Irish Fiscal Advisory Council

Strengthening Ireland's Fiscal Institutions

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All remaining errors and omissions are the responsibility of the Council.

Foreword

The Irish Fiscal Advisory Council was established in June 2011 as part of a wider agenda of reform of Ireland's budgetary architecture as envisaged in the Programme for Government. Forthcoming legislation under the 'Fiscal Responsibility Bill' (FRB) will recognise the Council as an independent body.

The role of the Council is to independently assess, and comment publicly on, whether the Government is meeting its own stated targets and objectives. The Council will assess the appropriateness and soundness of the Government's macroeconomic projections, budgetary projections and overall fiscal stance. The Council will also examine the extent of compliance with the Government's fiscal rules. The Council will perform other functions as may be assigned by the Minister for Finance.

The Council is initially being funded through a grant-in-aid provided by the Irish Government. The Council's long-term funding will be considered in the context of the FRB which is to be published in the coming months.

Under the EU/IMF Programme of Support, Ireland is committed to implementing a wide range of reforms in the area of budgetary management. This report is the Council's response to the Department of Finance's *Reforming Ireland's Budgetary Framework: A Discussion Document*, which was published in March 2011. This report was prepared at a time of discussions on major changes in economic governance in the Euro Zone and reflects the Council's thinking as of 22 January 2012.

The Council is chaired by Professor John McHale, National University of Ireland, Galway. The other Council members are Mr Sebastian Barnes, Organisation for Economic Co-operation & Development; Professor Alan Barrett, Trinity College Dublin (on secondment from the Economic & Social Research Institute); Dr Donal Donovan, University of Limerick (formerly Deputy Director at the International Monetary Fund) and Professor Róisín O'Sullivan, Smith College, Massachusetts.

Glossary

Automatic Stabilisers: An institutional feature of an economy that dampens its macroeconomic fluctuations, e.g., an income tax, which acts like a tax increase in a boom and a tax cut in a recession.

Budget Balance: The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit.

Central Government: All departments, offices, establishments and other bodies classified under general government, which are agencies or instruments of the central authority of a country, except separately organised social security funds.

Cyclical Adjustment: The adjustment of figures such as GDP, government spending, tax revenues, or the budget deficit to show what they would be if total activity was at its trend or potential level.

Cyclically Adjusted Budget Balance (CABB): This is the actual budget balance net of the cyclical component. The CABB gives a measure of the underlying trend in the budget balance. The structural balance is the CABB excluding one-off items.

Debt Sustainability: The ability of a debtor country to service its debt on a continuing basis.

Deficit Bias: The tendency of governments to allow deficit and public debt levels to increase.

Discretionary Fiscal Policy: The implementation of non-mandatory changes in taxation, spending, or other fiscal activities by a government in response to economic events or changes in economic conditions.

Fiscal Drag: Fiscal drag is the (endogenous) effect of changes in economic activity and incomes on tax revenues due to the progressivity of the tax system.

Fiscal Policy: Any macroeconomic policy involving the levels of government purchases, transfers, or taxes, usually implicitly focused on domestic goods, residents, or firms.

Fiscal Rule: A fixed constraint on fiscal policy which is usually defined in terms of an indicator of overall fiscal performance and is often expressed as a numerical ceiling or floor.

Fiscal Space: Fiscal space is the difference between the current level of debt and the sustainable debt limit.

Fiscal Stance: A measure of the intended impact of discretionary fiscal policy. It can be defined as the change in the primary structural budget balance relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General Government Balance (GGB): The GGB measures the fiscal performance of all arms of government. It provides an accurate assessment of the fiscal performance of a more complete government sector. The GGB does not reflect the position of commercial State sponsored bodies as these agencies are classified as being outside the general government sector.

MTO: The EU Medium-Term Objective which sets a country-specific numerical benchmark for the structural budget balance of the general government. The MTO cannot be lower than a structural deficit of 0.5 per cent of GDP.

Output Gap: The output gap is the difference between actual output and estimated potential output at a particular point in time.

Potential GDP/Potential Growth: The level of real output/GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, resources are lying idle and inflationary pressures abate.

Primary Balance (PB): Government net borrowing or net lending excluding interest payments on consolidated government liabilities.

Structural Budget Balance (SBB): See Cyclically Adjusted Budget Balance.

Executive Summary

Introduction

This report assesses elements of the National Fiscal Framework proposed in the Department of Finance's March 2011 Discussion Document *Reforming Ireland's Budgetary Framework*. The main focus of the report is on the proposed designs of a set of fiscal rules and a permanent independent fiscal advisory council.

The design of a new fiscal framework takes place against the backdrop of a number of on-going developments aimed at strengthening economic governance and fiscal institutions in the Euro Zone. There is also a commitment for Ireland under the EU/IMF programme to publish a Fiscal Responsibility Bill in the coming months. The escalation of the Euro Zone crisis in recent months has brought the issue of fiscal rules and institutions into an even sharper public focus.

Fiscal Institutions for Better Fiscal Policy

While the economics literature does not speak with one voice on "good fiscal policy", there is reasonably broad agreement on the principles of sound fiscal macroeconomic management. Sound management of the public finances should follow a number of key principles which can be summarised under three broad headings: sustainability, stability and counter-cyclicality. Unfortunately, the principles of sound fiscal management can pull in different directions and committing to the principles of sound public finances can be difficult. The latter is evident by the persistent deficits and high debt-to-GDP levels in many industrialised countries.

Fiscal rules and independent fiscal agencies with specific limited mandates can help narrow the gap between desirable and actual fiscal policies. The fiscal rules literature suggests that rules can help sustain fiscal consolidation efforts and maintain fiscal discipline. The design of fiscal rules is, however, complex, and is made even more difficult in a small open economy susceptible to shocks. Successful fiscal rules require an appropriate balancing of the principles of sound fiscal management (flexibility) and the capacity to influence fiscal policy (credibility). Due to this trade-off, there is a growing interest in the use of independent fiscal councils, which can be both a substitute for and a complement to numerical fiscal rules. Fiscal councils can provide an alternative mechanism for raising the political costs of inappropriate policies, while continuing to allow a role for necessary judgement. Such councils can also be used for *ex ante* monitoring of fiscal plans and *ex post* monitoring of fiscal performance.

Fiscal Rules

Fiscal rules in Ireland, in conjunction with an independent fiscal council, can play an important role in improving macroeconomic and fiscal performance. The design of the new national fiscal framework, however, must take into account requirements stemming from EU obligations under the *Stability and Growth Pact* (SGP) and the directive on national budgetary frameworks. Other elements of the overall context include the political commitment regarding a balanced budget in structural terms and the 'Fiscal Compact' which was agreed in December 2011 and which will be the basis of the proposed Treaty. In so far as they are known, this report takes these EU-level rules as given. However, the implementation of the EU rules in the national fiscal framework should recognise that margins of flexibility in the application of these rules will be required to ensure a sound path for fiscal policy.

The Department of Finance proposal contains three rules, closely related to the SGP:

The Public Finances Correction Rule (PFCR) applies only when either the general government (GG) deficit or GG debt exceeds 3 per cent or 60 per cent of GDP respectively. This rule controls the pace of budgetary correction by specifying the extent to which the primary budget balance as a percentage of GDP should be improved annually. If the GG deficit exceeds (or is projected to be in excess of) the 3 per cent ceiling or if the GG deficit ceiling is met but the GG debt is (or is projected to be) in excess of 90 per cent of GDP, a minimum consolidation of 1.5 percentage points of the primary balance is required. If the GG deficit ceiling is met and the GG debt is less than 90 per cent but greater than 60 per cent, the minimum required consolidation is 0.75 percentage points. There is a ceiling on the required primary balance of 4 per cent.

The Prudent Budget Rule (PBR) applies when both the 3 per cent GG deficit and 60 per cent GG debt ceilings under the SGP are being met but the Medium-Term Objective (MTO) is projected not to be met. There is a required minimum adjustment of 0.5 percentage points in the cyclically adjusted primary budget balance unless a smaller adjustment reaches the MTO. An exception applies if the specified adjustment causes the primary budget surplus to exceed 4 per cent of GDP.

The Sustainable Expenditure Growth Rule (SEGR) limits gross current government expenditure growth to the underlying medium-term nominal rate of economic growth, unless and to the extent that a higher rate of growth in expenditure in any year is met by a discretionary increase in taxes. It applies when both the 3 per cent deficit and 60 per cent GG debt ceilings are met and when the GG deficit is projected to meet the MTO.

The Department of Finance rules contain a number of desirable features that could help narrow the gap between sound and actual fiscal policies. However, the rules lack flexibility in some respects (especially with regard to cyclical sensitivity), which could at times lead to unsound policies and could undermine the credibility of the framework. The Council makes a number of recommendations aimed at improving the credibility-flexibility trade-off and strengthening the overall framework.

The enforcement of fiscal rules must balance flexibility and credibility, a trade-off that is improved by the existence of an independent fiscal council. The Fiscal Responsibility Bill should put the proposed fiscal rules in legislation. The Department of Finance proposes a "soft enforcement" mechanism in the form of a "comply or explain" requirement. The Minister would be required to explain to the Oireachtas deviations from the rules in prospective plans. While the requirement for such explanations is likely to impose a reputational cost on the Government, this cost is likely to be at the mild end of the spectrum, and thus would have limited effects on incentives for fiscal discipline and sound fiscal management. Therefore, while the proposed rules themselves are quite rigid and demanding, the enforcement mechanisms might not credibly constrain fiscal policy.

As a complement to proposals to introduce more flexibility into the rules and to ensure that the rules have a strong binding character, the Council recommends that the "enforcement" mechanisms be strengthened. The Council proposes that:

- A set of principles of sound fiscal management be clearly set out in legislation.
- Each new Government should set out an explicit target for the debt-to-GDP ratio over a five-year period as well as an indicative ten-year target. This would form part of a Fiscal Statement for Government.
- The Minister should be required to explain to the Oireachtas any actual or prospective deviations from the Government's stated fiscal targets and rules. This would encompass an annual report to the Oireachtas which would be assessed by the Council.

With regard to the implementation of the rules, the Council proposes the following:

PFCR

- The operational rule should be specified in terms of the cyclically adjusted primary balance (CAPB). The required consolidation of the CAPB of 0.75 or 1.5 percentage points should be specified in terms of discretionary fiscal adjustments.

- The proposed ceiling on the required primary balance should be replaced by a maximum required percentage point reduction in the debt-to-GDP ratio.

PBR

- The PBR should apply once the 60 per cent debt limit and 3 per cent deficit limit are reached.
- Application of the rule should be based on the domestic measures of the cyclically adjusted primary balance.
- The proposed ceiling on the required primary balance should be replaced by a maximum required percentage point reduction in the debt-to-GDP ratio.

SEGR

- Expenditure growth rules that do not allow for automatic stabiliser-related spending could force excessively pro-cyclical adjustments and are also unlikely to be credible. It is recommended that interest payments, unemployment benefits and possibly other cyclically sensitive welfare spending be excluded from the measure of expenditure, but that the categories be defined with considerable precision to limit circumvention of the rule.
- The SEGR at present allows for rates of growth in spending above the underlying rate of growth of the economy if such increases are financed through taxation. However, it should be clearly stated that the increase in taxation must be structural in nature and not the result of increased revenues arising from above-trend economic growth. Recent Irish experience has shown the difficulties that ensue from the practice of increasing public spending based on transitory revenues.
- The SEGR should apply to total general government expenditure. However, with low levels of public investment during the consolidation phase, care must be taken that the rule does not prevent economically efficient capital spending.

In the proposed Department of Finance rules, there is no facility or mechanism by which cumulative errors are corrected. In this regard, consideration could be given to some form of "debt brake". Such a mechanism would allow for some necessary flexibility in the face of shocks, but would also put a "brake" on how far the debt ratio can drift from the Government's target path.

