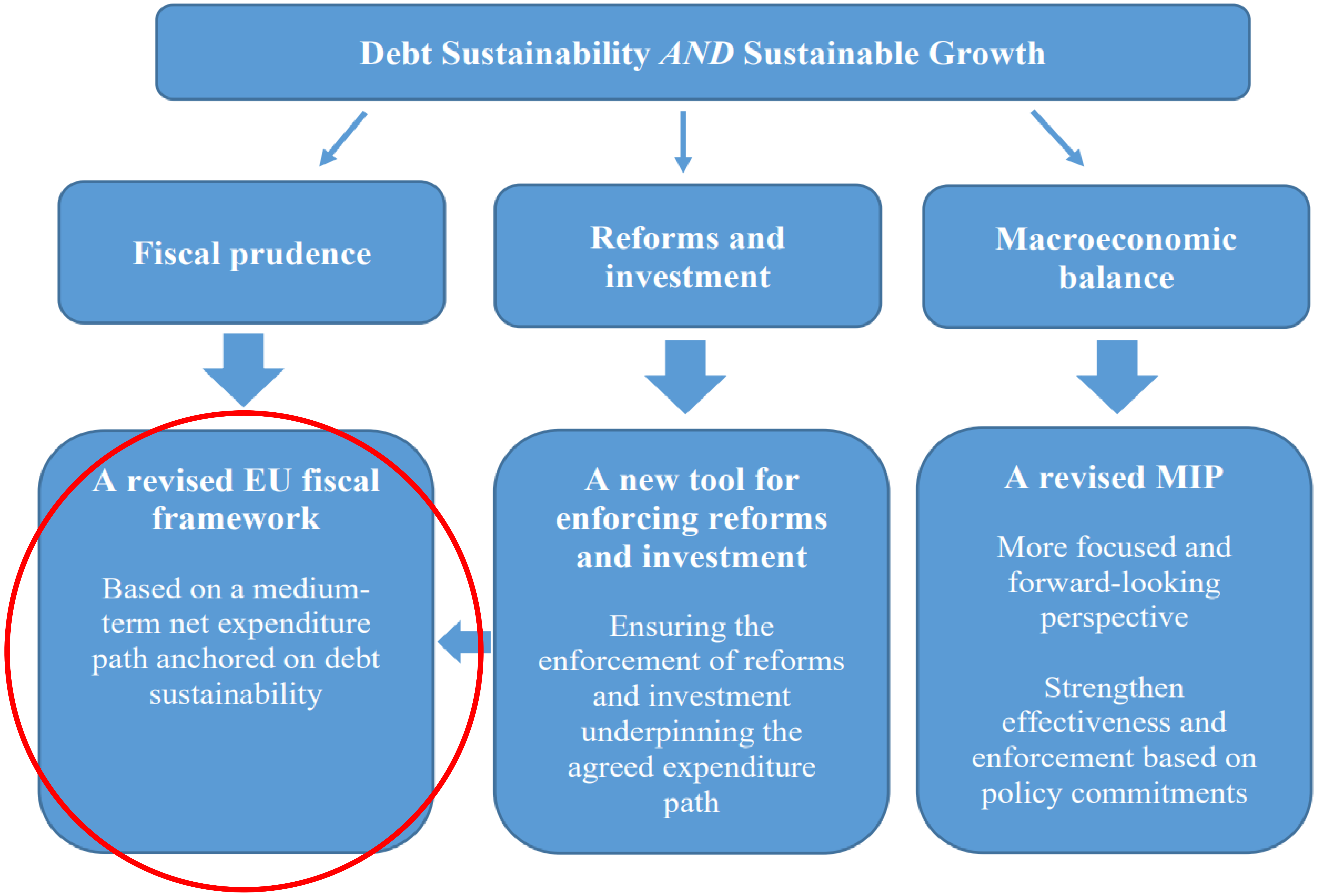
This gives the following benchmark:

$$bb_t = 60\% + \frac{0.95}{3}\left(bb_{t-1} - 60\%\right) + \frac{0.95^2}{3}\left(bb_{t-2} - 60\%\right) + \frac{0.95^3}{3}\left(bb_{t-3} - 60\%\right)$$

If debt is below the benchmark: debt criterion met

Otherwise forward looking assessment and correction for the cycle

Commission Proposals on reforms to framework



Debt Sustainability Analysis

Criteria for categorization of risk

- Established framework, in place since 2015
- Projections are replicable
- Reports published every year, including the risk classification and explaining the methodology in full transparency and presented in this committee
- Uses a baseline plus a range of scenarios and shocks around it, to account for uncertainty over the medium term
- Includes the cost of population ageing (but only for horizon of DSA- DSA starts year after end of plan (i.e. t+5 or t+8 – 10 year horizon)

Debt Sustainability Analysis

- Deterministic projections (10 year horizon)

- Stochastic projections (over 5 years)

Debt Sustainability Analysis

Deterministic projections (10 year horizon)

