Irish Fiscal Advisory Council

# Strengthening Ireland’s Fiscal Institutions

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# Background

- Fiscal Council asked to provide input into draft Fiscal Responsibility Bill (FRB)
  - Design of fiscal rules
  - Design of permanent fiscal council

- Focus of input is the DoF discussion document of March 2011 (included draft heads of bill)

- Evolving situation with negotiations over Fiscal Treaty/Compact

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# Overview (focus on rules)

- Rationale for fiscal rules
  - National case
  - European case
- Designing effective fiscal rules
- The critical importance of *flexibility*
- DoF proposals for fiscal rules
- Evolving treaty developments

# Rationale: The national case

- International concern over poor fiscal performance (deficit and debt biases)

- Broad agreement on principles of sound fiscal management
  - Sustainability
  - Stability
  - Countercyclicality

- Deviation from principles: Biases under political discretion
  - Conflicts of interest
    - Common pool problem
    - Short time horizon problem
  - Commitment problem (time inconsistency)
    - Soft budget constraint
    - Credibility of commitments not to default

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# Narrowing the gap

- Fiscal institutions can narrow the gap between sound and actual fiscal policies
  - Fiscal rules
  - Fiscal agencies
    - Fiscal authorities (delegation of authority)
    - Fiscal councils (advice/assessment)

- Common theme: Raising the cost of unsound fiscal management

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# Rationale: The European case

- Mutual insurance in a monetary union → Need for shared discipline
- Recent events show that the degree of mutual insurance (e.g. availability of LOLR) is conditional on arrangements for shared discipline

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# Challenge of designing effective fiscal rules

## **Flexibility vs. Credibility**

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# Proposed DoF rules

- Public finance correction rule (PFCR)
  - Debt > 90% or Def > 3% → 1.5pp of consolidation
  - 60% < Debt < 90% and Def% < 3 → 0.75pp of consolidation
- Prudential budget rule (PBR)
  - Structural deficit > 0.5% → 0.5pp of consolidation
- Sustainable expenditure growth rule (SEGR)
  - Current expenditure limited to grow at rate of potential output unless financed by discretionary tax increases

