Fiscal Rules

Matt McGann
Department of Finance
Presentation at IPA
9 February 2024

Overview

A. Fiscal rules: the basics and rationale

B. Current EU fiscal framework

C. Where to now? Proposals for reformed framework

Overview

A. Fiscal rules: the basics and rationale

B. Current EU fiscal framework

C. Where to now? Proposals for reformed framework

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

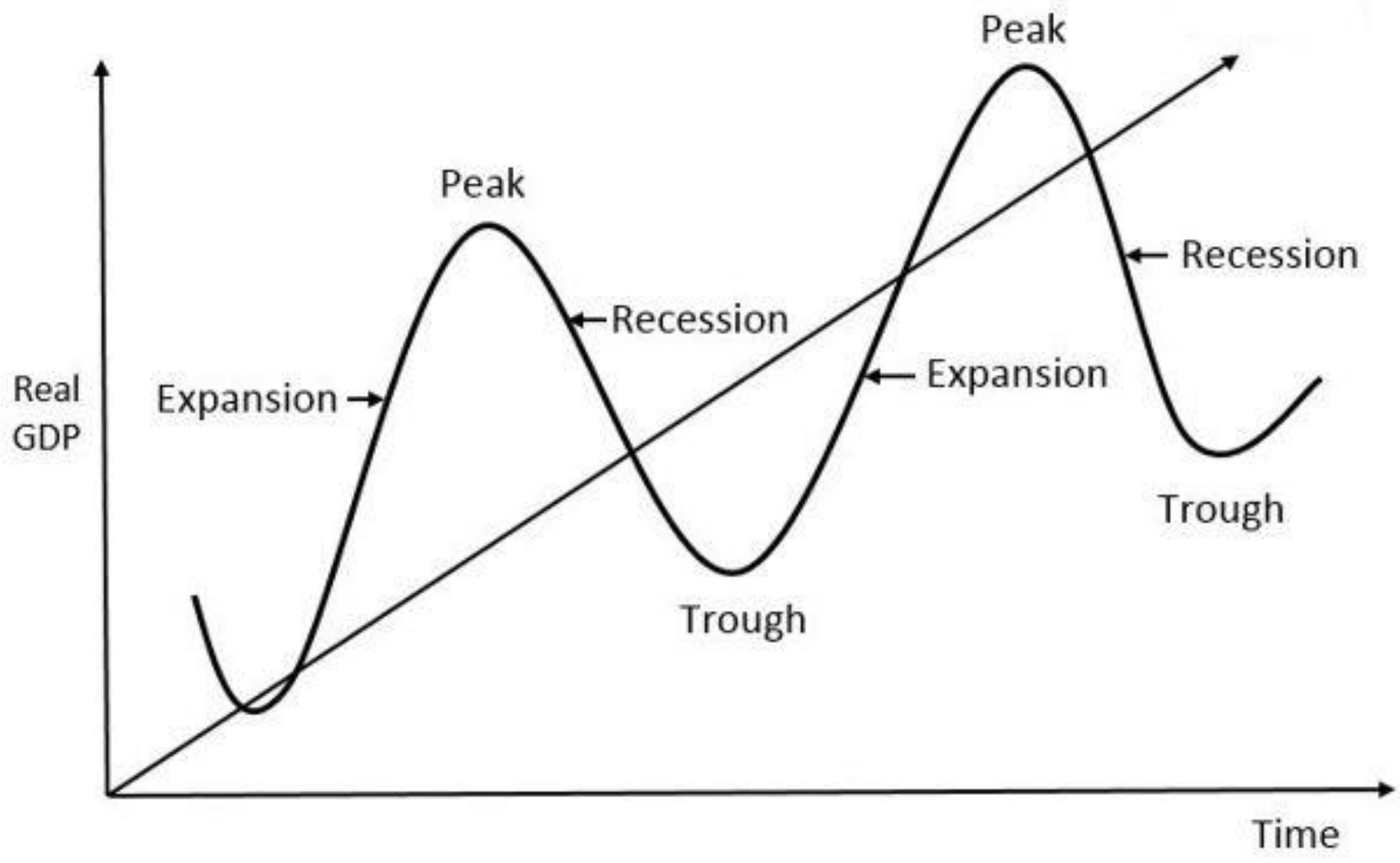
Potential output

- The level of output that an economy can sustain without over-heating
- Potential output growth is the sustainable (or trend) level of growth

Fiscal effort/adjustment

- The change in budgetary position as a result of change in Govt policy only
- Often measured through change in the structural balance

The business cycle and potential output



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 and also a signatory to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact)

- 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.*

- Introduced Medium-Term Expenditure Framework in 2021
    - *Annual net 'core' expenditure growth limited to 5% per annum*

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*

Timeline of the EU Fiscal Rules

1992

Maastricht Treaty

Establishes a benchmark to keep public debt below 60% and public deficits below 3% of GDP.