The Council supports the need for an escape clause in the event of exceptional circumstances, backed by a clear statement by the Minister for Finance with approval from the Oireachtas and an opinion from the Fiscal Council.

Given the need for flexibility in good rule design, the interpretation and application of a particular rule or rules is likely to involve significant elements of judgement.

The Design of the Fiscal Council

In setting up the Council, the Irish Government was following a developing trend in fiscal management. A number of inherent weaknesses in adhering to the principles of sound public finance management also stand out in the Irish experience not least the volatility and exceptional developments of recent years. The mandate of the Irish Fiscal Advisory Council, which is taken as given, is to independently assess, and comment publicly on, whether the Government is meeting its own stated targets and objectives. The Council is to assess the appropriateness and soundness of the Government's macroeconomic projections, budgetary projections and fiscal stance. The Council will also examine the extent of compliance with the Government's fiscal rules and it will perform other functions as may be assigned by the Minister for Finance.

If the Council is to be effective in encouraging the adoption of a more sustainable fiscal policy, its design must contain some key elements. The Council needs to be designed in a way whereby a government that ignores its advice or observations incurs a certain reputational cost. For this to be the case, the Council needs to be viewed as a body that is both analytically sound in terms of its economic analysis and independent from political influence. In this regard, the members of the Council must be highly-qualified professionals with expertise in the areas of macroeconomics and fiscal policy.

Members of the Council, including the Chair, should be appointed by the Minister for Finance, with the approval of the Government for a four year once renewable period. The Minister could terminate a Council member's appointment only on grounds of misconduct, conflict of interest, or the inability of the member to carry out their duties. Such a termination would only take place after prior approval of the relevant Committee of the Oireachtas. Except in the case of the Chair itself, any proposals to terminate the appointments of Council members should also pay due regard to the views of the Chair on the matter.

Concerning independence, any suggestions or suspicions of political or official interference in the activities of the Council will seriously undermine the authority of the Council. The Council must also be accountable and transparent with its work open to public scrutiny.

The Council should have sufficient resources to allow it to fulfil its mandate. The Council should provide for approval on an annual basis to the Minister/

Department of Finance a proposed overall budget for the coming year as well as an indicative budget for the following two years. The Council believes that that no public sector member should gain financially from their Council work. The Council recommends that Council members employed by the Irish public sector should receive a buy-out of time commensurate with that needed to fulfil the mandate set down by the Government. Comparable compensation would be provided to other members or their employers as appropriate.

The Council should be transparent in its day-to-day operations. In this regard, material relating to the composition of the Council, its overall budget, meetings and its reports should be posted on the Council's website. Regarding accountability, the Council should stand ready to meet with the relevant committee of the Oireachtas, at the latter's initiative, to discuss its reports and activities. The Council believes it would be helpful for the Minister/Department of Finance to respond in writing to the Council's assessments and recommendations on a regular basis.

It is recommended that the Minister for Finance request a peer review of the Council's activities by recognised outside experts on a regular basis which would be published on the Council's website. The first such peer review should be conducted within two years of the formal establishment of the Council in order to provide a timely assessment of the initial phase of its operations.

To the extent required, the Council should enter into structured arrangements with other Irish public sector institutions so as to ensure an appropriate flow of statistical or other information needed for the Council's work. Such arrangements might, in some instances, take the form of a written Memorandum of Understanding.

1. Introduction

This report assesses specific elements of the National Fiscal Framework proposed in the Department of Finance's March 2011 Discussion Document *Reforming Ireland's Budgetary Framework*. Although the 'Discussion Document' ranges more widely, the focus of this report is on the proposed designs of a set of fiscal rules and a permanent independent fiscal advisory council.

The design of a new fiscal framework takes place against the backdrop of a number of on-going EU developments. As part of the "six-pack" of measures to strengthen EU fiscal institutions, a new directive on national fiscal frameworks has been put in place and EU leaders have made additional commitments on budgetary surveillance, including the 'Fiscal Compact' that will lead to a new Euro Zone treaty.[1] For Ireland, the EU/IMF programme contains a commitment to the publication of a 'Fiscal Responsibility Bill' in the coming months. With the escalation of the Euro Zone crisis in the latter part of 2011, the issue of fiscal rules came into sharp public focus.

With these various international developments, it is easy to see more stringent fiscal institutions being imposed from the outside. Given the interdependencies between countries in an economic and monetary union, Member States have certain legitimate interests in one another's fiscal policies. More importantly, however, there is an extensive literature in economics that examines the role that fiscal institutions can play in improved macroeconomic policy and performance at a national level. While consistency with external commitments must be kept in mind when designing the new national fiscal framework, our primary consideration is how the framework affects domestic economic and social objectives.

The rest of the report is organised into three chapters. Chapter 2 draws on the relevant economics literature to briefly outline the case for fiscal institutions – rules and independent fiscal agencies. In Chapter 3, we assess the set of rules and enforcement procedures proposed in the March 'Discussion Document', and make a number of recommendations aimed at improving the effectiveness of the rules. Chapter 4 considers a number of issues relating to the design of a permanent independent fiscal advisory council. The mandate of such a council, as proposed by the Department of Finance, is taken as given and the discussion focuses on issues relating to capacity, independence, transparency and accountability.

[1] Further details on the "six-pack" can be found at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898

2. Fiscal Institutions for Better Fiscal Policy

2.1 Introduction

To help put our assessment of proposed fiscal rules and the permanent independent fiscal advisory council in context, this chapter briefly reviews arguments for strengthening fiscal institutions for better macroeconomic performance. While the economics literature does not speak with one voice on "good fiscal policy", there is reasonably broad agreement on the principles of sound fiscal management. After reviewing these principles, we draw on relevant economics literature to argue that biases can exist under unconstrained discretionary fiscal policy. This is followed by a discussion of how various fiscal institutions – notably fiscal rules and independent fiscal agencies with specific limited mandates – can help to narrow the gap between desirable and actual fiscal policies. The purpose of such rules and agencies is not to supplant democratic control over fiscal policy, but to allow that control to operate in a way that limits the damaging effects of unconstrained policy that hinders the achievement of a country's economic and social objectives.

2.2 Principles of Sound Fiscal Management

The State aims to meet a range of social objectives subject to a budget constraint. Sound management of the public finances should follow a number of key principles, which can be summarised under three broad headings: ***sustainability***, ***stability*** and ***counter-cyclicality***. These principles leave open the question of the size of the State in the economy, which is a matter of social and political choice.

Sustainability

A basic condition for fiscal sustainability is that the debt-to-GDP ratio is stable at an appropriate level or can reasonably be expected to become so in the future. Concerns about sustainability lead to increased perceptions of default risk. Such perceptions in turn lead to high interest rates being demanded by investors, which can further undermine perceived sustainability.

Recent events in the Euro Zone have shown how susceptible states can be to self-fulfilling crises of confidence. States without their own independent monetary policy are especially vulnerable. While debt sustainability is a necessary condition for a state's creditworthiness, the Euro Zone crisis has revealed a degree of "debt intolerance" that is greater than previously understood. Sound fiscal management requires achieving and sustaining safe debt levels, including a margin – "fiscal space" – to allow for unanticipated macroeconomic shocks.

Stability

Economic theory points to the value of stable tax and benefit rates over time. For a given level of government spending, economic efficiency is enhanced by stable tax rates. This is because economic distortions associated with taxation tend to rise in a non-linear way with the tax rate. Total tax-related distortions are lower with a stable tax rate than with one that fluctuates. It is also important that intergenerational equity concerns are factored into tax and expenditure policies.

Counter-Cyclicality

Fiscal policy can play an important stabilising role in the face of macroeconomic shocks. This occurs through the operation of automatic stabilisers – e.g., expenditures such as unemployment benefits increase and most taxes decrease in a recession – or through discretionary policies that "lean against the wind" of the economic cycle. The counter-cyclical role of fiscal policy is especially important where monetary policy is ineffective or cannot be used. In terms of the former, such a situation could arise when the interest rate has hit the zero lower bound. In terms of the latter, monetary policy is effectively a given for a small country within a large monetary union.

Unfortunately, the principles of sound fiscal management can pull in different directions. The balancing of principles can be especially challenging where there is high debt (and low creditworthiness), ageing related spending pressures and weak domestic demand. The principles of sustainability and stability point to the need to bring the debt down to safer and (inter-generationally) fairer levels. In contrast, the principle of counter-cyclicality points to the need to use fiscal policy to offset weak demand.

2.3 Challenges of Sound Fiscal Management

Committing and adhering to the principles of sound public finances can be difficult, as evidenced by the fact that most industrialised countries have experienced persistent deficits and a trend rise in the debt-to-GDP ratio. Indeed, a fundamental problem in the management of the public finances is the phenomenon of "***deficit bias***". While there are a number of explanations for this phenomenon, the predicted outcome is that governments have a tendency to allow public debt levels to climb.[2] Deficit bias is not just a theoretical notion. Over the past forty years, there have been many examples

[2] Hagemann (2011) notes that a number of factors, including electoral pressures, cause fiscal policy to suffer from severe deficit bias. Fiscal rules have, therefore, become "... an effective institutional means of addressing such bias".

of an upward drift in public debt levels, with the recent experience across the OECD membership being a particularly acute case.[3]

It can be difficult for politicians to set fiscal policy on a prudent basis. There are two key problems. The ***common pool problem*** occurs where some groups have influence over expenditure or taxation and can pass on the costs of their preferred policies to others, including future tax payers. The result is a bias towards deficits. This effect can be especially pronounced in good times – the so-called "voracity effect" – leading to a pro-cyclical bias. The ***short time horizon ("myopia") problem*** results from political time horizons or because current generations care too little about future generations. This creates a bias towards high spending or low taxes today, financed by debts payable in the future.

A further set of problems can result from the difficulties in credibly committing to future policies – the **time inconsistency problem**. One manifestation is the "soft budget constraint": a government may threaten to enforce hard budget constraints on spending departments – say in the areas of health or education – but may be unwilling to enforce these constraints after budgets are exceeded. Another manifestation occurs with commitments not to default. In order to secure low interest rates on its borrowing, a government may wish to commit not to default on its debts, but potential investors may realise that such commitments are not binding. Although the need to protect a reputation for creditworthiness can help to overcome an *ex post* incentive to default, the inability to make binding commitments can still result in a default premium. Under certain circumstances, expectations of default can become self-fulfilling, where a large default premium undermines the willingness and capacity to meet debt obligations.

Even well-intentioned policymakers can make serious mistakes, leading to bad fiscal outcomes. Policy decisions are made against the background of uncertainty about the future performance of the economy or when understanding of the economy is incomplete. This problem is highly relevant to Ireland with its relatively specialised and highly open economy, as well as the structural transformation of the economy over the past twenty years. With these challenges in mind, there is growing interest internationally in how fiscal institutions can help narrow the gap between sound fiscal management and the actual fiscal policies delivered by the political system.

[3] It is important to draw a distinction between "deficit bias" and recent experiences, as the former tends to refer to excessive deficits during good times.

2.4 Narrowing the Gap: The Role of Fiscal Institutions

Fiscal Rules

Kopits and Symansky (1998) define fiscal rules as "... a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance....often expressed as a numerical ceiling or target, in proportion to gross domestic product". Hagemann (2012) describes a fiscal rule as something which should "... constrain the government to deliver disciplined fiscal policy". A critical feature of fiscal rules is that once they are introduced they should be applied on a permanent basis, by successive governments. As Taylor (1993) points out, rules are not seen as credible unless they involve commitment over several business cycles. One of the better known examples of such rules is the Gramm-Rudman-Hollings Act, enacted in the US in 1985.[4] In Europe, the *Stability and Growth Pact* (SGP) is another example whereby, in broad terms, debt was to be kept below 60 per cent of GDP and deficits were not to exceed 3 per cent of GDP.