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# The workhorse equation

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

$$\Delta d = def - gd_{-1}$$

<u>Where</u>

d = debt/GDP

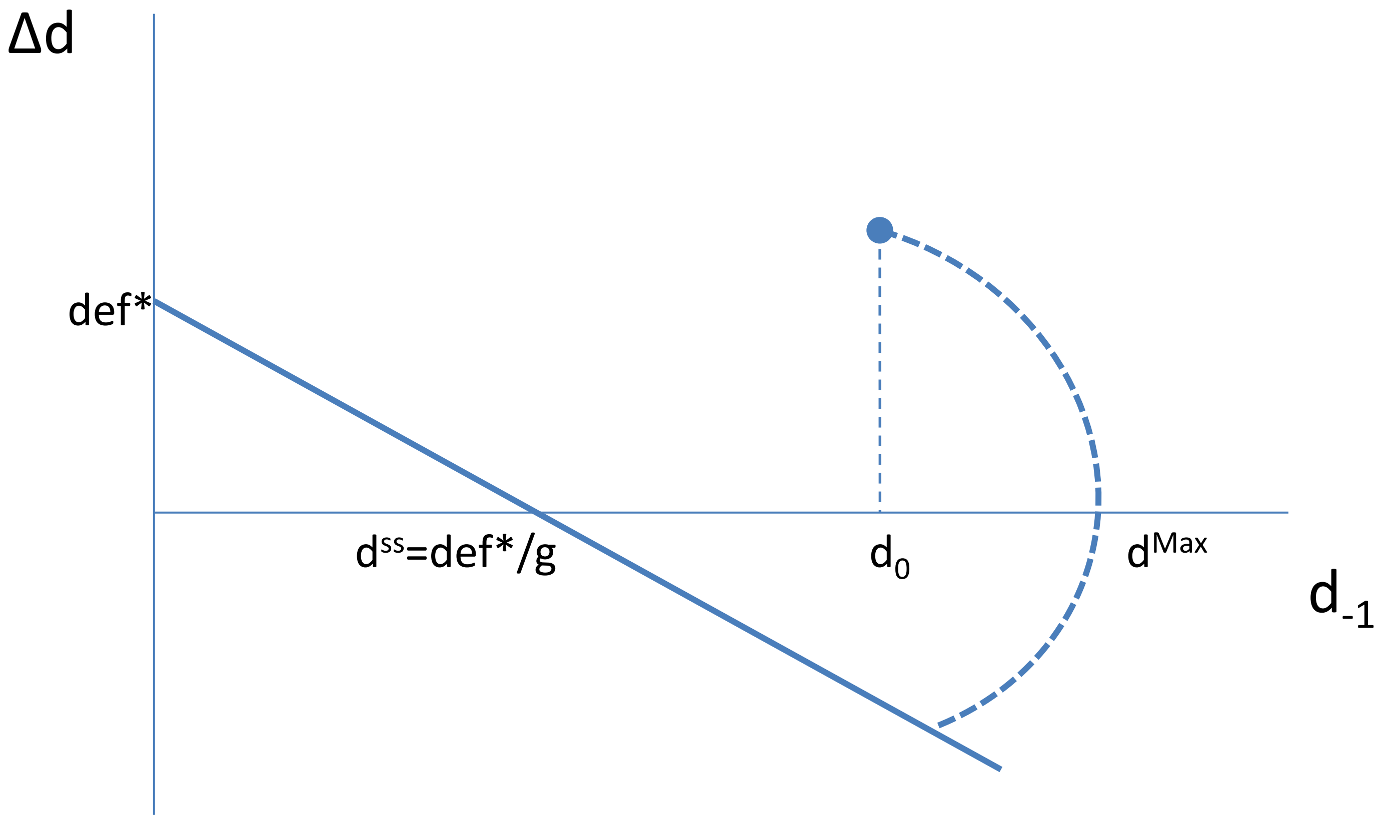
i = nominal interest rate

g = nominal growth rate

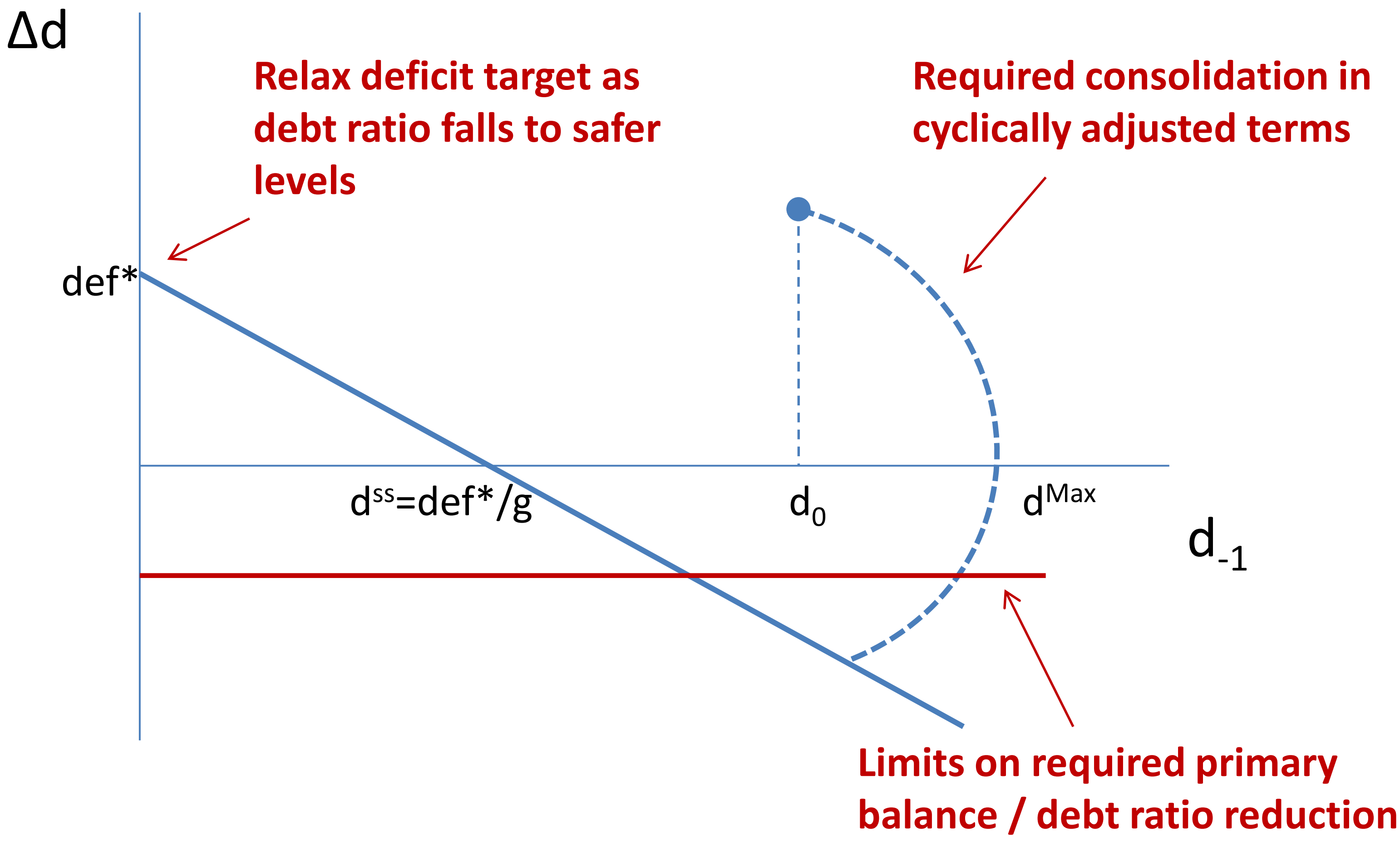
pb = primary balance

def = deficit as a share of GDP ($id_{-1} - pb$)

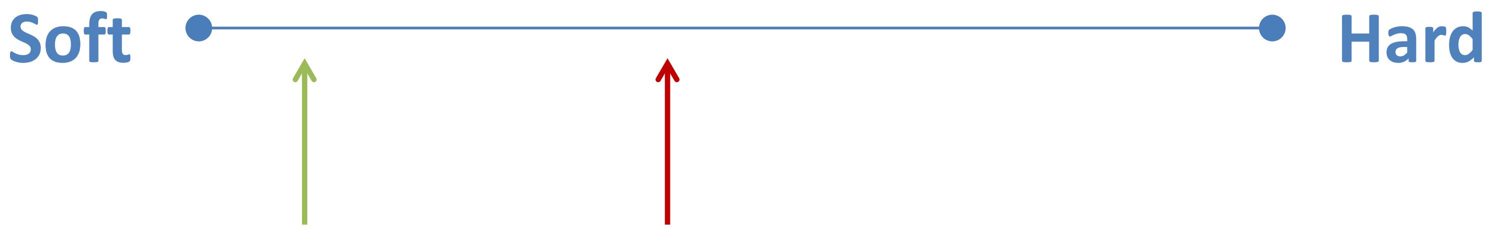
# Debt ratio dynamics: The “Grim Reaper”



# Potential flexibilities



# Enforcement




"Comply or Explain"

- Principles/rules in legislation
- 5-year debt targets
- Annual fiscal statements
  - Retrospective performance
  - Prospective plans
- Assessed by Fiscal Council

# DoF approach superseded by treaty

- Structural balance target: The "Golden Rule"
- Adjustment path: Determined by Commission
- Correction of deviations: Mechanism laid down in national law (according to principles laid down by Commission)

