# Investment and the Fiscal Rules

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# Investment and the Fiscal Rules

- Perceptions of fiscal rules range from a positive post-crisis development to a negative constraint imposed on the state.
- Views vary across the political spectrum and over time depending on context (e.g. interest rate environment) and priorities.
- In a hypothetical situation where additional investment is the policymakers priority, to what extent do the fiscal rules act as an asset or a constraint?

# Opposing views – asset or constraint.

- The fiscal rules as an Asset:
  - "The expenditure benchmark maintains expenditure growth in line with the long-term average potential growth of the economy, thereby ensuring that the level of spending is sustainable and can continue to be supported by the economy, in the absence of accommodating revenue raising policy measures." – Department of Finance, Summer Economic Statement 2016

- The fiscal rules as a Constraint:
  - "We need a robust rules-based approach to the management of day-to-day spending and taxation, but capital investment projects should be treated significantly more favourably. There is some existing flexibility, but in practice the rules bias toward recurrent expenditure over once off capital projects. In addition, raising funds through discretionary tax hikes makes little sense when interest rates are at record lows." – Danny McCoy (Sep. 2016)

# Outline

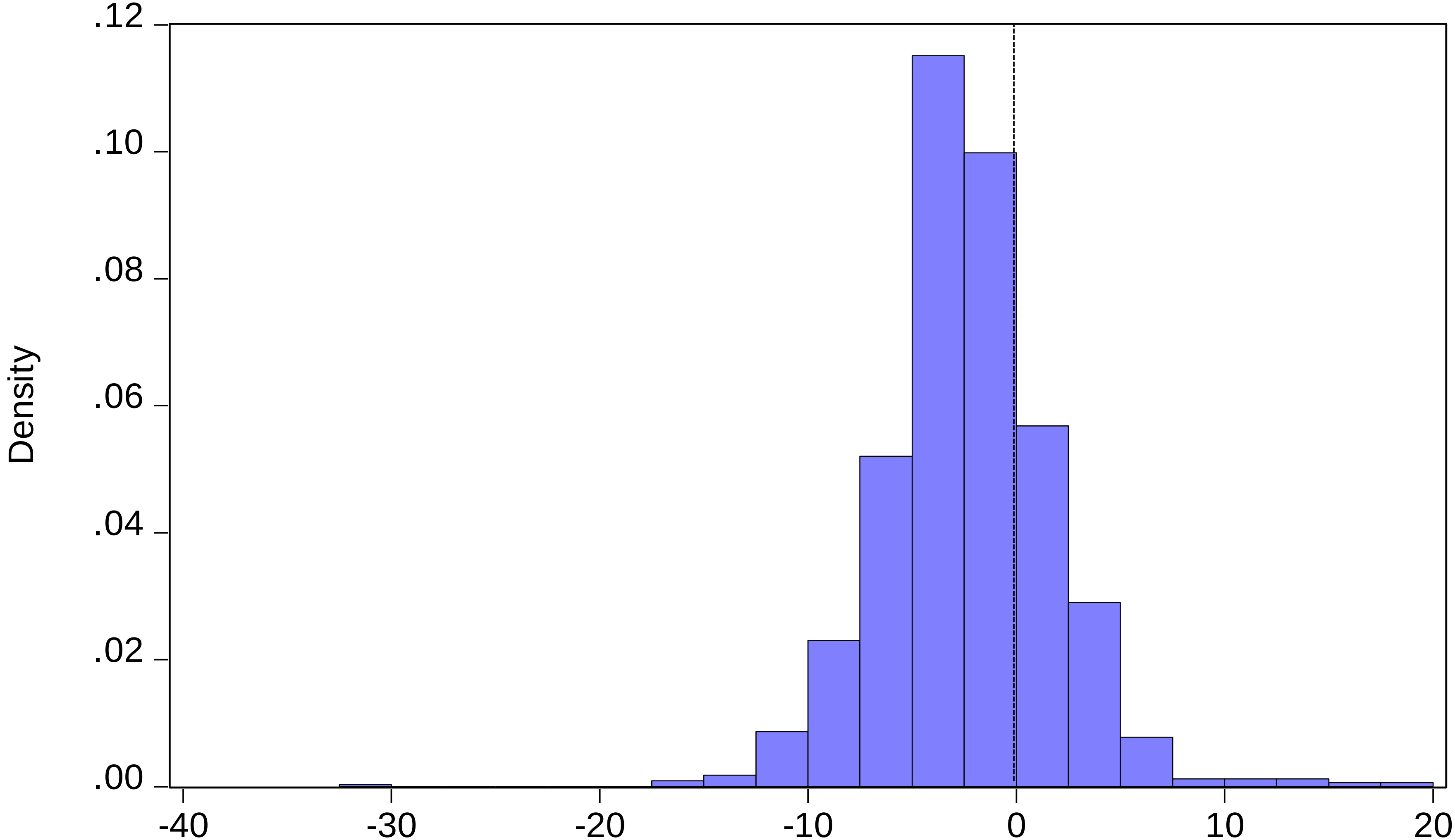
- Why do we have fiscal rules?
- What are the fiscal rules applicable to Ireland?
- The treatment of investment
- Alternative approaches
- Some conclusions

# Why do we have fiscal rules?

- Evidence of bias towards consistently running deficits
  - Composite budget balance of OECD countries, as well as most individual members, dominated by deficits over last 5½ decades.
- Can erode the capacity for countercyclical policy and lead to unsustainable debt dynamics
- Fiscal rules intended to limit potential damage of such biases
- Broad principles relatively uncontroversial
  - Spend within means
  - Ensure debt is sustainable
  - Avoid pro-cyclicality in good times and difficult retrenchments in bad times
  - Enable countercyclical supports to economy
  - Support long-run incomes and growth