In delivering disciplined fiscal policy, fiscal rules should contribute to fiscal stability, ensure sustainability of public debt and take into account counter-cyclical fiscal stances. A wide range of rules are in place worldwide—all of which, according to Hagemann (2012), are a variant of one of four types. The most prevalent rules are those that constrain either the stock of debt or the budget balance as a share of GDP. The four classes of rules are:

- Budget balance rules: these can set a target for the overall balance or the current balance. The targets, which can be set for a particular year or over the medium-term, are easy to monitor but can result in pro-cyclical policy. Rules can also target a cyclically adjusted or structural budget balance which allows automatic stabilisers to operate over the cycle.
- Debt rules: these specify an explicit target for public debt as a percentage of GDP. The target is met by adjusting the budget balance. Debt rules also need to be carefully designed so that they avoid pro-cyclicality.
- Expenditure rules: these are designed to constrain expenditure, especially during cyclical upswings. A key issue with expenditure rules is the coverage. For example, there are economic arguments for excluding cyclically sensitive items such as unemployment benefits and/or expenditure for capital purposes but these have to be weighed against the danger that such exclusions could lead to excessive reclassification of expenditure items.

[4] The Balanced Budget and Emergency Deficit Control Act of 1985.

- Revenue rules: these can set a cap on the tax burden or a floor on revenues, or they can establish *ex ante* the uses to which forecasted receipts can be put.

The effectiveness of fiscal rules has been studied by the EC (2006; 2009), the IMF (2009) and Guichard *et al.* (2007), among others. There is evidence that fiscal rules can help sustain fiscal consolidation efforts and maintain fiscal discipline.[5] The IMF (2009) shows that early debt reduction is greater and improvements in the deficit are more sustained in countries that use rules than those that do not. The literature also suggests that rules that combine targets for the budget balance with expenditure targets are most effective.

The design of fiscal rules is complex, made even more difficult in a small open economy subject to shocks. Poorly designed fiscal rules may force inappropriate fiscal adjustment or simply fail to constrain policy in an appropriate way. On the other hand, if the rules are made too flexible and easy to override, they can lose their potential to constrain unsound fiscal management. Taking the SGP as an illustration, it can readily be seen that fiscal rules, by themselves, can lack the required strength to constrain undesirable fiscal manoeuvre, where "undesirable" is defined in terms of breaches of the rules. For this reason, fiscal councils have emerged as a potential additional (or alternative) element in the institutional infrastructure aimed at achieving better fiscal outcomes. In theory, such councils could be given control over fiscal policy or at least broad fiscal aggregates. More generally, however, fiscal councils are given advisory and monitoring roles as envisaged in the case of the Irish Fiscal Advisory Council.

Independent Fiscal Councils

Successful fiscal rules require an appropriate balancing of the principles of sound fiscal management (flexibility) and also the capacity to actually influence fiscal policy (credibility). Unfortunately, flexibility and credibility can pull in different directions, as more flexibility can reintroduce greater discretion and its associated political biases (Calmfors, 2011). Drawing on the experience of independent central banks in the conduct of monetary policy, there is growing interest in the use of fiscal agencies to improve the flexibility-credibility trade-off.

The ECB (2010), the EC (2010a, 2010b) the OECD (in various Economic Surveys) and IMF staff (Annett *et al.*, 2005; Kumar and Ter-Minassian, 2007; IMF, 2009) maintain that better fiscal performance could be ensured through the establishment of independent fiscal watchdogs. In his report for Ireland's Joint Committee on Finance and the Public Service, Lane (2010) argues that

[5] There is some debate about whether better fiscal performance under rules reflects the greater tendency of disciplined governments to adopt rules in the first place.

the key to insulating the fiscal process is to find institutional devices that assist governments in maintaining an appropriate fiscal stance.

Debrun *et al.* (2009) distinguish between fiscal authorities – which have the power to make fiscal decisions in well-defined areas – and fiscal councils – which have an advisory/assessment role. They outline the conditions required for feasible delegation of economic policy decisions to an independent authority: failures with the existing system should have been clearly identified; there should be reasonable agreement on the objectives of policy; the policy should have limited redistributive implications; and there should be limited coordination issues between the policy in the relevant area and other policy areas. There is reasonable agreement that these conditions can be met for monetary policy, which has led to a trend towards independent central banks with well-specified objectives. Examples of independent central banks with an inflation-targeting mandate include the Bank of England, the Bank of Canada and the European Central Bank. For fiscal policy, however, disagreements over objectives and the redistributive impact of policies have led to reluctance to delegate fiscal authority to independent bodies, even with regard to the size of fiscal deficits. Debrun *et al.* (2009) note that there are no examples of independent fiscal authorities. Instead, independent agencies take the form of fiscal councils that advise, assess and/or take responsibility for macroeconomic forecasting and budgetary projections (see Box A).

Fiscal councils can be both a substitute for and a complement to numerical fiscal rules. In substituting for fiscal rules, a fiscal council could provide an alternative mechanism for raising the political costs of inappropriate policies, as a respected public body is in place to assess a government's fiscal policy. However, there is increasing interest in using fiscal councils as a complement to fiscal rules. As already noted, dangers with fiscal rules are that they can be subject to manipulation and can lack flexibility in the face of economic shocks. The more flexibility built into the rules, the more likely it is that opportunities for manipulation will arise.

Fiscal councils can be used for *ex ante* monitoring of fiscal plans and *ex post* monitoring of fiscal performance. They can also allow for credible use of more contingency-based rule designs.

Box A: Fiscal Councils

Fiscal advisory councils can play several roles: making macroeconomic forecasts and budgetary projections; assessing government forecasts and projections; assessing compliance with fiscal rules; and assessing the appropriateness of the government's fiscal stance. Control over fiscal policy remains with elected officials. However, fiscal councils can improve the analysis of fiscal policy and potentially raise the political costs of inappropriate fiscal decisions.

Fiscal councils have recently been established in countries such as Portugal (2011), the UK (2010), Sweden (2007) and Canada (2006), thereby joining those such as the Netherlands, the US and Denmark where such councils have existed for some time. The mandate and design of fiscal councils varies considerably between countries. The Office for Budget Responsibility in the UK is tasked with the production of forecasts for the economy and the public finances. It must also judge the Government's progress towards its fiscal targets and predict the probability that these targets will be met. Other elements of the mandate include assessing the long-term sustainability of the public finances and estimating the cost of budget measures. The Swedish Council, on the other hand, has a mandate to provide an independent evaluation of the Swedish Government's fiscal policy objectives such as the fiscal stance, long-run sustainability, the budget surplus target, and the central government expenditure ceiling. The Swedish Council also reviews the Government's economic forecasts and the models used to achieve them but it does not generate its own set of forecasts.

3. Fiscal Rules

3.1 Introduction

This chapter reviews the Department of Finance proposals for national fiscal rules, as set out in the 'Discussion Document', which aim to achieve sound fiscal management and consistency with EU Treaty commitments and rules.[6] In reviewing the proposals, we focus on both the effectiveness of the proposed rules, in terms of their ability to credibly influence fiscal policies, and how they balance the often competing principles of sound fiscal management.

As regards effectiveness, the well-known failures of the SGP, with numerous countries breaching the 3 per cent and 60 per cent deficit and debt limits, have led to understandable scepticism that fiscal rules will in fact be respected and, thus, influence actual fiscal policies. Mechanisms that improve the likelihood that the rules will be adhered to are needed. In terms of balancing the (at times) competing principles of sound fiscal management, the Council is sensitive to concerns that the application of the rules will force pro-cyclical deficit and debt reductions. Although there is no easy escape from the hardships of bringing deficits and debts to safe levels given the starting point, the design of rules appropriate for Ireland should aim to limit pro-cyclicality bias while reinforcing the credibility of long-run debt sustainability.

The discussion acknowledges the need to comply with the EU fiscal framework, including the requirement for Member States to enshrine numerical fiscal rules in national law. As noted in footnote 6, there is a high degree of fluidity in the international context. The implementation of the EU rules in the national fiscal framework should recognise that margins of flexibility in the application of the EU rules (for example where the EU Commission or Council are expected to exercise judgement or where exceptional circumstances can be evoked) will be required to ensure a sound path for fiscal policy.

This chapter is structured as follows. The proposed Department of Finance rules are outlined in Section 3.2 and are assessed in Section 3.3. Section 3.4 reviews some general specification and measurement challenges associated with the design of the numerical fiscal rules. Section 3.5 draws from this discussion to make a number of recommendations to improve the credibility-flexibility trade-off and to strengthen the proposed framework. Section 3.6 discusses the limitations of fiscal rules in general.

[6] At the time of writing, elements of the EU framework are still evolving, including a final version of the 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union' and proposals from the European Commission for further changes to economic governance. References in this chapter reflect the situation as of 22 January 2012.

3.2 The Proposed Department of Finance Rules

Ireland is required to comply with its EU obligations under the SGP and the directive on national budgetary frameworks. Ireland also has to take into account the political commitment regarding a balanced budget in structural terms. The proposed Department of Finance rules are closely related to the revised EU SGP (i.e., there are thresholds for the deficit at 3 per cent of GDP and the debt-to-GDP ratio at 60 per cent, there is a rule set in relation to the EU Medium-Term Budgetary Objective (MTO) for the budget balance in cyclically adjusted terms and there is an expenditure rule). Political commitments and the proposed European Treaty point towards a European requirement for national legislation to require a balanced budget in cyclically adjusted terms, defined as a structural deficit of no more than 0.5 per cent of GDP, with an automatic mechanism to ensure improvement if this standard is not met.

Three fiscal rules for Ireland are proposed in the 'Discussion Document'. The rules are intended to be in operation generally one at a time and to have effect prospectively. The rules are summarised in Box B. A summary of the EU rules is provided in Box C.

Box B: Proposed Fiscal Rules from the Department of Finance 'Discussion Document'

1. Public Finances Correction Rule (PFCR)

This rule applies only when either the general government (GG) deficit or GG debt exceeds 3 per cent or 60 per cent of GDP respectively. This rule controls the pace of budgetary correction by specifying the extent to which the *primary budget balance as a percentage of GDP* should be improved annually.

Two minimum rates of consolidation, depending on the deficit and debt levels, are required. Specifically, if the GG deficit exceeds (or is projected to be in excess of) the 3 per cent ceiling or if the GG deficit ceiling is met but the GG debt is (or is projected to be) in excess of 90 per cent of GDP, a minimum consolidation of 1.5 percentage points of the primary balance is required. If the GG deficit ceiling is met and GG debt is less than 90 per cent but greater than 60 per cent, the minimum required consolidation is 0.75 percentage points. There is a ceiling on the required primary balance of 4 per cent.

2. Prudent Budget Rule (PBR)

This rule applies when both the 3 per cent GG deficit and 60 per cent GG debt ceilings under the SGP are being met but the MTO is projected not to be met.

The stability programme must include a plan for consolidation of the *cyclically adjusted primary budget balance* in the next year. There is a required minimum adjustment of 0.5 percentage points in the *cyclically adjusted primary budget balance* unless a smaller adjustment reaches the MTO.

(*Note*: the MTO is defined in terms of the overall structural balance.) An exception applies if the specified adjustment causes the primary budget surplus to exceed 4 per cent of GDP, in which case the required adjustment (if any) is limited to the amount up to that ceiling.

3. Sustainable Expenditure Growth Rule (SEGR)

This rule applies when both the 3 per cent deficit and 60 per cent GG debt ceilings are being met and when the GG deficit is projected to meet the MTO, i.e., all SGP requirements are satisfied. The rule limits gross current government expenditure growth to the underlying medium-term nominal rate of economic growth unless, and to the extent that, a higher rate of growth in expenditure in any year is met by a discretionary increase in taxes.