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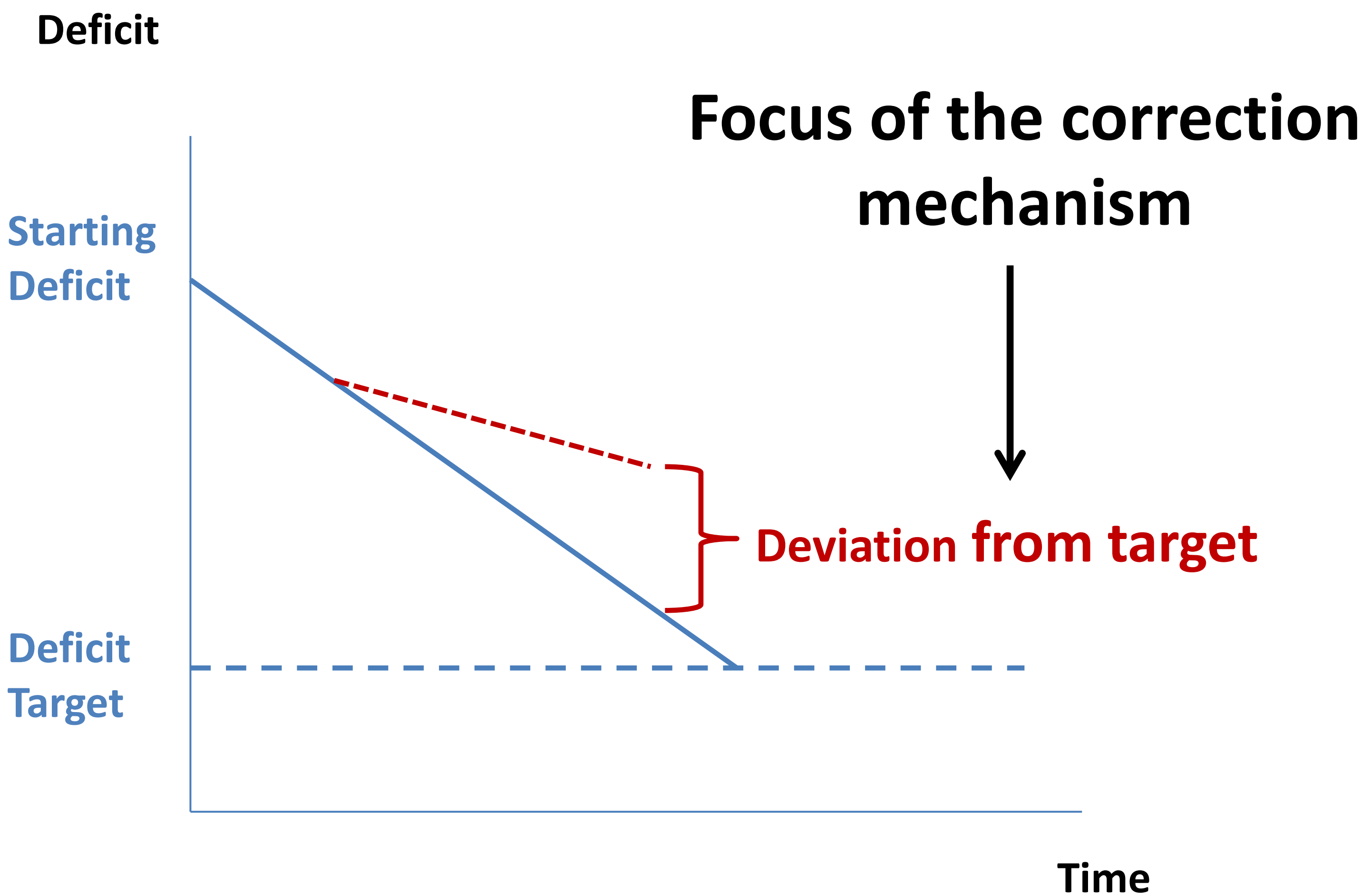
# Proposed rules in treaty



# Flexibility remains critical

- Adjustments specified in cyclically adjusted terms
- Reasonable adjustment path towards MTO/Golden Rule
- Relax structural deficit target as debt reaches safer levels (current proposal is to relax target to 1% of GDP – does not seem enough)

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# Relevance of the proposed treaty

- The importance of the Treaty lies less in the additional rules imposed (almost all already in place)

- Main innovation is use of national law to enforce corrections
  - Dissatisfaction with European-level enforcement mechanisms

# Most recent draft

National law

Correction mechanism:

*Binding force + permanent character*

(preferably constitutional)

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# Concluding thoughts

- Need for greater understanding of the implications of rules design
- But most of the European rules machinery already in place
- Cannot avoid the fact that mutual insurance mechanisms (ESM, ECB, Eurobonds, etc.) are likely to be conditional on effective rules
- Needed emphasis on sensible implementation of European rules