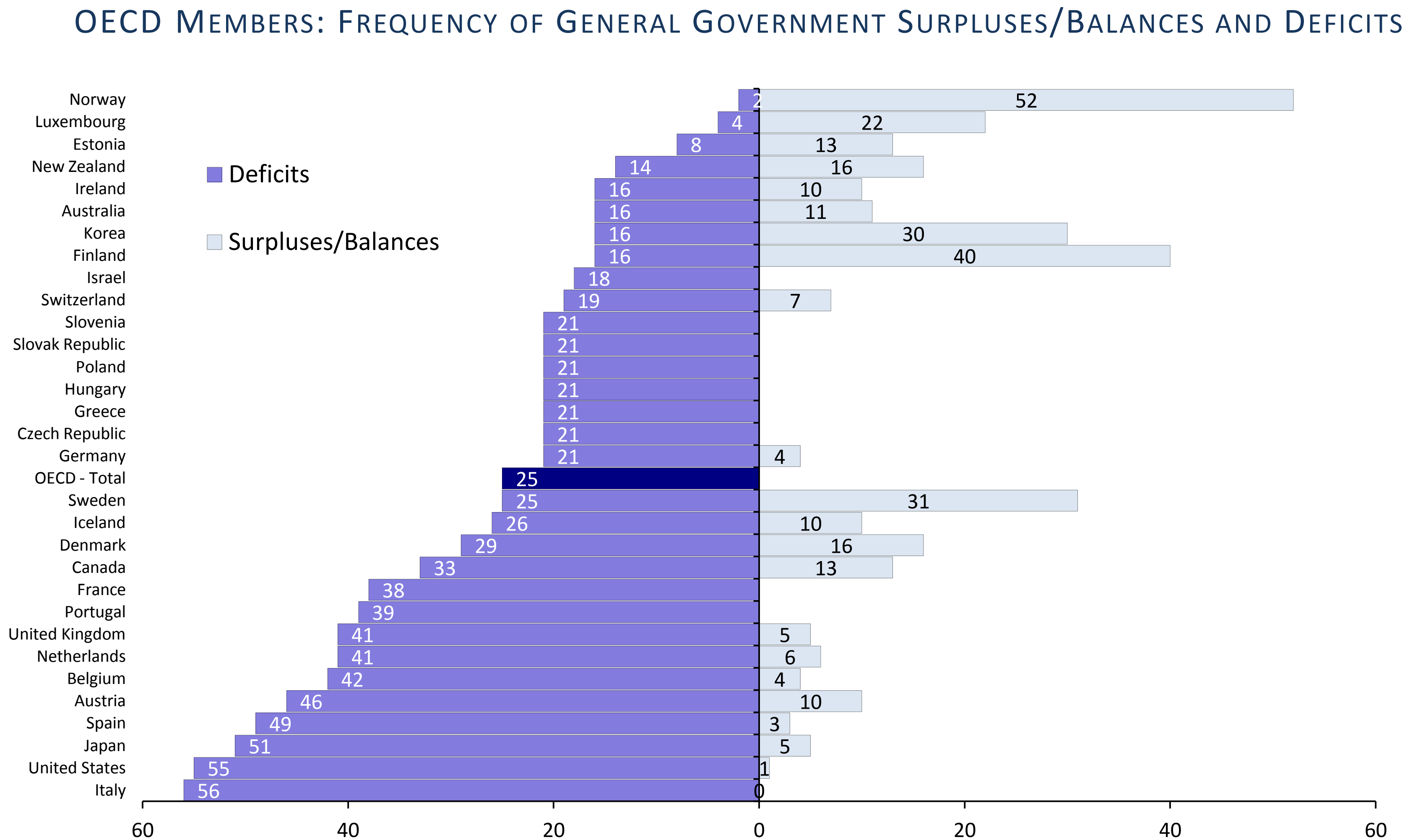
# OECD: Deficit Bias

Distribution of OECD Member Deficits (% GDP, 1960 – 2015)