Box C: EU Fiscal Rules

Budgetary policy in Ireland is subject to a number of requirements under the proposed EU Treaty and the SGP. The EU framework commits all Member States to avoid running deficits on their public finances greater than 3 per cent of GDP, and to maintain debt levels below 60 per cent of GDP. Under the MTO, the structural balance should reach and be held at a level to contribute to long-term stability, but any structural deficit cannot be greater than 0.5 per cent of GDP.

A revised framework for fiscal and economic governance in the EU was approved in 2011 through five regulations and a directive – known as the 'six-pack'. The new package aims to provide greater clarity around the previous rules, improve enforcement by the EU Council through procedural changes, introduce a new mechanism of sanctions and improve statistical information. The sanctions include new interest and non-bearing deposits as well as fines of 0.2 per cent of GDP.

There are two substantive changes to the pre-2011 rules. First, the debt convergence rule will require that for countries with debt above 60 per cent of GDP, debt be reduced by approximately 1/20th of the percentage point gap each year on average over a three year period. In case of non-compliance, Member States can be fined 0.2 per cent of GDP. Second, progress towards the MTO will now also be assessed on the basis of expenditure developments. Expenditure growth should be linked to the medium-term GDP growth rate unless explicit revenue raising measures are identified. Failure to respect the agreed expenditure principles can result in fines of 0.2 per cent of GDP.

In December 2011, EU leaders further strengthened EU budgetary requirements for the Euro Area in a ‘Fiscal Compact’ that will form the basis of a proposed future treaty and possible future legislation.

3.3 Assessment of the Proposed Department of Finance Rules

3.3.1 Understanding the Operation of the Rules: Some Simulations

To understand how the proposed Department of Finance rules might work in practice, we first conduct some basic simulation exercises to capture the long-term implications for the public finances. The assumptions underlying the simulations are discussed in more detail in the Appendix, with the broad macroeconomic and budgetary outlook to 2015 taken from last April's *Stability Programme Update* (SPU). The simulation does not incorporate cyclical developments and assumes an annual average real GDP growth rate of 3.3 per cent from 2016 onwards. A number of further simplifying assumptions are made in order to arrive at a long-term baseline under which no fiscal rules are operative. The baseline is not in any sense a forecast but merely a counter example to a scenario in which fiscal rules are in operation.

The simulation is then adjusted to allow for fiscal rules. A PFCR, along the lines of the proposals in the Department of Finance 'Discussion Document', is applied starting in 2016. The rule requires a consolidation of 1.5 per cent in the primary balance, which results in a primary budget surplus of 4 per cent of GDP in 2016, which is then maintained until 2031 (Table 3.1).

The PFCR applied here would essentially imply that a primary surplus of 4 per cent would be maintained for many years (Figure 3.1). If the economy were at trend over the period, the MTO, which requires a minimum improvement in the structural balance of 0.5 per cent per annum (Figure 3.2), would not be complied with given the ceiling on the primary balance. The simulation shows that a 1.5 per cent PFCR would imply an average general government deficit of ¾ per cent from 2016 to 2031. The 3 per cent SGP deficit limit would be complied with over the horizon.

In terms of debt dynamics, the PFCR, under the assumptions of this model, would lead to a rapid reduction in the debt-to-GDP ratio, which would fall below 60 per cent in 2031 (Figure 3.3). The reduction in the debt ratio would exceed the EU benchmark for debt reduction (1/20th rule). The PBR would not be used as its targets would be achieved by the time the debt-to-GDP ratio reaches 60 per cent under the PFCR. Once the debt ratio falls below 60 per cent, the SEGR would apply.

The envisaged debt reduction under the PFCR in this scenario would be sizeable. The pace of debt reduction would be comparable with that achieved in Ireland in the post-1987 consolidation phase.[7] Moreover, in an international context, sustained primary surpluses of the order of 4 per cent per annum are extremely rare. For example, a review of EU countries over the past decade

[7] From 1988 to 1995 the national debt-to-GDP ratio declined by 4.2 per cent per annum.

shows that only Denmark and Finland have come close to such a level. The average primary surplus in the Euro Zone from 2000 to 2010 was 0.5 per cent. Ireland's average surplus over the pre-crisis period (1995 to 2007) was 3.5 per cent, although this was helped by a robust growth performance which is unlikely to be repeated. The framework proposed by the Department of Finance appears likely to more than comply with EU requirements to reduce debt towards 60 per cent of GDP, including the 1/20th rule. However, the budget balance would remain in deficit for at least a decade and would only slowly improve. As a result, it would not meet Ireland's current MTO of a structural balance of -0.5 per cent of GDP nor would it meet the numerical benchmarks for progress towards the MTO.[8] However, the numerical MTO is only part of the assessment of compliance with the preventive arm of the EU SGP and the rapid rate of reduction in the debt-to-GDP ratio, if the proposed Irish framework is implemented, could be a strong argument for the soundness of Irish fiscal policy.

Table 3.1: PFCR with a 4 Per Cent Ceiling

Year	*Binding Rule*	*Required Policy Action*	*Debt/GDP Ratio*	*Decline In Debt/ GDP Ratio*	*GGB*	*Decline in GGB*
2016	PFCR	1.5 per cent of Primary Balance	107	-3.5	-2.1	-0.7
2017	PFCR	Maintain Primary Balance at 4 per cent	104	-3.5	-2.0	-0.2
2018	PFCR	As Above	100	-3.6	-1.7	-0.3
2019	PFCR	As Above	97	-3.6	-1.5	-0.2
2020	PFCR	As Above	93	-3.5	-1.4	-0.2
2021	PFCR	As Above	90	-3.1	-1.2	-0.2
2022	PFCR	As Above	87	-3.2	-1.0	-0.2
2023	PFCR	As Above	84	-3.2	-0.8	-0.1
2024	PFCR	As Above	81	-3.2	-0.7	-0.1
2025	PFCR	As Above	77	-3.3	-0.4	-0.2
2026	PFCR	As Above	74	-3.3	-0.3	-0.1
2027	PFCR	As Above	71	-3.3	-0.1	-0.1
2028	PFCR	As Above	67	-3.4	0.1	-0.2
2029	PFCR	As Above	64	-3.4	0.3	-0.2
2030	PFCR	As Above	61	-3.4	0.4	-0.2
2031	PFCR	As Above	57	-3.5	0.7	-0.3

Source: Internal Calculations.

Note: Rounded to nearest decimal place.

[8] In addition, methodological differences between domestic and EU methods of assessing the structural balance could lead to difficulties (see Section 3.4.3)

Figure 3.1: Primary Balance: Baseline and Rules-Based

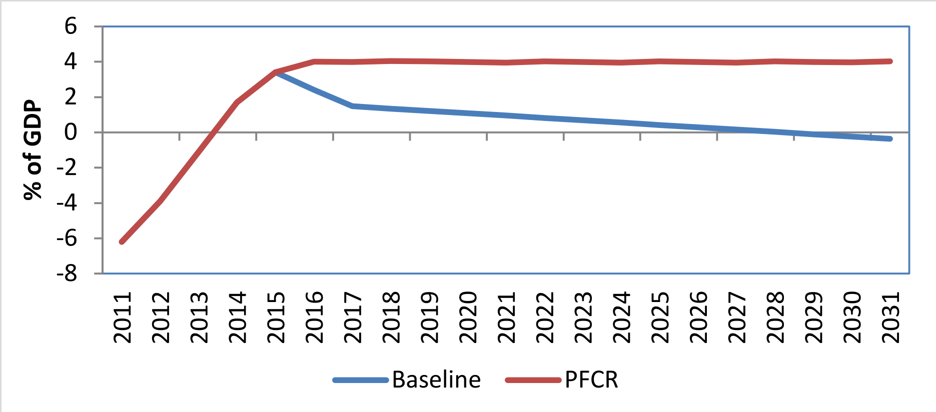


Figure 3.2: Overall Balance: Baseline and Rules-Based

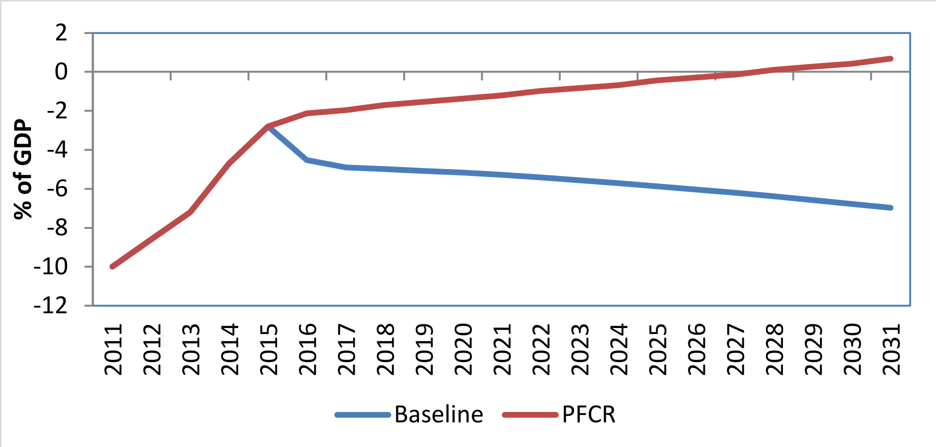
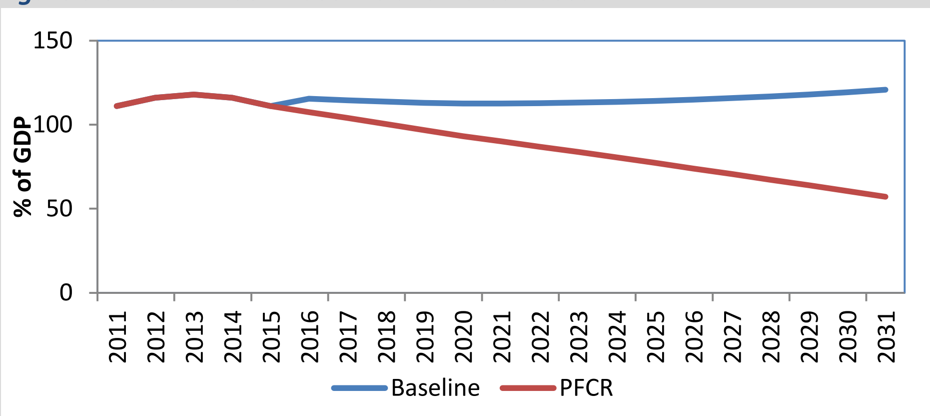


Figure 3.3: Public Debt: Baseline and Rules-Based



Source: Internal Calculations.

3.3.2 Assessing the Proposed Rules: Strengths and Weaknesses

The Public Finance Correction Rule (PFCR)

Potential strengths

- This rule would guide, with well-defined requirements, the reduction of debt back to the 60 per cent of GDP EU ceiling and would require that deficits above the 3 per cent of GDP EU ceiling be tackled.
- The primary balance is relatively easy to measure and is a well defined aggregate.
- The rule imposes a ceiling on the required primary budget surplus as a share of GDP to avoid the possibility that the size of the required primary surplus (and the associated rate of reduction in the debt-to-GDP ratio) would become inappropriately large under the rule.

Potential weaknesses

- Required primary balance adjustments are not cyclically adjusted. This means that sizeable pro-cyclical primary balance adjustments could be needed in a recession.[9] While at present (and with very high levels of debt) such policies are necessary to achieve debt sustainability, it would be desirable to allow counter-cyclical policies to operate once debt is at a lower level.
- The ceiling on the primary balance might not be sufficient to ensure debt sustainability in certain circumstances, such as when the nominal growth rate is significantly below the nominal interest rate and the debt level is high (this is discussed in more detail in Section 3.4.1).

Prudent Budget Rule (PBR)

Potential strengths

- The PBR is consistent with EU requirements for a cyclically adjusted balance (net of one-off adjustments).
- Clear actions are required in terms of adjustment of the cyclically adjusted primary balance when the medium-term budgetary objective is not being complied with.