1997

Stability and Growth Pact

Agreement to strengthen the monitoring and coordination of national fiscal and economic policies to enforce the Maastricht rules.

1998

Preventative Rules

Aims to drive strong underlying public finances.

1999

Corrective Rules

Aims to correct gross policy errors - Excessive Deficit Procedures.

As a response to the vulnerabilities exposed by the 2008-2009 crisis, the EU took measures to strengthen the framework

2005

SGP Amendment

Addition of Structural Balance.

2011

Six Pack

The SGP is made more comprehensive and predictable.

2013

Fiscal Compact and Two Pack

The ‘Fiscal Compact’, requires national provisions to target the budgetary objectives set by the SGP.

Changing economic environment & new challenges

Limitations of the rules identified

2023

Economic Governance Review

In April, Commission publishes legislative proposals for reform of the framework and Council reaches agreement on amended version of these proposals in December 2023

2024

Trilogue with Parliament

Council and Commission have entered ‘trilogue’ negotiations with European Parliament to try and agree new legislation.

Overview

A. Fiscal rules: the basics and rationale

B. Current fiscal framework

C. Where to now? Proposals for reformed framework

Existing rules: the Stability and Growth Pact

- SGP is the framework within which Member States make their budgetary decisions. The rules are intended to ensure sound public finances and economic cooperation.
- Under the current EU rules, there are two arms:
  - **The preventive arm** aims to ensure strong underlying public finances
  - **The corrective arm** (excessive deficits procedure - EDP) corrects gross policy errors
- The Treaty establishes two reference values, the 60 per cent debt-to-GDP ratio and the 3 per cent budget deficit.

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

Existing rules: the preventive arm

Two pillars: The **structural balance** and the **expenditure benchmark**.

The structural balance: budget balance adjusted for cyclical expenditure and one-offs.

- Member States set a medium-term budgetary objective (MTO) - a specific value for the structural balance - subject to agreed criteria.
- Each year, Member States must remain at their MTO or make progress towards it by a benchmark amount of 0.5 per cent – with many caveats.

The expenditure benchmark: Government expenditure net of 'discretionary' revenue measures

- For Member States at MTO, expenditure must grow at most in line with potential GDP.
- For Member States not yet at their MTO, the growth of expenditure must be below the rate of potential GDP growth.

Excludes debt servicing, cyclical expenditure, expenditure matched by EU funds, and includes 'smoothed' investment

Existing rules: the corrective arm

- Aim = correct gross policy errors of budgetary policy.
- General government deficit must be at/below 3% of GDP .
- Debt < 60 per cent of GDP <u>or</u> sufficiently diminishing and approaching 60 per cent at a satisfactory pace.
- If breached, an **Excessive Deficit Procedure (EDP)** can be opened.

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 debt rule

Need for reform (2020-2023)

Fit-for purpose: Major crises have occurred since the rules were originally devised. There are calls for greater recognition of investment and growth needs within the rules. Relatedly, there is a need to recognise and address long-term issues (ageing costs, climate costs).

Effectiveness: Debt levels at 86% of GDP in EU, 94% in euro area, 170% in Greece, nearly 145% in Italy.

Complexity: Even prior to COVID, rules were viewed as complex. Measurement issues - sizable measurement errors.

Overview

A. Fiscal rules: the basics and rationale

B. Current fiscal framework

C. Where to now? Proposals for reformed framework

Legislative Proposals on reforms to framework

- Commission published legislative proposals in April 2023
- Extensive discussions with Council through the year to reach political agreement on amended set of proposals.
- The legislative proposals on the EGR come in three parts:

a) **proposal** for a Regulation replacing Regulation (EC) No **1466/97** (the **preventive arm** of the Stability and Growth Pact) and;

b) **amendments** to Regulation (EC) No **1467/97** (the **corrective arm** of the Stability and Growth Pact);

c) **amendments** to Council Directive 2011/85/EU (the **Directive** on requirements for budgetary frameworks of the Member States).