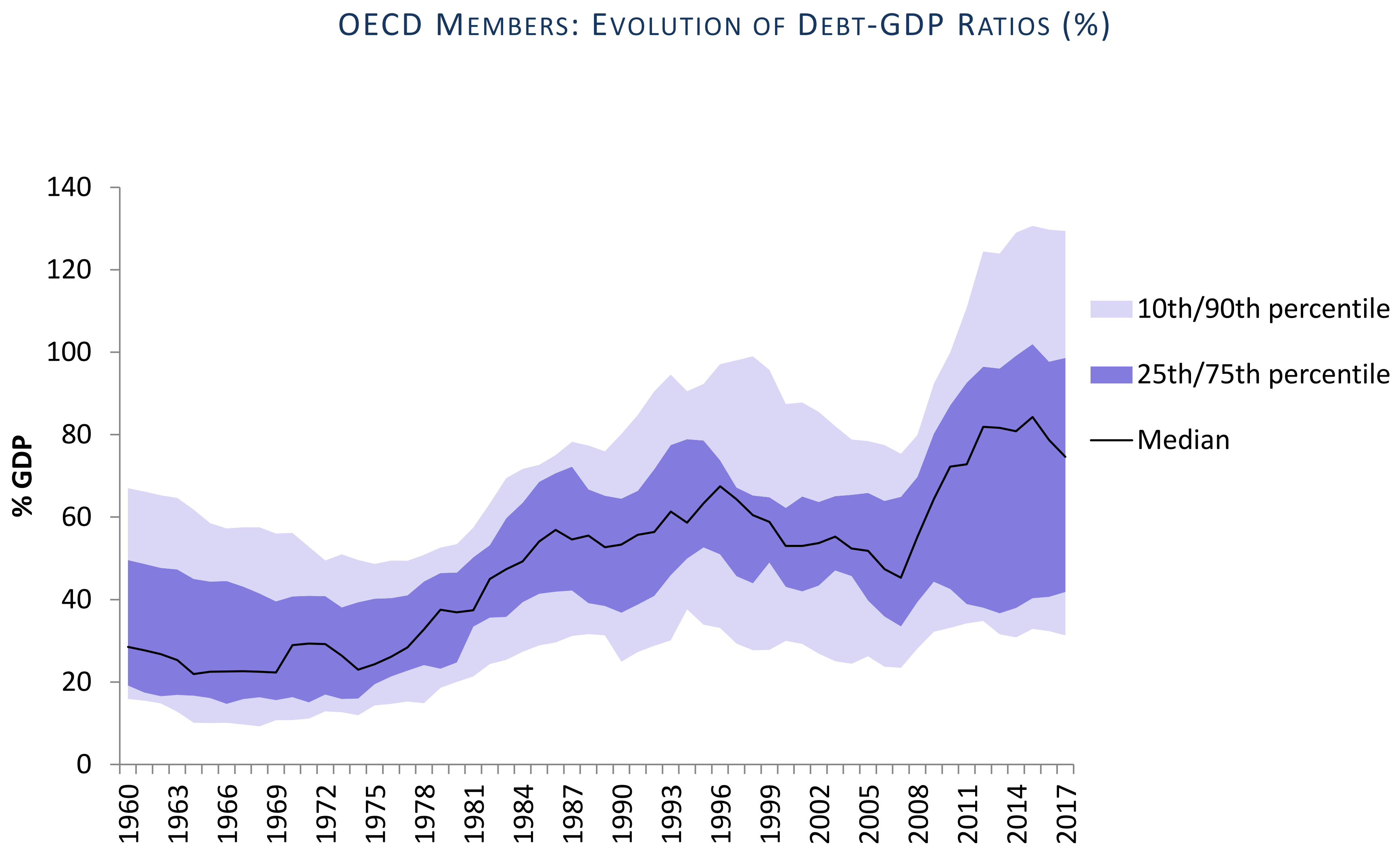

*Source*: OECD.

# OECD: Deficit Bias




*Source:* OECD.
*Note*: Data cover available observations for 1960-2015 and are expressed as % GDP.

# OECD: Debt




*Source*: OECD.
*Note*: Covers 19 Members for which data are consistently available.