Potential weaknesses

- A requirement for a cyclically adjusted budget balance could lead to very low steady-state debt-to-GDP ratios for reasonable nominal

[9] Symmetrically, the Government could, under the rule, inadvertently target a pro-cyclical policy stance in an upswing since it is only committed to a minimum improvement in the unadjusted primary balance, whereas the “right” stance might call for a greater improvement than 1.5 per cent of GDP.

growth rates (See Box D). The effective elimination of sovereign debt is unwarranted.

- Under current projections, the rule is not likely to become binding for a number of years. This could leave Ireland out of compliance with the proposed EU requirements for the cyclically adjusted budget balance for a sustained period. This requirement will be a centre piece of the new European rules framework, both in terms of current legislation, political commitments and the proposed European Treaty.

Sustainable Expenditure Growth Rule (SEGR)[10]

Potential strengths

- There is a clear requirement that current expenditure growth should not exceed the underlying potential growth rate of the economy. This imposes a critical restraint on expenditure growth during the boom phase of the economic cycle.
- This rule avoids the risk of excessive restrictions in capital expenditure in order to satisfy the rule.
- Any "excess" expenditure growth must be matched by discretionary increases in tax revenue.
- Maintaining expenditure in line with growth in this way is part of EU assessments of fiscal policy under the new legislation.

Potential weaknesses

- This is not a multi-annual rule because a new prospective 5-year plan is made each year. A true multi-annual rule would help to ensure that planned medium-term expenditure growth is restricted under the rule.
- The measure of current expenditure includes cyclically sensitive components, most notably unemployment benefits.
- In addition to excessive current expenditure growth, there is a risk that capital expenditure growth could be excessive.
- There is a potential risk of manipulation of the categorisation of current and capital expenditure in order to relax the constraining effect of the rule.
- The rule is asymmetric in its treatment of expenditure and taxation and, as such, may not prevent problems arising from undue reliance on taxes that are of a temporary nature. The rule does not take due account of discretionary tax changes with high uncertainty relating to

[10] Since the March 2011 'Discussion Document', the Department of Public Expenditure and Reform published the *Comprehensive Expenditure Report 2012-2014*, which followed the publication of the *Infrastructure & Capital Investment 2012-2016: Medium-Term Exchequer Framework*. These documents are part of the ongoing reform of Ireland's budgetary framework and a move to binding current and capital expenditure ceilings as part of a medium-term expenditure framework.

their sustainability (e.g., tax revenues that are dependent on a continuing asset-price boom.)

- It is not clear whether the rule applies to general or central government expenditure.

3.4 The Design of Fiscal Rules: Some Practical Considerations

3.4.1 Introducing Limits on Required Adjustments

A critical factor in the design of a set of fiscal rules is the relationship between the primary balance as a share of GDP and the rate of change in the debt-to-GDP ratio. A standard equation for understanding the key linkages shows how the change in the debt-to-GDP ratio (Δd) depends mechanically on the average nominal interest rate on outstanding debt (i), the nominal GDP growth rate (g), the initial level of the debt-to-GDP ratio (d_{-1}), and the primary balance as a share of GDP (pb):

$$\Delta d = (i - g)d_{-1} - pb.$$

The key to the rate of change in the debt-to-GDP ratio is the size of the gap between the first and second terms on the right-hand side of the equation.[11] Figure 3.4 graphs this linear equation for given values of the nominal interest rate, growth rate and starting value for the debt-to-GDP ratio. The point where the downward sloping line crosses the horizontal axis gives the debt stabilising primary balance. Any primary balance above this level is associated with a falling debt ratio, and would be consistent with *debt sustainability*.

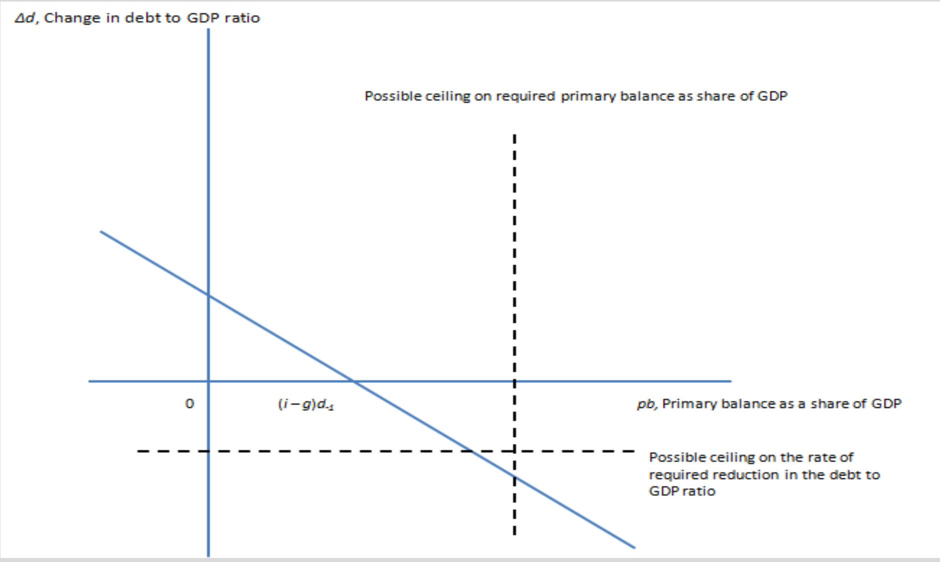
This framework can help us understand the implications of the rules proposed in the Department of Finance 'Discussion Document'. The proposed rules focus on required improvements in the primary balance when certain deficit and debt thresholds are exceeded. Increases in the primary balance reduce the "gap" between the first and second terms on the right-hand side of the equation above, and thus increase the speed at which the debt ratio is declining.

The solution proposed in the 'Discussion Document' is to put a cap on the size of the required primary balance at 4 per cent of GDP. However, if the first term on the right hand-side of the equation is large – say, because of a disappointing growth performance – the cap might not be consistent with debt sustainability (i.e., $\Delta d > 0$). This could also undermine the credibility of the framework with potential investors in Irish debt.

[11] For example, if the gap between the nominal interest and growth rates is one percentage point and the debt-to-GDP ratio is 100 per cent of GDP, the first term on the right hand side is 1 per cent of GDP. If the primary surplus is, say, 3 per cent of GDP, then the debt-to-GDP ratio is falling at the rate of 2 percentage points of GDP.

As with the cap on the primary balance, this ceiling puts a limit on the primary balance reductions that are required under the operational rules. This method of reasonably limiting the required primary balance improvements would ensure that the framework is consistent with debt sustainability (i.e., $\Delta d \leq 0$). Such an alternative practical limit on required adjustments may, thus, provide a better compromise between the need to ensure adequate debt reduction and excessively large required primary balances.

Figure 3.4: Relationship Between the Rate of Change in the Debt-to-GDP Ratio and the Primary Balance as a Share of GDP



Box D: Choosing a Deficit Target: Some Trade-offs

How should the ultimate numerical deficit target be chosen? In thinking about this question it is useful to divide the adjustment to safer deficit and debt levels into three phases: a consolidation phase, a transition phase, and the steady-state debt-to-GDP ratio phase that is approached as the transition proceeds.

For illustration, we assume that the target for the structural budget deficit is 0.5 per cent of GDP. With most EU countries running structural (or cyclically adjusted) budget deficits much higher than this, they cannot be expected to jump to this target immediately. The **consolidation phase** involves requiring given annual adjustments – measured, say, in annual required percentage point improvements in the cyclically adjusted primary balance. For example, the consolidation requirement might be a one percentage point of GDP improvement in the cyclically adjusted primary balance each year.

The **transition phase** captures how the debt-to-GDP ratio declines once the 0.5 per cent cyclically adjusted deficit is reached. This change in the debt-to-

GDP ratio is (approximately) captured by a simple equation:

$$\Delta d = (i - g)\, d_{-1} - pb,$$

where d is the debt-to-GDP ratio, Δd is the change in that ratio, i is the nominal interest rate, g is the nominal GDP growth rate, and pb is the primary balance as a share of GDP. Noting that the overall deficit as a share of GDP is $id_{-1} - pb$ (i.e., the sum of interest costs and the primary deficit), and letting this overall deficit equal 0.5 per cent of GDP, we can rewrite this equation as,

$$\Delta d = 0.005 - gd_{-1}.$$

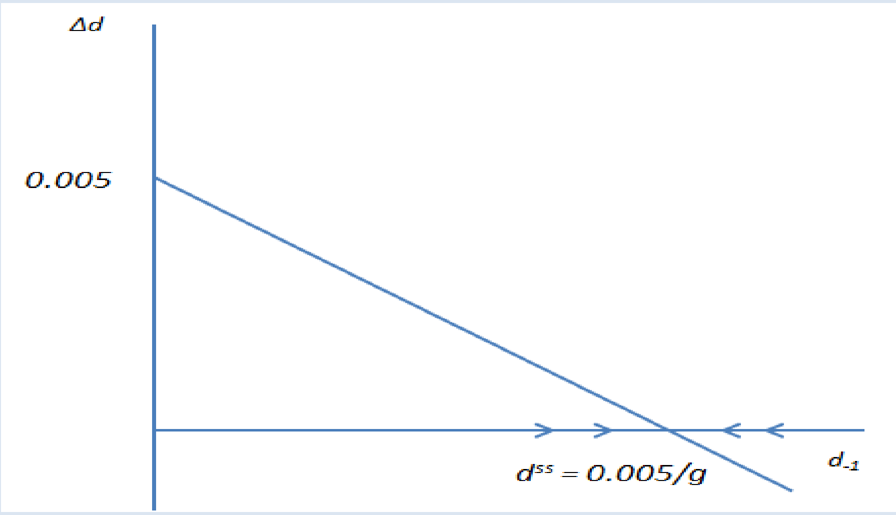
This relationship is graphed in Figure D1. The **steady-state debt-to-GDP ratio**, d^{ss}, is found by setting this equation equal to zero,

$$d^{ss} = 0.005/g.$$

For example, if the nominal GDP growth rate, g, is 5 per cent, the steady-state debt-to-GDP ratio will be 0.005/0.05 = 0.1 (or 10 per cent).

One criticism of the proposed EU rules for a cyclically adjusted deficit of 0.5 per cent of GDP is that it implies an excessively low steady-state debt-to-GDP ratio. However, the choice of the target also affects the speed of decline of the debt ratio over the transition (see Figure D1; an increase in the target deficit would shift the entire line upwards by a vertical distance equal to the change in the target). With a nominal growth rate of 5 per cent, raising the target cyclically adjusted deficit to 1.5 per cent of GDP would raise the steady-state debt-to-GDP ratio to 30 per cent of GDP. However, it would also slow the rate of decline in the debt ratio by 1 per cent of GDP per year, lengthening the time it takes to reach safer debt levels. Thus, an important factor to consider in the choice of parameters for the rules is the trade-off between a possibly excessively low steady-state level of the debt-to-GDP ratio and the speed of decline towards a safer debt ratio.

Figure D1: Dynamics of the Debt-to-GDP Ratio



3.4.2 The Necessity of Cyclical Adjustments

A potential further concern with the PFCR proposed in the 'Discussion Document' is that it is not specified in cyclically adjusted terms. In a recession, the requirement to bring about an actual improvement in the primary balance of 1.5 per cent of GDP would require discretionary measures that are considerably larger than 1.5 per cent of GDP. This is because the discretionary measures would also have to counteract the effect of automatic stabilisers, such as the increase in the cost of unemployment benefits and the recession-related loss of tax revenue. While the Council recognises the difficulties of making credible cyclical adjustments to the primary balance (see Box E), we believe this is essential to ensure a framework that does not force excessively pro-cyclical adjustments (or which might strain the bounds of political credibility).