Proposals for Reform

Cornerstone: medium-term fiscal-structural plans proposed by each MS but on the basis of guidance (technical fiscal trajectories) provided by the Commission. Plans will:

- Be binding for 4 years*
- Include a period of fiscal adjustment after which debt trajectory must meet certain criteria
- Be tailored to the specific situation of Member States > more realistic goals
- Include commitments on reforms and investment (which can grant an extension of the fiscal adjustment period, subject to clear criteria)
- Use of net primary expenditure as operational indicator, allowing revenues, cyclical unemployment spending, and debt servicing to fluctuate freely, providing a high degree of macro-stabilisation

*Fiscal-structural plans have the potential to be reworked in exceptional circumstances, or with accession of a new Government.

Proposals for Reform

1. Commission presents a multi-annual expenditure path anchored on debt sustainability analysis (DSA)
2. Member State discuses with Commission and subsequently submits its fiscal-structural plan
3. Commission provides an assessment of the plan (to be endorsed by Council)
4. Member State implements plan and Commission and Council monitors compliance with the endorsed fiscal-structural plan

Proposals for reform

One single operational indicator: country-specific net expenditure paths

The net expenditure path of a fiscal-structural plan must meet **three** criteria:

1) Debt is on a continuously declining path over the medium-term
2) There is a sufficiently high probability that debt will decline, given uncertainty
3) The budget deficit remains **below 3%** of GDP over the medium-term

The Commission will use its established debt sustainability analysis (DSA) framework to assess plans on the basis of these criteria.

They will be applied by the Commission to the 10 years (i.e. medium term) following the end of the adjustment period included in each Member States' fiscal-structural plan.

Key definition: **net** expenditure is (General) government expenditure less interest expenditure, discretionary revenue measures and other budgetary variables outside the control of the government ^

^ As defined in Annex II, budgetary variables outside the control of the government = expenditure on programmes of the Union fully matched by Union funds revenue and cyclical elements of unemployment benefit expenditure

Debt Sustainability Analysis

- 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
- DSA projects a baseline scenario of debt dynamics for all Member States and computes the minimum adjustment required to meet the criteria – known as the technical fiscal trajectory
- Uses a baseline plus a range of scenarios and shocks around it, to account for uncertainty over the medium term
- Projections include the cost of population ageing.

Debt Sustainability Analysis

Deterministic projections (10 year horizon)