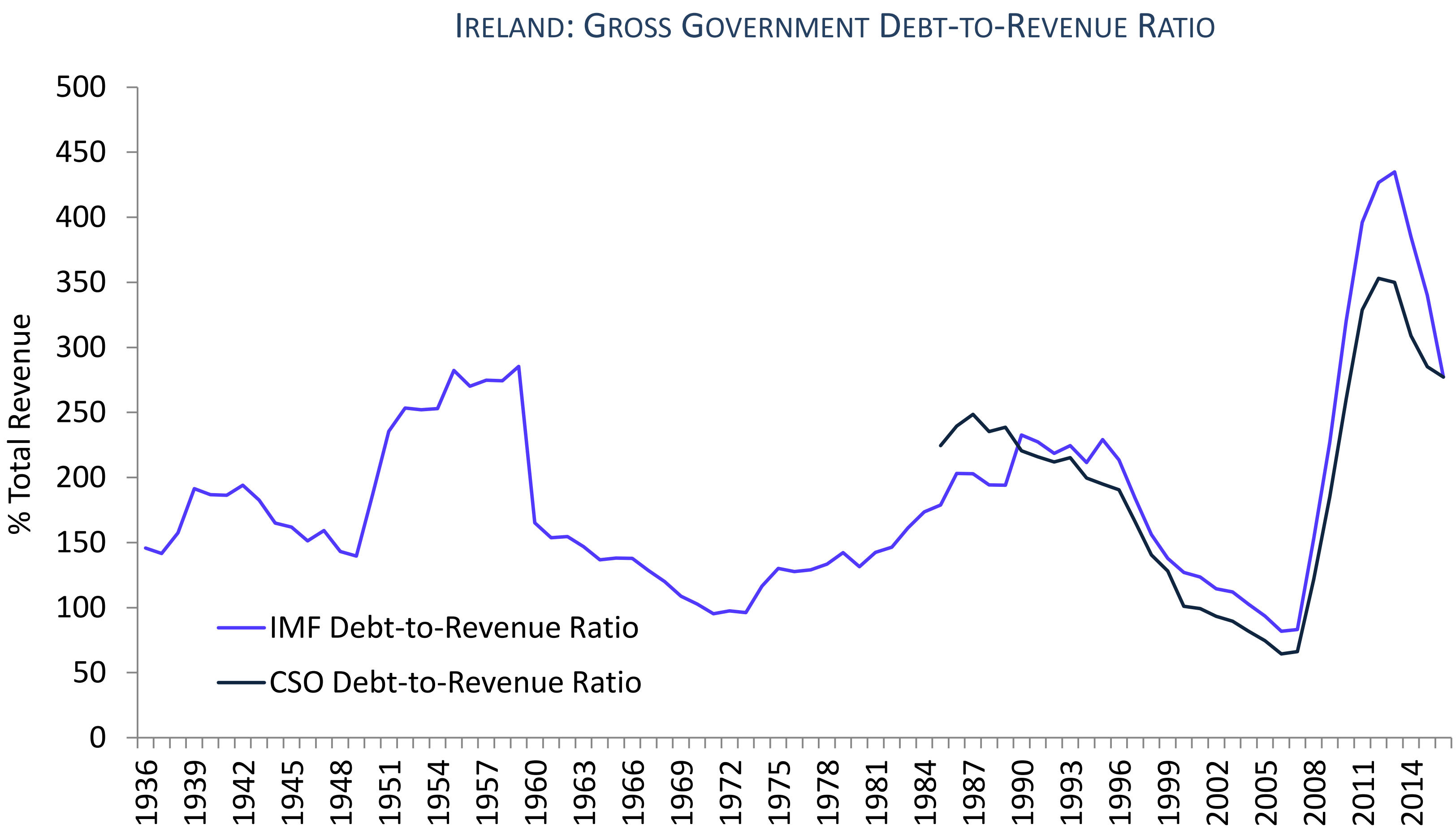
# Experience in Ireland

- Evidence of deficit bias & debt sustainability concerns

- Procyclical fiscal policy

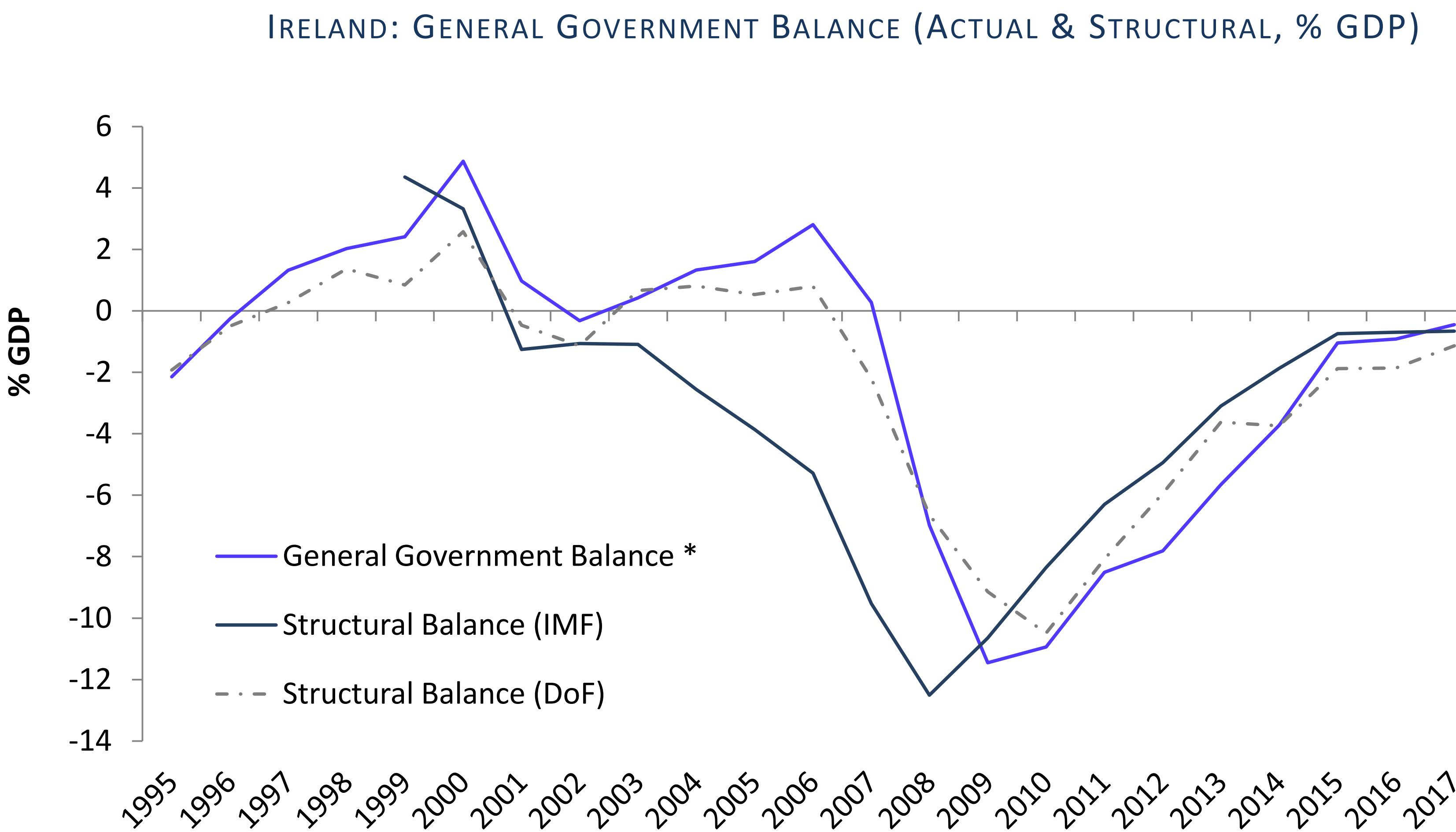
- Formal attempts at containing these biases ⇨ Fiscal Rules
  - Avoid risk of unsustainable debt dynamics.
  - Avoid risk that fiscal policy remains procyclical.