The use of a cyclically adjusted measure of the balance, while most appropriate from an economic viewpoint, leads to significant complications in practice. This is because calculation of the cyclically adjusted budgetary position requires: (1) an estimate of the cyclical position of the economy – whether or not there is a positive or negative "output gap" and, if so, what is its size; and (2) a coefficient is required to calculate the impact of the budget on the economy at any given point in the economic cycle. [12]

There is considerable room for judgement as to how these two parameters should be calculated. The EU Stability Programmes use a common EU methodology to calculate the output gap. However, it has been argued that the use of this methodology has produced unsatisfactory and implausible results for Ireland. In the EU methodology, the second parameter, linking the budget deficit to cyclical factors, is calculated as 0.4 for Ireland.[13] It is critical to the functioning of the proposed fiscal rules, that a sound and transparent method of cyclical adjustment is found. This is essential in order to avoid pro-cyclical policies. The Council suggests that a methodology be put in place domestically that is best suited to Irish circumstances. Meanwhile, efforts should continue to improve the EU methodology in order to make it more appropriate, both for Ireland and other countries. This is likely to take a considerable length of time to bring to fruition, however.

The development of the methodology could be undertaken under the overall responsibility of the Department of Finance, though outside expertise could be employed as required. The views of the Fiscal Council could also be sought.

[12] The latter is likely to vary across time because not all tax bases move exactly in line with GDP and because the elasticity of different taxes with respect to their bases is also likely to vary.
[13] See the Department of Finance *Pre-Budget Outlook November 2009* for a detailed discussion.

The legislation specifying this aspect of the application of the rules should state the need to take into account the relevant elements, including alternative methodologies for estimating the output gap. For example, output gap estimates could be derived from indicators of spare capacity, the current account position, the credit cycle and a disaggregated analysis of the sustainability of government revenues. The methodology adopted for both parameters as well as the associated calculations of the cyclically adjusted balance should be set forth publicly. It should be accompanied by a discussion of a reasonable range around the central estimate, in order to reflect uncertainties about the appropriate parameter values and the significant elements of judgement present.

In any event, the underlying methodology, as well as the outcomes for the cyclically adjusted balance in relation to the rule(s), would be subject to assessment by the Fiscal Council. The Council could also provide its views on proposals as they may emerge from the EU.

3.4.3 Measuring Changes in the Cyclically Adjusted Fiscal Position

For the purposes of measuring *changes* to the cyclically adjusted primary balance, a potentially more practical approach than output gap based approaches could be to quantify directly discretionary changes in fiscal policy. The required consolidation measures could be specified in terms of discretionary changes in revenues and expenditures, rather than the cyclically adjusted primary balance itself. The discretionary adjustments could be easier to measure, particularly if revenues are forecast to change due to cyclical or other exogenous factors. In addition, this approach is likely to be easier to communicate and is closer to the existing practice of discussing budget adjustments in cash terms.[14] A more detailed description of this approach is outlined in Box E.

Box E: Measuring Changes to the Cyclically Adjusted Primary Balance

The Council is of the view that it is essential to specify key fiscal rules in terms of cyclically adjusted magnitudes. Failing to make cyclical adjustments could force excessive adjustments in times of recession – and inadequate adjustments in times of boom – leading to an economically inefficient and politically non-credible set of rules. However, making credible cyclical adjustments is difficult, particularly for a small open economy undergoing substantial structural change.

[14] Measuring discretionary changes requires a clear benchmark for "no change" policies. While formal indexation may not be desirable, normal practice would include updating social benefits in line with inflation, updating government wages in line with overall wage growth and indexation of tax thresholds for wage growth. In broad terms, these policies would be roughly consistent with revenues remaining at a constant share of GDP.

It is important to distinguish, however, between the challenge of measuring cyclically adjusted budget balances and measuring changes to such balances. Under certain circumstances, the latter may be less problematic because measures of the output gap are not required.

To better understand the issues involved it is useful to write the nominal primary balance (PB) as the sum of two components:

$$PB = \alpha Y^* + \beta(Y - Y^*)$$

where Y* is potential nominal GDP, Y is actual nominal GDP, and α and β are parameters measuring the sensitivity of the nominal primary balance to potential nominal GDP and the output gap – the difference between actual nominal GDP and potential nominal GDP – respectively. Dividing through by Y* yields:

$$PB/Y^* = \alpha + \beta((Y - Y^*)/Y^*)$$

The first term on the right-hand side, α, is the cyclically adjusted primary balance (expressed as a share of potential nominal GDP). The second term on the right-hand side is the cyclical adjustment term, where the adjustment is some fraction, β, of the (proportional) output gap.

If the values for the proportional output gap and the β parameter are known (an estimate of 0.4 is used by the Department of Finance), then we have a straightforward measure for identifying both the level of and changes to the cyclically adjusted primary balance – we simply have to subtract the second term on the right-hand side from the actual primary balance as a share of potential nominal GDP. The challenge arises because the β and the output gap are unknown, or at least measured with significant uncertainty.

However, even where there are significant measurement difficulties for β and the output gap, it may still be possible to develop a credible measure of changes to the cyclically adjusted primary balance. For example, consider a benchmark where fiscal parameters – tax rates, benefit rates, public sector pay rates, etc. – are assumed to be adjusted only in line with nominal potential GDP. Such adjustments would keep the cyclically adjusted primary balance constant. Discretionary changes relative to this benchmark would result in changes to the cyclically adjusted primary balance, which are in principle identifiable without knowledge of β and the output gap.

Of course, this procedure still, in principle, needs knowledge of the underlying growth in potential nominal GDP. If credible measures of potential growth are not available, there are a number of alternative approximations to the rule that may be sufficient. In the absence of any discretionary policy change, the main impact of nominal growth would be to increase tax revenues. This would mostly increase the level of revenues, but it would also tend to raise the share of taxation in nominal GDP through nominal and real fiscal drag (notably as taxpayers move above nominal tax thresholds). However, it is normal practice to make discretionary changes to government spending on wages, inputs and transfers in line with nominal growth so that the volume of government services and the relative value of transfers is effectively maintained as nominal prices and the opportunity cost of resources increases.

The key conclusion is that by focusing on discretionary adjustments it may be possible to make reasonable measurements of the change to the cyclically adjusted primary balance even when measures of β and the output gap are not available. Such discretionary adjustment could replace changes to the cyclically adjusted primary balance in the operationalisation of certain fiscal rules.

3.5 Proposals to Strengthen the Rules Framework

As already outlined, the Department of Finance's proposed "multi-weather" rules contain a number of desirable features that would narrow the gap between sound and actual fiscal policies. However, the rules lack flexibility in some respects (especially with regard to cyclical sensitivity), which could at times lead to unsound policies and could undermine the credibility of the framework. In this section, the Council makes a number of recommendations aimed at improving the credibility-flexibility trade-off, which would also strengthen the overall framework. We first make recommendations aimed at improving credibility for any given set of numerical rules. Drawing on the discussion in Section 3.3, we then make recommendations for changes to the specific numerical rules that would lead to a more flexible balancing of the principles of sound fiscal management. Together, we believe these modifications would lead to a more robust rules framework.

3.5.1 Improving Credibility: Recommendations to Improve the Constraining Effect of the Rules Framework

The enforcement of fiscal rules must balance flexibility and credibility, a trade-off that is improved by the existence of an independent fiscal council. The Fiscal Responsibility Bill should put the proposed fiscal rules in legislation. The Department of Finance proposes a "soft enforcement" mechanism in the form of a "comply or explain" requirement. The Minister would be required to explain to the Oireachtas deviations from the rules in prospective plans. While the requirement for such explanations is likely to impose a reputational cost on the Government, this cost is likely to be at the mild end of the spectrum, and thus would have limited effects on incentives for fiscal discipline and sound fiscal management. Therefore, while the proposed rules themselves are quite rigid and demanding, the enforcement mechanisms might not credibly constrain fiscal policy. As a complement to introducing more flexibility into the rules, the Council recommends that the "enforcement" mechanisms be strengthened, while still allowing ultimate democratic control. The Council does not recommend including fiscal rules in Ireland in the Constitution as this would lack the necessary flexibility and operability.

The binding nature of the Irish fiscal rules could be more effectively and credibly achieved by requiring the Government to:

Set out clearly **in legislation a set of principles** of sound fiscal management. This model has been adopted by countries such as Australia and New Zealand. This should be in line with the principles set out in Chapter 2.

Each new Government should set out explicit **targets for the debt-to-GDP ratio over a five-year period as well as an indicative ten-year target**. This would form part of a **Fiscal Statement** for Government. Within this statement, the indicative consolidation measures that are required to meet the targets and other changes in the financial position of the Government would be set out, along with off-balance sheet liabilities (such as Public Private Partnerships). The Government's intended approach to meeting future pension liabilities should also be presented.

Under proposals in the 'Discussion Document', the Government is only required to ensure that its prospective plans comply with the fiscal rules. The Council does not believe this is sufficient for effective public accountability and views a **retrospective element** as essential. The Minister should be required to explain to the Oireachtas any actual or prospective deviations from the Government's stated fiscal targets and rules. This would encompass **an annual report to the Oireachtas**. This annual report could be provided at the time of the Budget. An assessment of this annual report would be part of the mandate of the Irish Fiscal Advisory Council. (The retrospective element could be further strengthened through some form of automatic corrective mechanism such as a "debt brake". The rationale and possible form of a debt brake is further discussed in Box F.)

At the time of writing, it is unclear what the proposed European Treaty will require in terms of the legal status of the balanced budget rule. While the 'Discussion Document' proposals and Council recommendations would appear to achieve compliance with this rule over a long-term horizon, it would be for the European Court of Justice to rule upon the future Treaty as to whether the national framework was compliant with the new Treaty in a legal sense.

Box F: A Debt Brake

In the proposed rules from the Department of Finance 'Discussion Document', there is no facility or mechanism by which cumulative errors are corrected. In this regard, consideration could be given to some form of "debt brake". For example, the Government could be allowed to deviate from its target debt-ratio reduction path by a given percentage of GDP (say 5 per cent). However, once that limit is reached, additional annual discretionary adjustments of, say, 0.5 per cent of GDP would be required until the deviation of the debt-to-GDP ratio falls back into the permitted margin.

Such a mechanism would allow for some necessary flexibility in the face of macroeconomic shocks, but would also put a "brake" on how far the debt ratio can drift from the Government's target path. The EU 'Fiscal Compact' agreed in December 2011 included a requirement for automatic adjustment in the event of deviations of the structural budget balance from target – effectively applying a brake to the deficit rather than the debt measure. It is important to note here that the proposed PFCR and PBR already provide a brake on the deficit – deviations from well-defined thresholds require well-defined consolidation measures to be undertaken. The deficit/debt distinction is important. Intuitively, the Council believes a "brake", if implemented, should apply to a stock variable such as debt. The debt brake should automatically reflect the cumulative slippage from targets.

3.5.2 Improving Flexibility: Recommendations to Achieve a Better Balancing of the Principles of Sound Fiscal Management

Recommendations on the Public Finance Correction Rule (PFCR)

- The operational rule should be specified in terms of the cyclically adjusted primary balance (CAPB).[15] The required consolidation of the CAPB of 0.75 or 1.5 percentage points should be specified in terms of discretionary fiscal adjustments.

[15] For example, if the debt-to-GDP ratio is above 90 per cent and the overall deficit is above 3 per cent of GDP, the PFCR would require that there is an improvement of 1.5 per cent of GDP in the CAPB. If the overall deficit is less than 3 per cent of GDP but the GG debt is greater than 60 per cent but less than 90 per cent of GDP then there should be a requirement to improve the CAPB by 0.75 percentage points. While the rule could still potentially require pro-cyclical consolidation when there are urgent pressures with the public finances, over time it allows more room for automatic stabilisers to operate once debt dynamics have become more favourable than a rule based on the unadjusted primary balance.