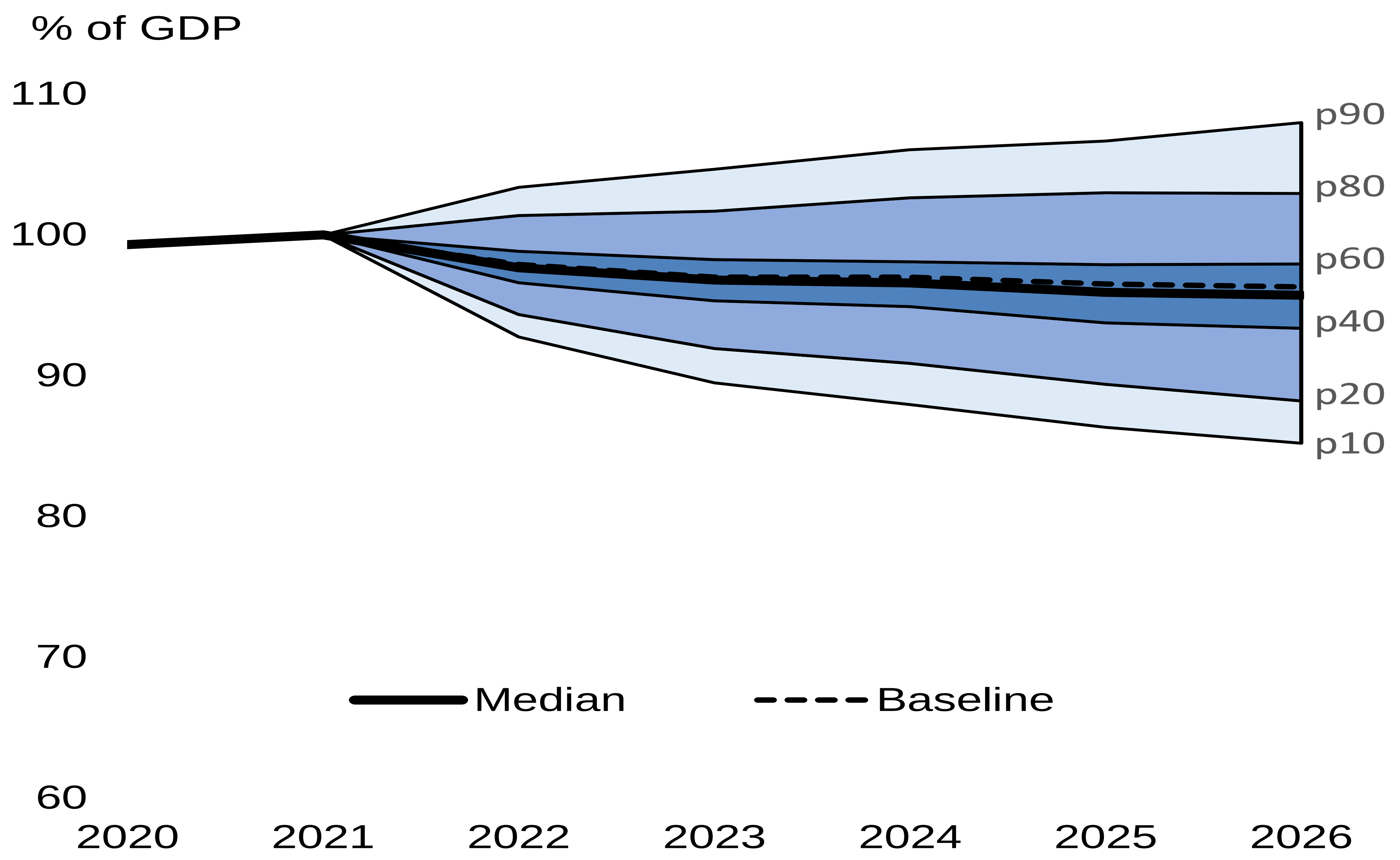
- Baseline
  - **Fiscal:** no-fiscal-policy-change assumption, i.e. no additional fiscal measures beyond the plan's horizon; primary spending only affected by changes in cost of ageing as projected in Ageing Report
  - **Growth:** in line with EU commonly agreed methodology
  - **Inflation and interest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

High debt

- 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 **will** provide minimum adjustment path

Debt Sustainability Analysis

Low debt

- 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: **4 years**; possible extension to 7 years together with reforms and investments
- COM **will not** provide minimum adjustment path but will provide technical information if requested by MS

Additional Safeguards

- Due to some countries' concerns regarding robustness of new system, in particular the DSA, a number of additional elements were developed in discussions since April.

- Article 6 now sets out three additional safeguards for formulation of the technical trajectories:
  - ***no backloading safeguard***: a Member State cannot delay a disproportionate amount of their required adjustment to the later years of the adjustment period;
  - ***debt reduction safeguard***: the debt ratio must decreases by a minimum annual amount of
    - 1% of GDP if debt is above 90%
    - 0.5% of GDP if debt is between 60% and 90%;
  - ***deficit safeguard:*** when headline deficit comes below 3% threshold, fiscal adjustment should continue until structural 'resilience margin' of 1.5% of GDP is achieved.

Summary of proposals

Increased national ownership	Simplification	Enforcement
• 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	• 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	• 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 • Establishment of new notional control account to track small annual deviations (and over-performance)