# Experience in Ireland



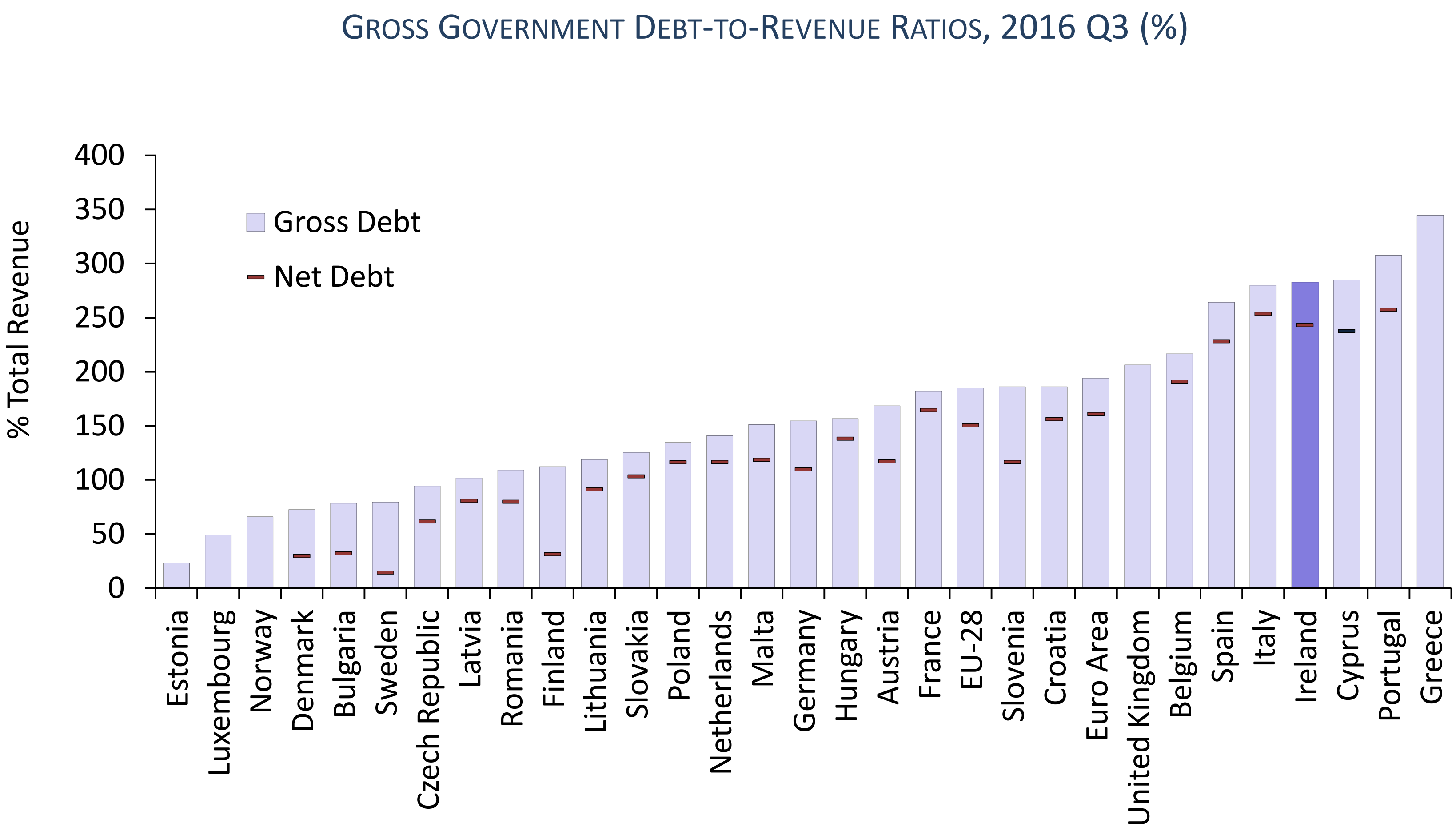

*Sources*: IMF (Historical Public Debt Database); and CSO.

# Experience in Ireland




Sources: IMF (WEO, Oct 2016); Department of Finance (Budget 2017); CSO.

# Experience in Ireland




*Source:* Eurostat; internal IFAC calculations.
*Note:* Net debt from Eurostat Government Finance Statistics calculated as Gross Consolidated Debt less EDP debt instrument assets (F2: Currency and Deposits; F3: Debt securities; and F4: Loan assets). Total General Government Revenue = 4 quarter sum.