- The proposed ceiling on the required primary balance should be replaced by a maximum required percentage point reduction in the debt-to-GDP ratio.[16] (See Box G for an illustrative example).[17]

Recommendations on the Prudent Budget Rule (PBR)

- The PBR should apply once the 60 per cent debt limit and 3 per cent deficit limit are reached.
- Application of the rule should be based on the domestic measures of the cyclically adjusted primary balance.
- The proposed ceiling on the required primary balance should be replaced by a maximum required percentage point reduction in the debt-to-GDP ratio.

Recommendations on the Sustainable Expenditure Growth Rule (SEGR)

- Expenditure growth rules that do not allow for automatic stabiliser-related spending could force excessively pro-cyclical adjustments and are also unlikely to be credible. It is recommended that interest payments, unemployment benefits and possibly other cyclically sensitive welfare spending be excluded from the measure of expenditure, but that the categories be defined with considerable precision to limit circumvention of the rule.
- The SEGR at present allows for rates of growth in spending above the underlying rate of growth of the economy if such increases are financed through taxation. However, it should be clearly stated that the increase in taxation must be structural in nature and not the result of increased revenues arising from above-trend economic growth. Recent Irish experience has shown the difficulties that ensue from the practice of increasing public spending based on transitory revenues.
- The SEGR should apply to total general government expenditure. However, with low levels of public investment during the consolidation phase, care must be taken that the rule does not prevent economically efficient capital spending.

[16] Given the role of factors other than the budget balance in affecting the gross debt ratio, the application of this ceiling should be based on accumulated balances, excluding items such as the stock flow adjustment.

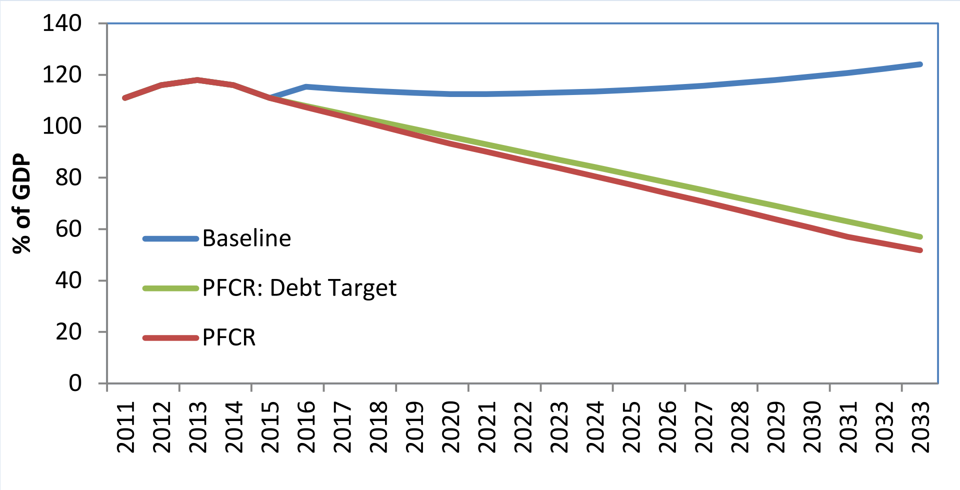
[17] The explicit focus on debt reduction would ensure meaningful progress towards the 60 per cent of GDP standard for debt in the EU Treaty. Depending on the level of debt, it would most likely, but not necessarily, achieve the EU 1/20th numerical benchmark.

Box G: The Effect of a 3-Percentage Point Cap on the Required Debt-to-GDP Ratio Reduction: An Illustrative Example

Using the simple long-term public finance simulation exercise described earlier, the baseline is amended to allow for a targeted 3 percentage point annual reduction in the debt-to-GDP ratio. This, in effect, constitutes a recalibration of the PFCR described in Section 3.3.1, but where it is assumed that the 3 percentage point cap on the required rate of debt reduction is operative from 2016 instead of the 4 per cent cap on the primary balance as a share of GDP. The revised rule remains binding until the debt ratio falls below 60 per cent of GDP which happens in 2033. The pace of debt reduction, in this case, exceeds the EU benchmark for debt reduction (1/20th rule).

Once the 60 per cent target is reached, the level of consolidation is adjusted so that a balanced position in general government terms is achieved and maintained. Figure G1 shows that the rate of debt reduction is marginally slower under the debt rule than under the proposed PFCR (with a primary surplus cap).[18] Under the baseline assumptions, putting either a 4 per cent cap on the primary balance or the 3 percentage point cap on the rate of debt ratio reduction lead to quite similar time paths for the debt-to-GDP ratio. However, even where the gap between the nominal interest rate and the nominal GDP growth rate turns out to be quite unfavourable, putting the cap on the debt ratio reduction would ensure debt ratio sustainability (see Section 3.4.1).

Figure G1: Debt-to-GDP Ratio: Baseline, PFCR and a 3 Per Cent Debt Adjustment



[18] A sensitivity analysis around the debt reduction requirement shows that if the debt rule changes to a 2 per cent reduction per annum, the 60 per cent target is not reached until 2041. On the other hand, if the debt reduction target is increased to 4 per cent per annum, the 60 per cent target is achieved in 2028.

Recommendations on Sequencing of the Proposed Fiscal Rules

In the Department of Finance 'Discussion Document', it was proposed that the fiscal rules apply one at a time with the PFCR applying initially. The Council is of the view that two of the rules, namely the modified PFCR and the expenditure rule should apply from the outset, with the PBR applicable once the 60 per cent debt limit and 3 per cent deficit limit are reached.

Even if it is not a binding constraint given the extent of expenditure adjustment during the consolidation phase, it will be beneficial to develop clear processes for expenditure control while the memory of the last boom-bust cycle is still strong. The expenditure rule is best thought of as supporting both the required overall balance and allowing the budget balance to vary over the cycle.[19] While the SEGR would be unlikely to bind during the consolidation phase, it would help to support compliance with the PFCR in later years. Conversely, once debt is below 60 per cent of GDP, a balance and expenditure rule would be mutually reinforcing and provide a strong basis for keeping debt at a sustainable level, allowing the automatic stabilisers to work and ensuring that cyclical revenues are not spent in good times. The Council's proposals on the sequencing of the rules are summarised in Table 3.2.

While the level of debt is very high, achieving a balanced overall budget would require a large primary balance surplus and imply a rapid reduction in the debt-to-GDP ratio. The size of the primary surplus and pace of debt reduction could be excessive and lack credibility. The proposed ceiling on the rate of debt reduction should guard against excessively tight fiscal policy. Given that Ireland is currently under a programme supported by the EU/IMF, the constraints associated with this programme would also need to be taken into account.

Table 3.2: Proposal for Applying Balance and Expenditure Rules Simultaneously

Debt Level	*Balance Rule*	*Expenditure Rule*
>60 per cent of GDP	PFCR	SEGR
<60 per cent of GDP	PBR	SEGR

Recommendations on Exceptional Provisions

In the Department of Finance 'Discussion Document', it is proposed that the fiscal rules may not apply in the event of:

A national emergency;

A severe macroeconomic disturbance;

[19] This would be the outcome if expenditure keeps on a steady trend path and there are no substantive policy changes to revenue.

Such other exigencies as may be specified.

These circumstances would require the Minister for Finance to set out an opinion to the Oireachtas for approval. This statement would also specify the period of time during which the rules would not apply.

The Council supports the need for an escape clause in the event of exceptional circumstances, backed by a clear statement by the Minister for Finance with approval from the Oireachtas and an opinion from the Fiscal Council.

To prevent abuse and to comply with EU requirements, the escape clause should be more narrowly defined in terms of severe events outside the control of Government, explicitly:

A national emergency;

A severe macroeconomic disturbance.

3.6 The Limitations of Fiscal Rules

For the reasons outlined in Chapter 2, fiscal rules, along the lines discussed in this chapter, can play an important role in helping to improve the quality of fiscal policy. At the same time, it is necessary to recognise their limitations. Inevitably, given the need for flexibility in good rule design, the interpretation and application of a particular rule or rules is likely to involve significant elements of judgement. Thus, as noted earlier in this chapter, some rules require an assessment of the cyclical position of the economy, the underlying structural budget balance and/or the future sustainable growth path. Rules cannot provide a panacea should judgements on these key aspects turn out to be incorrect by a significant margin.[20]

Mechanical rules cannot therefore be a full substitute for sound judgement. However, combined with their directly constraining role, they can serve an important function in encouraging greater analytical rigour, transparency and accountability, and thus help to promote improved fiscal discipline. As a complement, structured arrangements for informed, independent analysis and commentary on fiscal matters can help avoid undue complacency and the emergence of a "cosy consensus". The following chapter considers how the appropriate design of an independent Fiscal Council can further this objective.

[20] This issue is illustrated in the case of Ireland's recent experience, where it is not clear that having a rule limiting the structural balance or an expenditure rule such as the SEGR in place would have triggered the appropriate degree of remedial action given the serious misestimation of the output gap and the effects of the asset price bubble.

4. The Design of the Fiscal Council

4.1 Introduction

This chapter outlines the Council's views on the appropriate design of the Irish Fiscal Advisory Council from the perspective of the legislation which will set up the Council on a statutory basis. In order to provide context for the detailed proposals below, some broader issues relating to the rationale for the Council are first outlined.

4.2 Rationale for the Irish Fiscal Advisory Council

In setting up the Council, the Irish Government was following a developing trend in fiscal management. As discussed in Calmfors and Wren-Lewis (2011), countries such as the UK, Sweden and Canada have recently established fiscal councils, thereby joining those such as the Netherlands, the US and Denmark where such councils have existed for some time. As explained by Calmfors and Wren-Lewis, "...the common motive is a desire to adapt the good experiences of independent central banking to the fiscal sphere".

A number of weaknesses in adhering to the principles of sound public finances stand out in the recent Irish experience. There has been a tendency to spend revenues when they are strong: spending growth exceeded even the pace of expansion of the economy through most of the period from 2001 to 2007, in large part through increases in transfer payments and public sector compensation. Revenues have also been volatile and their sustainability was overestimated (see Addison-Smyth and McQuinn, 2010). Structural weaknesses in the tax system, such as a narrowing of the tax base contributed to fragility. The overestimation partly reflects a misjudgement of the strength of the economic cycle but, more importantly, the failure to take into account developments in specific tax bases.

Furthermore, the fiscal stance has been pro-cyclical, both in good times and bad times. There is also evidence of an electoral fiscal cycle with a tendency to ease fiscal policy in the year prior to an election. The Irish experience over recent decades has been volatile. Debt peaked at 107 per cent of GDP in 1987 before falling to 25 per cent in 2006[21] due to a tight fiscal stance at the start of the period and exceptionally strong nominal growth from the mid-1990s.

The current crisis led to a sharp deterioration in tax revenues and massive bank rescue costs. Fiscal consolidation measures already taken and planned are expected to keep the peak of the debt-to-GDP ratio at just-under 120 per

[21] Debt statistics are taken from the NTMA and Eurostat. The measurement of debt in 1987 refers to National Debt whereas the 2006 figure refers to general government debt.

cent of GDP. While Ireland has an impressive track record in terms of fiscal consolidation, policy has been less successful at fulfilling the principles of sound fiscal management when external financing constraints are less binding. The difficultly of doing the right thing in good times is a common problem across countries.

4.3 Mandate for the Council

The mandate of the Council – which is taken as given for the purposes of this report[22] – is to independently assess, and comment publicly on, whether the Government is meeting its own stated targets and objectives. The Council is to assess the appropriateness and soundness of the Government's macroeconomic projections, budgetary projections and fiscal stance. The Council will also examine the extent of compliance with the Government's fiscal rules. The Council will perform other functions, including an assessment of the implications of budgetary plans for economic growth, investment and employment, as may be assigned by the Minister for Finance.