EGR: state of play

Feb 2020: COM launch consultation on potential reform of governance framework

March 2020: Onset of the Covid-19 crisis - consultation is suspended

Oct 2021: Review is relaunched

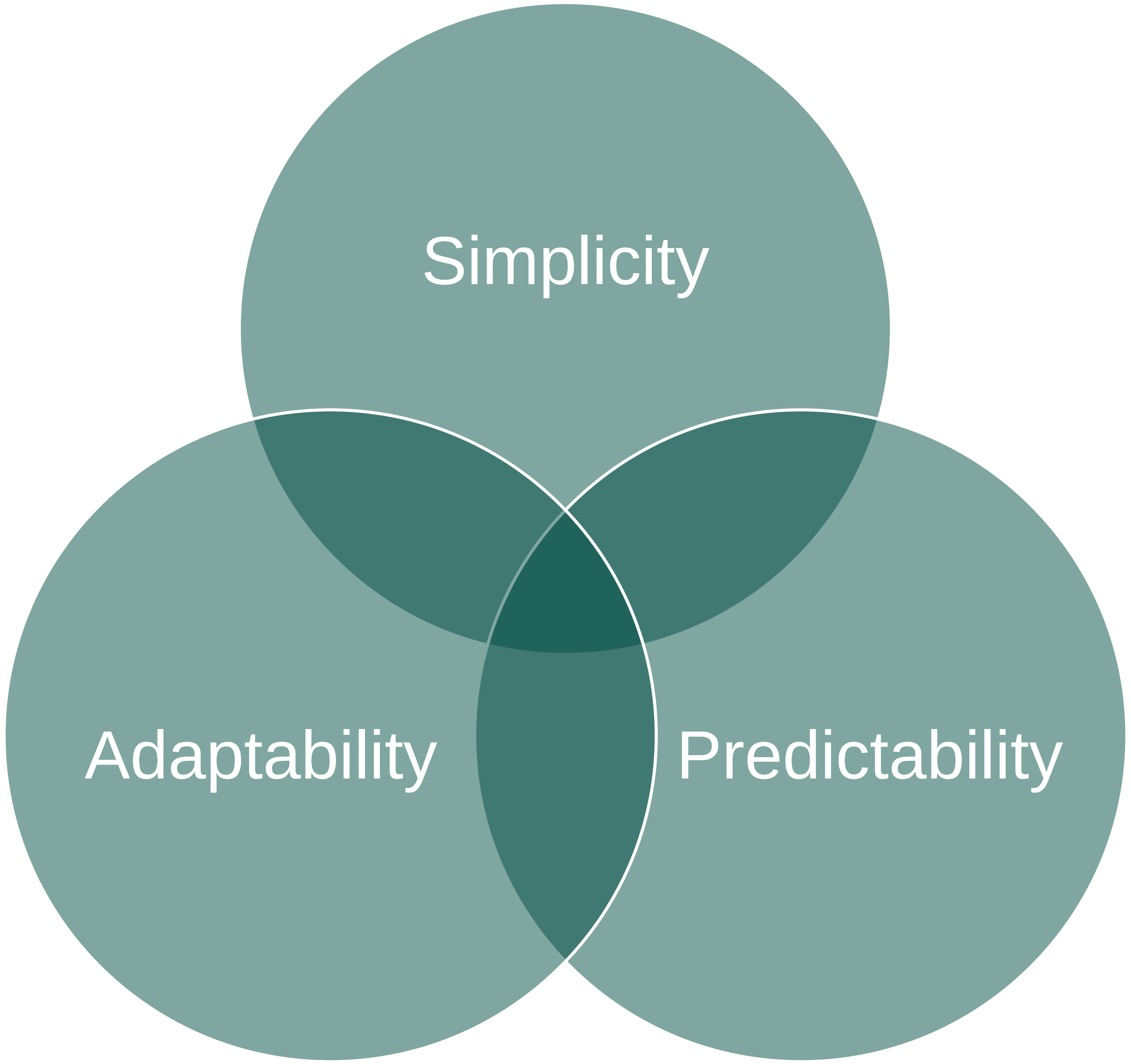
Nov 2022: COM publish communication containing orientations for a reform of the governance framework