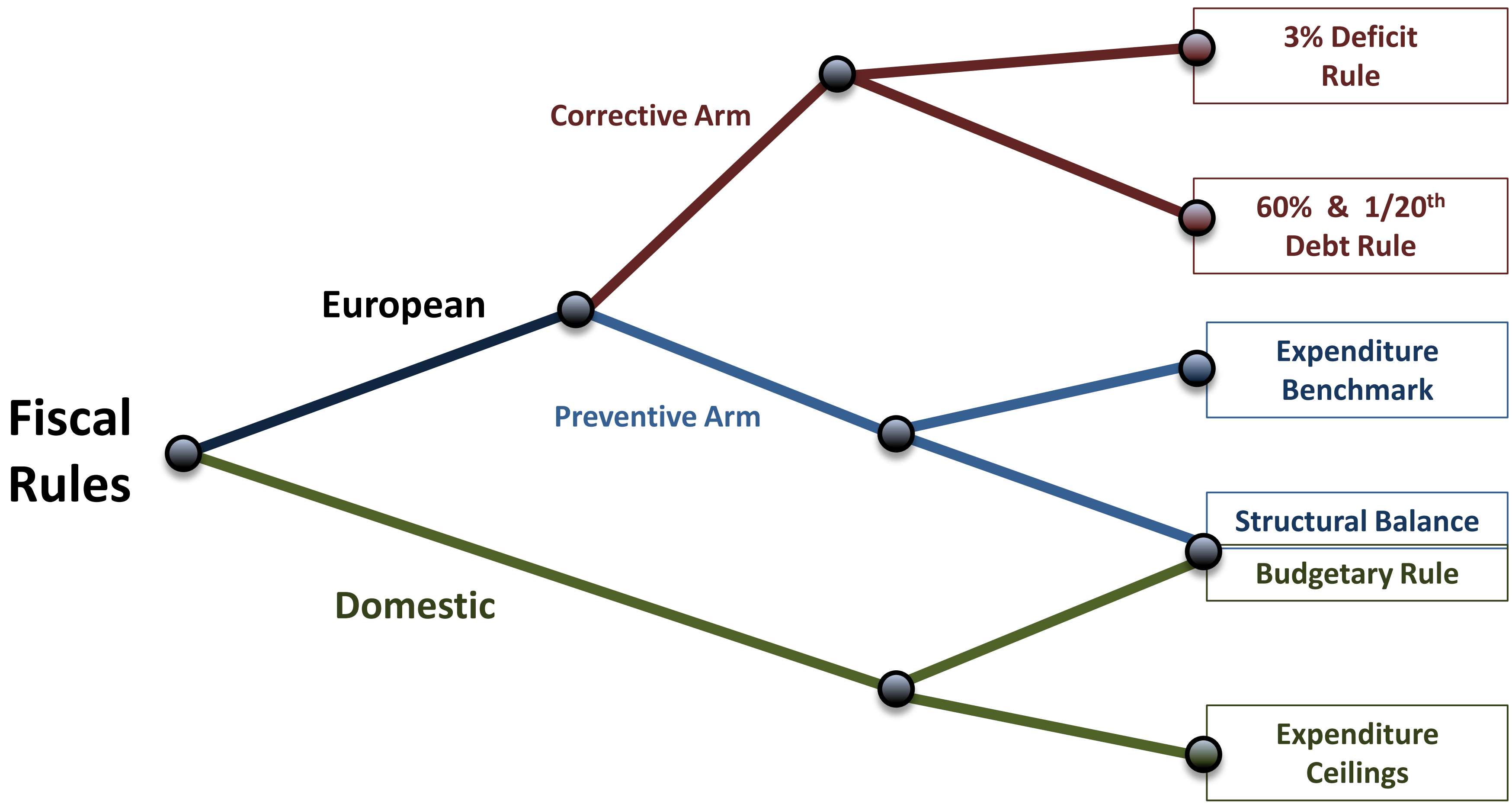
# Fiscal Rules as an Asset

- Still developing literature suggests that fiscal rules are associated with stronger fiscal performance (e.g., Debrun et al., 2008; Debrun and Kumar, 2007; European Commission, 2006; Deroose et al., 2006;).

- Typically associated with smaller cyclically adjusted primary deficits (but causation and omitted variable bias).

- To the extent that this influences debt dynamics and risk premia, additional benefits may be conferred.

# What are the fiscal rules applicable to Ireland?



# Expenditure Benchmark: Aggregate

- When assessing Expenditure growth, the Benchmark uses a modified aggregate that strips out interest spending, matched EU programme spending, spikes in investment, cyclical unemployment benefits and, finally, new revenue measures.

**General Government Expenditure**

\- Interest expenditure

\- Government expenditure on EU programmes which is fully matched by EU funds revenue

\+ Gross fixed capital formation averaged over t-3 to t

\- Gross fixed capital formation (for year t)

\- Cyclical unemployment benefit expenditure

= **Modified Expenditure Aggregate ($E_t$)**

\- Incremental year t impact of discretionary revenue measures ($\Delta R_t$)

= **Expenditure Net of Discretionary Revenue Measures ($E_t$-$\Delta R_t$)**

% Net expenditure growth rate for year t: $g_t = (E_t - \Delta R_t - E_{t-1})/E_{t-1}$

Deflate with GDP deflator to obtain net expenditure growth in real terms.

# Expenditure Benchmark: Max Growth Rate

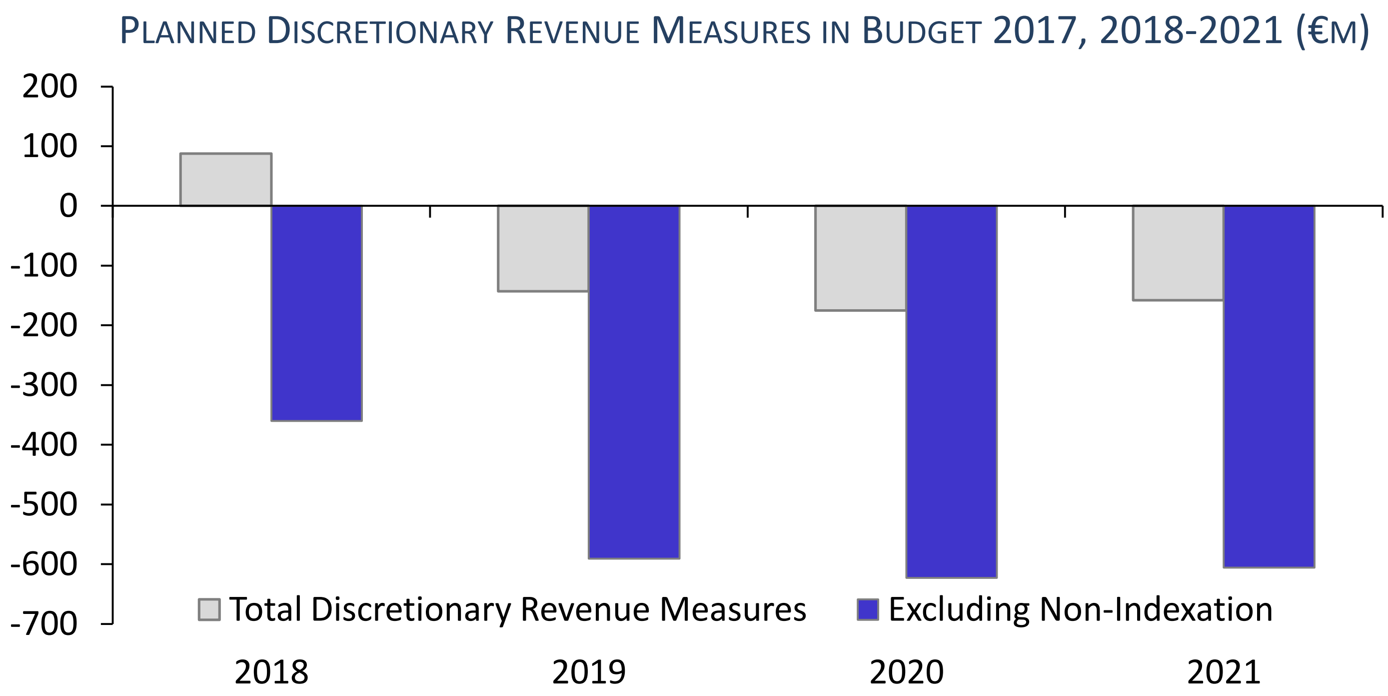
- The maximum allowable real growth rate reflects:
  - Reference Rate ($RR_t$): potential growth estimates averaged over a 10yr period (t-5 to t+4): $RR_t = \text{mean}(\Delta Y^*_{t-5 \text{ to } t+4})$
  - Convergence Margin ($C_t$): This reflects the adjustment path towards a country's MTO: $C_t = (0.5/PE_t) * (SBAdjReq_{t+1}/0.5)$
  - $EB_t = RR_{t-1} - C_{t-1}$
- The deflator that applies is the average of EC Spring + Autumn forecasts made in t for period t+1
- Limit applies for t+1 to the modified expenditure aggregate in t:

# The Treatment of Investment

- If investment is deemed a priority, it is important to note that this is not prevented outright by the fiscal rules
- Starting with existing levels of annual investment spending (the Expenditure Benchmark is a growth-based rule) other flexibilities relevant for investment include:
    - Faster expenditure growth (i.e., above the maximum pace set) is allowed if financed through Discretionary Revenue Measures
    - Investment clause
    - Structural reform clause
    - PPPs, SPVs and European investment funds
    - Spikes in investment are allowed through use of deviation from 4yr average

# The Treatment of Investment

- Expenditure growth above maximum pace set by Expenditure Benchmark allowed if financed through Discretionary Revenue Measures.




*Sources:* Department of Finance (*Budget 2017*); and internal IFAC calculations.
*Note:* Ex-post forecasts consistent with stated policy to use estimated fiscal space for tax cuts and spending increases.

# The Treatment of Investment

- **Investment Clause**
- Temporary deviation from MTO (or adjustment path) if:
  - output growth is negative or output gap ≤ -1.5%
  - deviation does not lead to an excess deficit over 3% GDP and an appropriate safety margin is preserved
  - investments have positive, direct and verifiable long-term budgetary effects on growth and on the sustainability of public finances
  - Investments are linked to EU co-funded projects under the Structural and Investment Funds, Trans-European-Network (TEN) and Connecting Europe Facility (CEF) and to national co-financing of investment projects also co-financed by the EFSI
  - Co-financed expenditure does not substitute for nationally financed investments, so that total public investments are not decreased
  - the Member State compensates for any temporary deviations and the MTO is reached within the four-year horizon of its current Stability or Convergence Programme.

# The Treatment of Investment

- **Structural Reform Clause**
- Temporary deviation from MTO (or adjustment path) if reforms:
  - are “major"
  - have verifiable direct long-term positive budgetary effects, including by raising potential sustainable growth
  - are fully implemented
  - Member States present a dedicated structural reform plan providing detailed and verifiable information, as well as credible timelines for adoption and delivery.
- Deviations cannot exceed 0.5% of GDP, and the MTO is reached within the four year horizon of the Stability or Convergence Programme of the year in which the clause is activated
- An appropriate safety margin must be preserved so that the deviation from the MTO or the agreed fiscal adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

# The Treatment of Investment

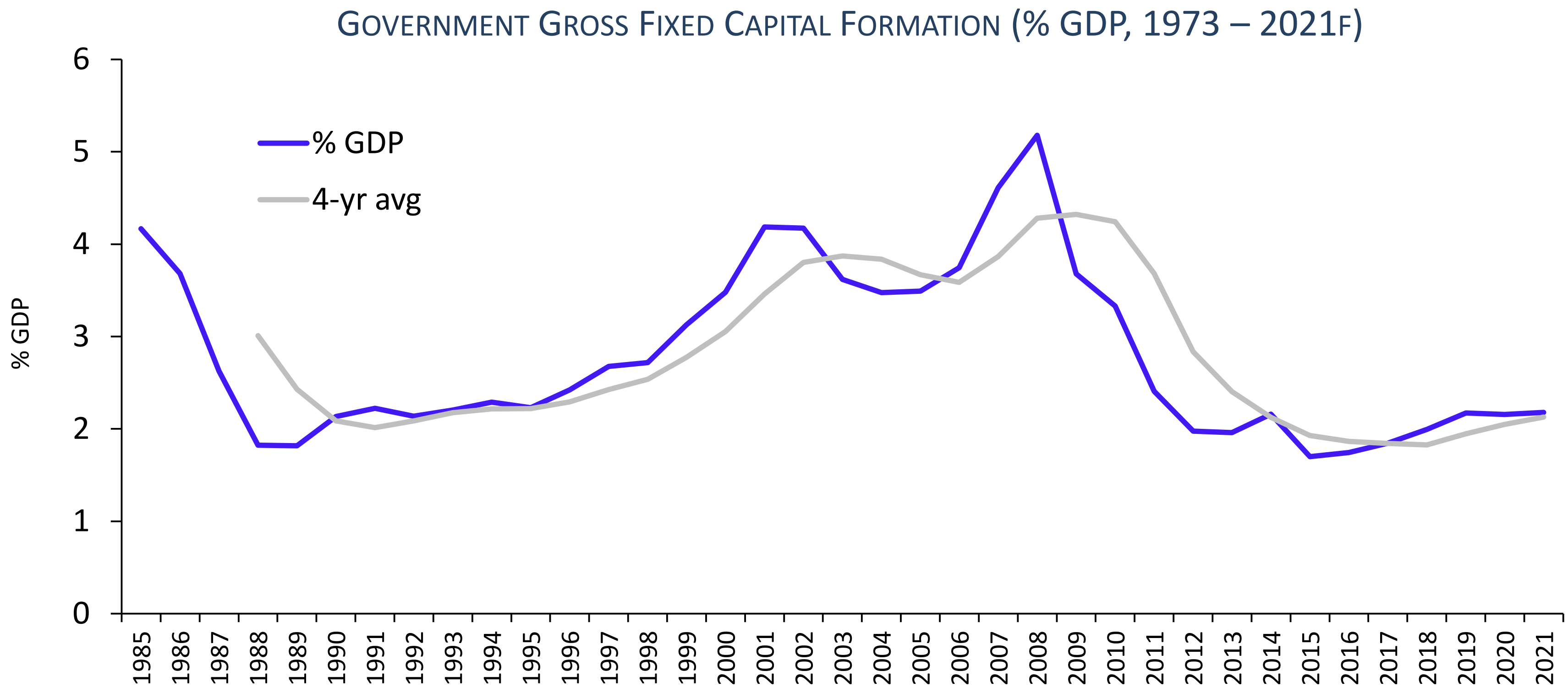
- **Ireland Strategic Investment Fund**
- NPRF successor - €8.1bn fund with legislative mandate to invest on commercial basis supporting employment and output growth

- Specific legal requirements:
  - Return on assets of whole fund > annual interest cost of the general government debt averaged over 5yrs
  - Seek to ensure that investments do not negatively impact net general government borrowing for any year

- Aims to leverage additional funding, while avoiding crowding-out of private sector investment

# The Treatment of Investment

- Averaging over 4yrs allows for spikes in investment




*Source:* CSO, Department of Finance Forecasts, internal IFAC calculations.