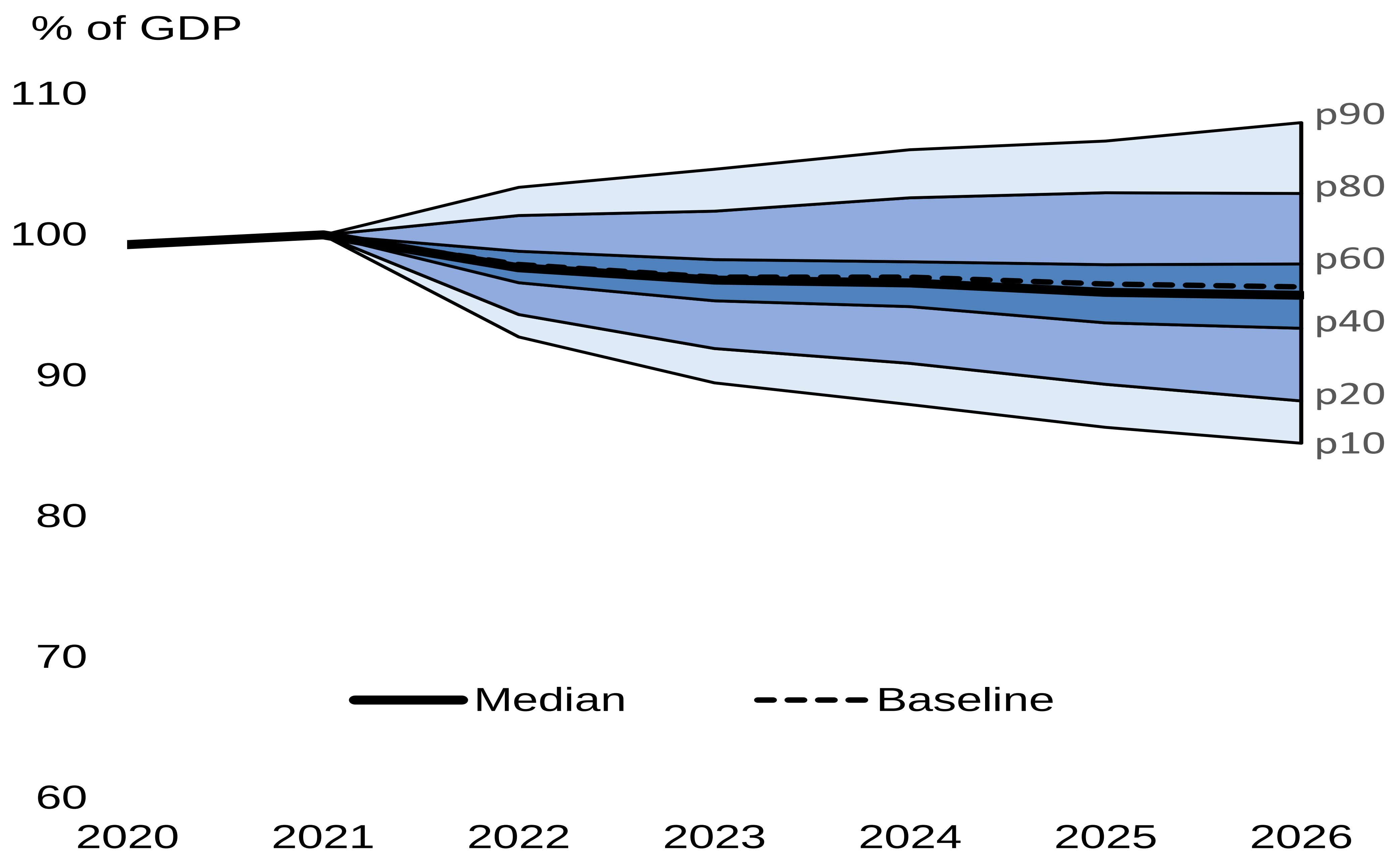
- Baseline
  - **Fiscal:** no-fiscal-policy-change assumption, i.e. no additional fiscal measures beyond the plan's horizon; primary spending only affected by changes in cost of ageing as projected in Ageing Report
  - **Growth:** in line with EU commonly agreed methodology
  - **Inflation and interest rates**: gradual convergence to long-term values

- Alternative scenarios
  - **Historical SPB:** structural primary balance (SPB) converges to country-specific historical average
  - **Lower SPB:** weaker SPB v baseline
  - **Adverse *'r-g'* differential**: less favourable snowball v baseline
  - **Financial stress**: one-year shock on market interest rates

Debt Sustainability Analysis

Stochastic (5 year horizon)

- 2,000 shocks on interest rates, growth, primary balance and exchange rate
- Based on country-specific historical data
- Attaches probability to debt ratio not increasing over 5 years (main criterion for risk classification)
- Cone width gauges size of uncertainty surrounding baseline



Debt Sustainability Analysis

<u>High risk requirements</u>

- The net expenditure path should ensure that, at the latest after **4 years**:
  - the 10-year debt trajectory at unchanged policies is on a plausibly and continuously declining path
  - the deficit is maintained below the 3% of GDP reference value over the same 10-year period at unchanged policies

- Default adjustment period: **4 years**; possible extension to **7 years** together with reforms and investments
- COM **<u>will</u>** provide minimum adjustment path

Debt Sustainability Analysis

Moderate risk requirements

- The net expenditure path should ensure that, after the **4-year** plan horizon:
  - the debt trajectory at unchanged policies is on a plausibly and continuously declining path at **most 3 years** after the plan horizon
  - the deficit is maintained below the 3% of GDP reference value over 10-year period at unchanged policies

- Default adjustment period: **7 years**; possible extension to 10 years together with reforms and investments
- COM **will** provide minimum adjustment path

Debt Sustainability Analysis

Low risk requirements

- The net expenditure path should ensure that, after the **4-year** plan horizon:
  - the deficit is maintained below the 3% of GDP reference value over 10-year period at unchanged policies, at most 3 years after the horizon of the plan

- Default adjustment period: **7 years**; possible extension to 10 years together with reforms and investments
- COM **will not** provide minimum adjustment path

Disclaimer and other information:

The views expressed in this presentation are those of the presenter and do not necessarily reflect the views held by the Department of Finance, the Minister for Finance or the Government of Ireland.

The analysis set out in this presentation is based on "*Annual Report on Public Debt in Ireland* " published by the Department of Finance (August 2019).

Outturn data are sourced from a variety of sources including the Department of Finance, Central Statistics Office, European Commission (AMECO) and the Central Bank of Ireland.

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