April 2023: COM publish full legislative proposals for reform

Dec 2023: Council reaches political agreement on an amended set of proposals

Ongoing: BE Presidency enters ‘trilogue’ negotiations with European Parliament

Fiscal rules impossible trinity



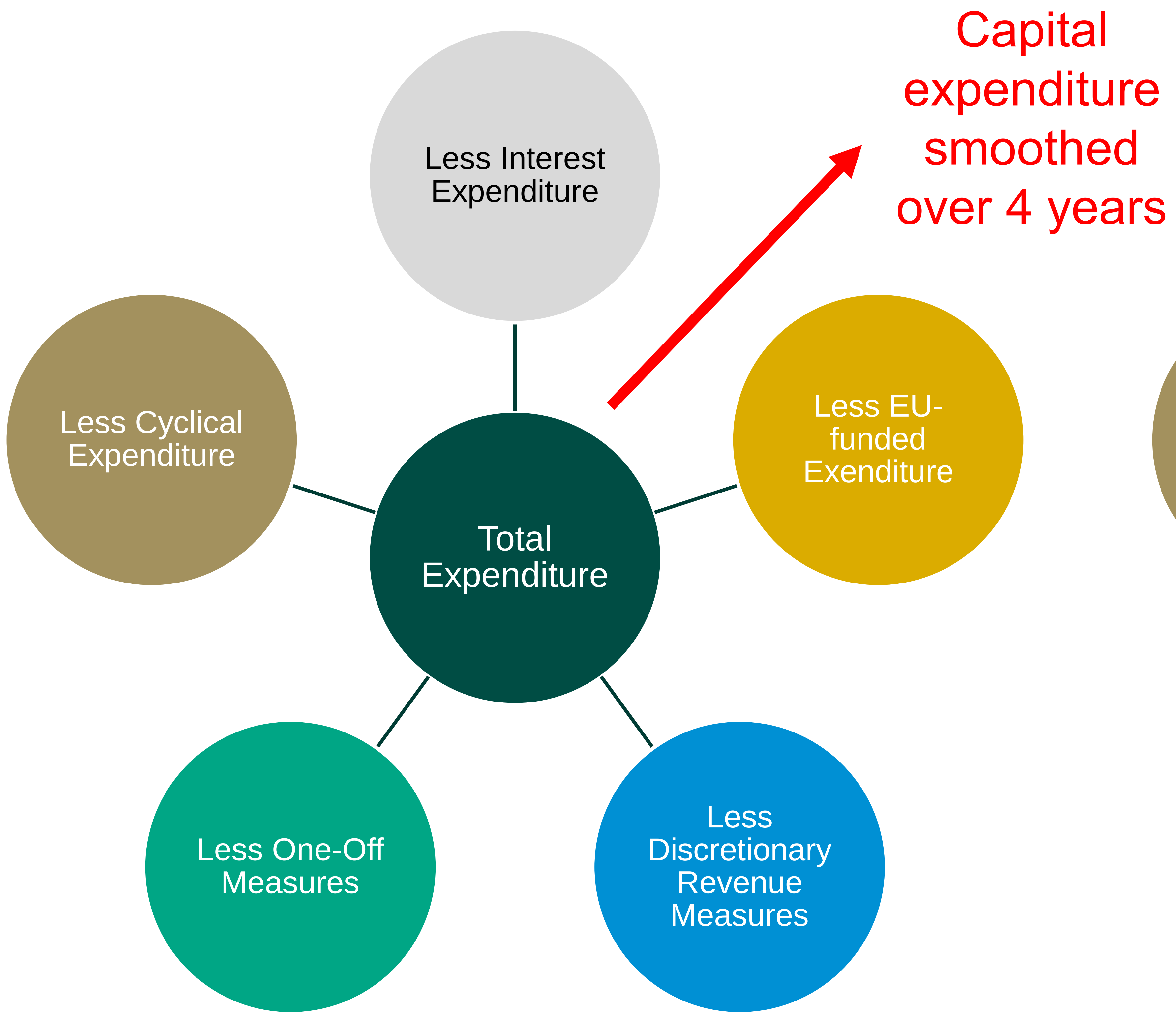
Thanks for your attention

Matt McGann
Dept of Finance

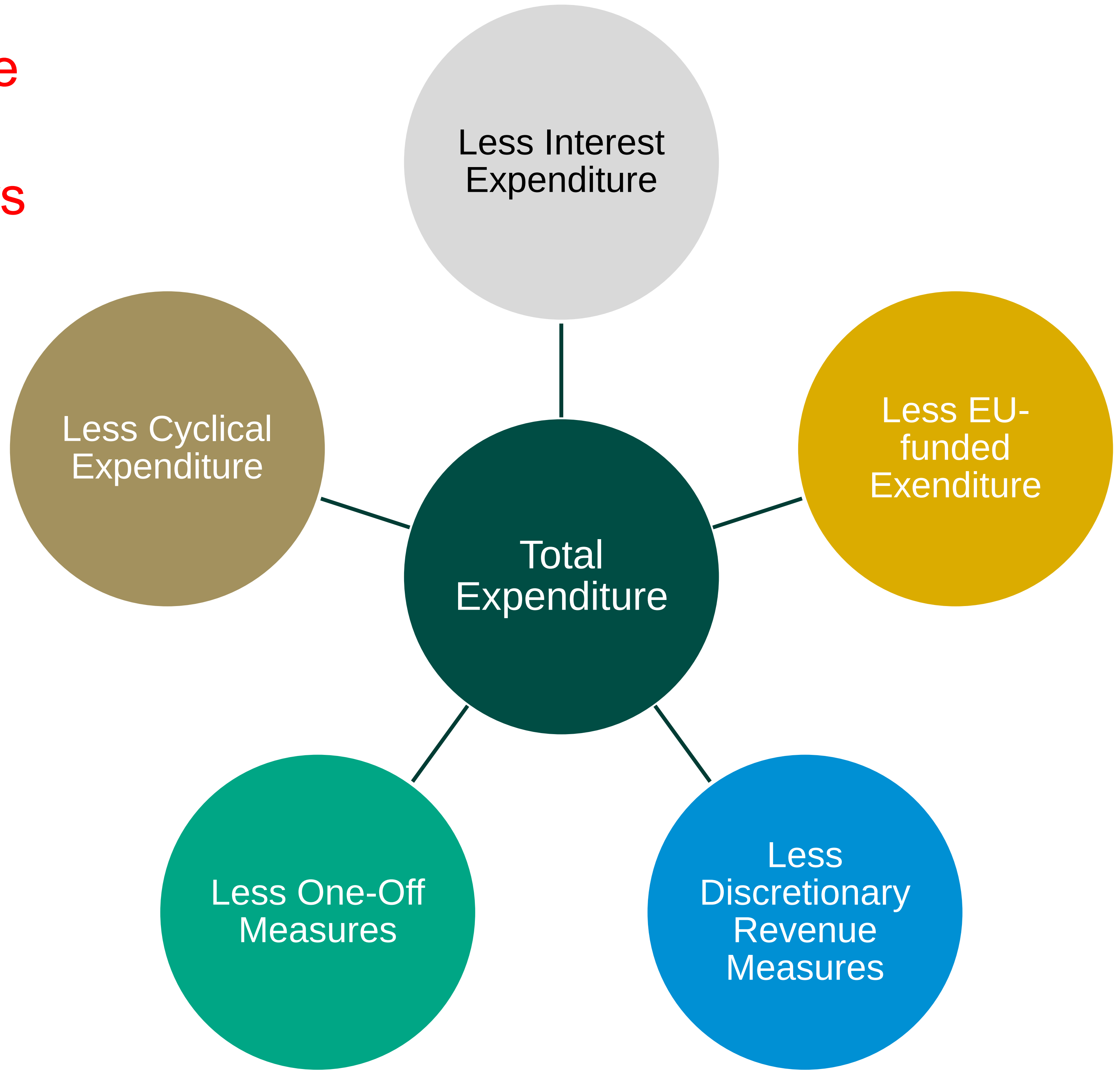
matthew.mcgann@finance.gov.ie

ANNEX

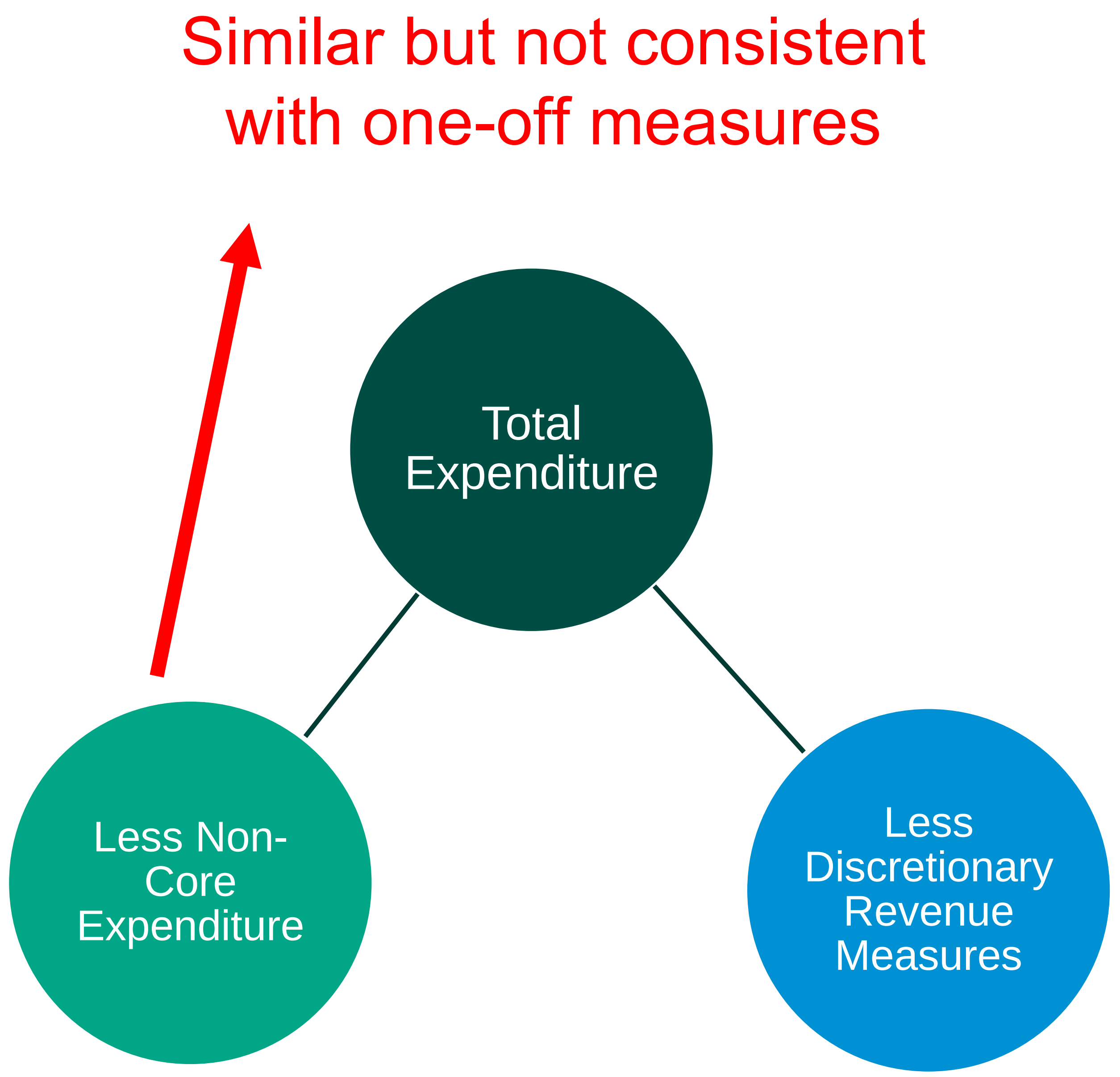
Measures of expenditure



Current EU Expenditure Benchmark: must grow below potential GDP growth (if not at MTO)



Proposed EU Net Expenditure: must grow in line with agreed fiscal plan (i.e. in line with a debt sustainable path)