# The Treatment of Investment

- Often argued that public investment fosters long-run growth and so should be excluded from fiscal targets altogether (Fall et al., 2015).

- Difficult to decide where line should be drawn:
  - Physical Investment is typically first to mind (too narrow a view?)
  - Macroeconomists also think of education, R&D, health...

- If debt-financed, is it better to take account of this debt created immediately or later (some positive demand effects on growth are reaped in the short run; other supply-side effects in the long-run with spill-overs to the private sector).

# Alternative approaches

- In order for rules to work, they must navigate a tricky line between being sufficiently comprehensive to accomplish objectives, anticipate loopholes and avoid excessive complexity (Below, B., 2016).
- Tension between designing rules for optimal behaviour, and designing rules effective at preventing deficit bias (Portes and Wren-Lewis, 2015).
- Are there alternatives that might give different consideration to investment?

# Alternative approaches: Golden Rule

- One often cited proposal is the Golden Rule:
  - only current expenditure needs to be balanced by ordinary revenue, but that a country can— within limits—safely run a fiscal deficit (an amount it must borrow from domestic or foreign investors) equal to the capital spending of the government.
  - i.e., cover current budget with government revenues, whatever you can for the capital budget.

- But, several issues:
  - Promotes new investment projects over maintenance of existing assets.
  - Primacy of fixed assets "… borrow for building a new hospital but not for hiring doctors or nurses or for buying medicines" (Tanzi and Davoodi, 1998).
  - What is included as investment? Physical infrastructure, but macroeconomists also consider Health, Education, R&D as investment.

# Alternative approaches: Golden Rule

- ESA 2010 definition of Gross Fixed Capital Formation:

  - **Excluded (3.130) :** *(a) transactions included in intermediate consumption, like: (1) purchase of small tools for production purposes; (2) ordinary maintenance and repairs; (3) the acquisition of fixed assets to be used under an operational leasing contract (see also Chapter 15: Contracts, leases and licences).*

  - **Included (3.125):** *(1) new or existing fixed assets purchased; (2) fixed assets produced and retained for producers' own use (including own account production of fixed assets not yet completed or fully mature); (3) new or existing fixed assets acquired through barter; (4) new or existing fixed assets received as capital transfers in kind; (5) new or existing fixed assets acquired by the user under a financial lease; (6) major improvements to fixed assets and existing historic monuments; (7) natural growth of those natural assets that yield repeat products.*

  - **Major Improvements (3.128)**: *(a) reclamation of land from sea by the construction of dikes, sea walls or dams for this purpose; (b) clearance of forests, rocks, etc. to enable land to be used in production for the first time; (c) draining of marshes or the irrigation of deserts by the construction of dikes, ditches and irrigation channels; prevention of flooding or erosion by the sea or rivers by the construction of breakwaters, sea walls or flood barriers.*

# Alternative approaches: Golden Rule

General government expenditure by function (2014, COFOG)

| | % GDP | % Total Exp |
|---|---|---|
| Health | 7.6 | 19.8 |
| Education | 4.3 | 11.2 |
| R&D | 0.5 | 1.3 |
| Transport | 1.3 | 3.4 |
| Housing and community amenities | 0.7 | 1.8 |
| Environment protection | 0.6 | 1.6 |
| Water supply | 0.5 | 1.3 |
| Waste water management | 0.3 | 0.8 |
| Fuel and energy | 0.2 | 0.5 |
| Mining, manufacturing and construction | 0.1 | 0.3 |
| Protection of biodiversity and landscape | 0.1 | 0.3 |
| Environmental protection n.e.c. | 0.1 | 0.3 |
| Housing development | 0.1 | 0.3 |
| Community development | 0.1 | 0.3 |
| **Total of Above Items** | **16.5** | **43.1** |
| **Total Expenditure** | **38.3** | **100.0** |

*Source*: Eurostat.

# Alternative approaches: Distributed Costs

- Another proposal is to, as in corporate accounting, distribute the cost of an investment is over future years during the service life of investment (Claeys, Darvas and Leandro, 2016).
  - Idea is that the cost of investment is not charged to a single year when the investment is implemented, but distributed across the years of its use.
  - Additional complexities (appropriate service life of specific investments…)

# Alternative approaches: Investment Targets

- A further proposal is to set out *ex-ante* a targeted level of public investment that policymakers would then stick to (Portes and Wren-Lewis (2015))
  - Have a separate target for the public investment to GDP ratio
  - e.g., governments could aim to achieve overall levels of public investment of at least x% of GDP.
  - Idea is to help ensure that any fiscal retrenchment does not lean too heavily on public investment projects.

# Some Conclusions

- Rules exist for good reasons – grow spending at sustainable rates, avoid aggravating boom-bust tendencies and guide debt to safe levels. Absent rules, past mistakes are more likely to recur.

- Arguments exist why investment might be treated differently

- But not clear that rules constrain investment any more than recurrent expenditure:
  - Some additional flexibilities for investment in rules
  - Scope for discretionary revenue measures

- Changes would create additional issues:
  - Tension between optimal behaviour and effective control of deficit bias
  - Possible unintended distortions related to ‘investment’

# Thank You