4.4 Guiding Principles for the Council

If the Council is to be effective in restraining governments' tendency towards deficit bias (as discussed in Chapter 2), and in encouraging adoption of a more sustainable fiscal policy, its design must contain some key elements. As control over fiscal policy remains with the Government, as should generally be the case in a democratic society, the Council needs to be designed in a way whereby a government that ignores its advice or observations incurs a certain reputational cost. For this to be the case, the public, and other observers such as international lenders, need to view the Council as a body that is both analytically sound in terms of its economic analysis and independent as regards the possibility of being subject to any political influence.

The guiding principles in this section draw on the experience with other fiscal councils to date. As the review paper by Hagemann (2011) observed "...the effectiveness of fiscal councils hinges on several factors, including having full autonomy within the scope of their mandates, active and unfettered dissemination of their analysis and their credibility".

The members of the Council must be highly-qualified professionals with expertise in the areas of macroeconomics and fiscal policy to ensure ***analytical***

[22] Discussion at EU-level has proposed that national budgetary forecasts should be carried out by a body with a functional independence from Ministers for Finance. This report does not consider the impact of this proposal which, irrespective of whether or not such a role was allocated to the Council, would have a significant impact on its current mandate.

competence. Also, the Council should have ***sufficient resources*** to allow it to produce and disseminate high-quality analysis.

Concerning ***independence,*** any suggestions or suspicions of political or official interference in the activities of the Council will seriously undermine the authority of the Council and its capacity to generate confidence in the State's fiscal integrity. Moreover, in such a situation, it is unlikely that high-calibre individuals will be willing to serve as members of the Council, compromising the goal of analytical competence. Fiscal councils, similar to independent central banks in the conduct of monetary policy, should be free from political biases in making judgements and offering their assessments. However, the inherent distributional nature of budgetary actions makes it essential that the implementation of fiscal policy remains under political control. Furthermore, central banks typically have a relatively simple objective – such as an inflation target – which leaves a more complex and wide-ranging set of policy tasks for fiscal policy.

The Council's analytical competence and independence also need to be clearly demonstrated and accepted by the public. Many public and private bodies in Ireland in the economic and financial spheres have suffered severe reputational damage in recent years. Thus, a body such as the Irish Fiscal Advisory Council will not automatically command respect and sufficient credibility. For this reason, the Council must also be ***accountable*** (including being subject to assessment by outsiders) and ***transparent***, with its work open to public scrutiny.

In sum, three overall principles are required to be kept uppermost in mind in designing specific arrangements for the establishment and *modus operandi* of the Council: first, ***independence*** with respect to membership and budgetary management i.e., the Council needs to be protected from inappropriate involvement in detailed budgetary/staff matters or from the risk of the termination of appointments due to policy differences; second, full ***transparency*** concerning the work of the Council; and third, ***accountability*** with regard to the quality of the Council's output and the fulfilment of the mandate it has been given.

While establishing and preserving the independence of the Council is thus a vital element that needs to be safeguarded, as with any non-elected body, mechanisms are required to ensure appropriate broad oversight of the Council's activities. The specific recommendations that follow concerning (a) composition of the Council (b) budgetary provisions (c) transparency (d) accountability and (e) arrangements vis-à-vis other institutions are designed to achieve an appropriate balance between the above two considerations.

The recommendations below are generally consistent with the approach to the Fiscal Council outlined in the Department of Finance 'Discussion

Document'. Finally, the Council recommends that these provisions be reflected in the draft Fiscal Responsibility Bill (with the possible exception of some of the specific transparency aspects discussed in Section 4.7).

4.5 Composition of the Council

The following principles should apply:

Membership – should consist of persons with recognised professional expertise in the relevant areas of the Council's mandate.

Experience – due regard should be paid to ensuring an appropriate blend of domestic and international experience in macroeconomic and fiscal matters.

Appointments – members, including the Chair, should be appointed by the Minister for Finance, with the approval of the Government. The Minister would seek the names of potential nominees from the existing Council and would also consult, as appropriate, the relevant Committee of the Oireachtas in advance of making appointments.

Term of Office – appointments to the Council should be made for a four year period. However, given the substantial investment of time likely to be required by Council members, the need to maintain continuity and the size of the pool of potential members, the Minister may extend the initial nomination of a member for an additional non-renewable period of up to four years.[23] Once the membership of the current (interim) Council, who were appointed on a staggered basis (i.e., for periods varying between two and four years) expires, members would be eligible for reappointment for one such non-renewable period.

Terminations – the Minister could terminate a Council member's appointment prior to the date stipulated in the original letter of appointment only on grounds of misconduct, conflict of interest, or the inability of the member to carry out their duties. Such a termination would only take place after prior approval of the relevant Committee of the Oireachtas. Except in the case of the Chair itself, any proposals to terminate the appointments of Council members should also pay due regard to the views of the Chair on the matter.

[23] The Council considered, but on balance did not favour, an alternative arrangement whereby members could be appointed for a single (for example, six years or so) non-renewable term. While such an approach could enhance the independence of the Council, it was felt that this was outweighed by the loss of flexibility this might entail in seeking to ensure a continuous high quality contribution by Council members.

4.6 Budgetary Provisions

The Council should provide for approval on an annual basis to the Minister/ Department of Finance a proposed overall budget for the coming year as well as an indicative budget for the following two years. It is recommended that the Secretary General write a letter, following consultation with the Council, setting out the intended budget for the Council over the forthcoming three year period and the Government's intention to support this budget unless major changes in circumstances were to intervene.[24] The budgets would be based on the fulfilment of the Council's ongoing activities as well as incorporating any special tasks, which, as provided in the Council's mandate, the Minister may request the Council to undertake. In this eventuality, if necessary, a revised budget would be prepared by the Council for the Department of Finance. The budget allocation for the Council should be shown as a separate line in the overall budget. The Council would decide on the appropriate allocation of expenditure within the overall approved budget.

Given experience with the initial operations of the Council, and even after allowing for substantial start-up costs, the work of the Council will entail a very significant ongoing commitment of time by members who are likely to have substantial other professional responsibilities.[25] However, in the current circumstances, the Council believes that that no public sector member should gain financially from their Council work. The Council, therefore, recommends that a buy out of time commensurate with that needed to fulfil the mandate set down by the Government take place. This approach would be applied to members employed by the Irish public sector. Comparable compensation would be provided to other members or their employers as appropriate.

The Council would also decide on the appointment of staff to the Council Secretariat and the terms of appointment, subject to compliance with accepted norms regarding grading and remuneration.

4.7 Transparency

Material relating to the composition of the Council and its overall budget should be posted on the Council's website. The Council would post on the website all of its regular reports, as well as reports on special topics or any specific advice it may be requested to provide. The Council would also indicate

[24] This approach would mirror the practice adopted in the UK's Office for Budgetary Responsibility.

[25] At the time the Council was established, it was anticipated that members could undertake Council work on a volunteer basis (with the exception of small stipends for non-Irish public sector members). However, the Council's experience to date has made clear that such a model is not effective or sustainable on an ongoing basis. It is estimated that members are likely to have to devote at least 20 per cent of their time to Council activities, with the Chair's commitment approximately two and a half times that.

on its website official meetings held between the Council and representatives of the Department of Finance or other relevant agencies.

4.8 Accountability

Accountability involves two distinct aspects. First, accountability of the Minister for Finance with respect to his involvement vis-à-vis the Council; and second, accountability of the Council itself for the activities it undertakes.

As regards the first aspect, and as already noted, the Minister should consult with the relevant Committee of the Oireachtas regarding appointments to the Council. The Minister should also consult with the relevant Committee of the Oireachtas on any other matters pertaining to the Council's activities, as appropriate.

In addition, and in order to promote an informed debate on fiscal policy matters, the Council believes it would be helpful for the Minister/Department of Finance to respond in writing to the Council's assessments and recommendations on a regular basis.

As regards the Council's own accountability, the Council would stand ready to meet with relevant committee of the Oireachtas, at the latter's initiative, to discuss the reports and activities of the Council.

On a regular basis, e.g., every four years, it is recommended that the Minister for Finance request a peer review of the Council's activities by recognised outside experts. The review may suggest amendments to the Council's mandate and/or modifications to the manner in which it is being fulfilled. The report of the peer review should be published on the Council's website. It is recommended that on an exceptional basis, the first such peer review be conducted within two years of the formal establishment of the Council in order to provide a timely assessment of the initial phase of its operations.

4.9 Arrangements vis-à-vis Other Public Sector Institutions

To the extent required, the Council should enter into structured arrangements with other Irish public sector institutions so as to ensure an appropriate flow of statistical or other information needed for the Council's work. Such arrangements might, in some instances, take the form of a written Memorandum of Understanding.

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Appendix

A Long-term Public Finance Simulation

A long-term public finance simulation was developed by the Council to examine how fiscal rules may operate, in terms of the impact on key fiscal variables, such as, the primary balance, the general government balance and the debt ratio.

Assumptions

It is assumed that the economy grows by 3.3 per cent per annum. This is based on the September report of the IMF, which projected a real GDP growth rate of 3.3 per cent and an output gap of 0 in 2016. The real growth rate is held at 3.3 per cent per annum until 2060. The GDP deflator is assumed to be 1.5 per cent. The interest rate is assumed to be 5.8 per cent i.e., the rate predicted by the IMF for Irish debt in 2016. Interest expenditures are then calculated as the previous year's debt stock times the nominal interest rate. These assumptions reflect an interest-growth rate differential of 1 per cent per annum.

Public Finances

Government expenditure is defined as the sum of interest expenditure, age related expenditure and non-age non-interest expenditure. Capital expenditure is held constant as a share of GDP post-2015. Age related expenditure is 17.2 per cent of GDP in 2007 (EC and Economic Policy Committee, 2008). EC and Economic Policy Committee (2008) predict that this will grow to 20.9 per cent in 2035 and 26.1 per cent in 2060. Non-age non-interest expenditure is held constant at 15.1 per cent of GDP between 2016 and 2060.

Government revenue in 2015 is 35.1 per cent of GDP according to the SPU. This is held constant over the period to 2060. For budgetary consolidation, it is assumed that two-thirds of the adjustments are on the expenditure side with one-third on the taxation side.

Operationalising the Rules

As no budgetary adjustments are implied in the baseline scenario, the fiscal position deteriorates as the costs of ageing and interest expenditure escalate. However, the baseline outlook can be easily modified to reflect different fiscal rules.

The Public Finance Correction Rule (PFCR)

Starting in 2016, the PFCR requires consolidation of the primary balance of 1.5 per cent per annum as long as debt ratio is above 90 per cent of GDP and/or the deficit is above 3 per cent of GDP.

As the debt-to-GDP ratio in 2015 is above 90 per cent, the primary balance is tightened in 2016, so that the surplus improves from 3.4 per cent of GDP in 2015 to the 4 per cent ceiling in 2016.

The budgetary adjustment is allocated across revenue and expenditure categories. No effect on GDP growth is assumed.

From that point on, the amount of consolidation is changed so that the primary surplus is maintained at the 4 per cent ceiling. Using this rule, the debt falls every year and declines to less than 60 per cent of GDP in 2031. As an alternative, a primary balance ceiling of 5 per cent would mean that the debt ratio would fall below 60 per cent in 2027.

PFCR: Debt Reduction Target

In this case the baseline was modified to allow for the application of a minimum improvement in the debt ratio of 3 per cent per annum. This was done by changing the budgetary adjustment in each year so that a 3 per cent reduction in the debt ratio was achieved. Under this rule, our simulations showed that a debt-to-GDP ratio of below 60 per cent is achieved in 2033.[26]

[26] A sensitivity analysis of the debt rule showed that a 2 per cent per annum debt reduction results in the debt ratio falling below 60 per cent in 2041. An annual debt reduction of 4 per cent causes the debt ratio to fall below 60 per cent in 2028.