IE Expenditure Rule: must grow in line with estimate of potential output growth (currently 5 per cent)

Debt sustainability analysis: projections

DSA projects a baseline scenario of debt dynamics for all Member States and computes the minimum adjustment required to meet the criteria – known as the technical fiscal trajectory. This process includes scenarios of several different shocks and stochastic projections (i.e. probable range of outcomes) to account for uncertainty over the medium term. Projections include the cost of population ageing.

- Baseline scenario (10 years)
  - **No fiscal policy change** assumption beyond the 4-year fiscal-structural plan, but cost of ageing incorporated (as projected in Ageing Report)
  - GDP growth in line with EU commonly agreed methodology
  - Inflation and interest rates gradually converge to long-term values
- Alternative scenarios (10 years)
  - **Lower Structural Primary Balance (SPB):** weaker SPB vs baseline
  - **Adverse *'r-g'* differential**: less favourable snowball vs baseline
  - **Financial stress**: one-year shock on market interest rates
- Stochastic projection (5 years)
  - 2,000 shocks applied to baseline in terms of interest rates, growth, and primary balance
  - This give a range of outcomes for the debt ratio which can be associated with different probabilities
  - Can attach probability to debt ratio not increasing over 5 year period post-adjustment, COM criterion that this is > 70 per cent

Criteria 1 and 3: Debt and deficit

Criterion 2: Debt declining with sufficient probability