5. Compliance with Fiscal Rules: A Preliminary Examination

5.1 Introduction

As part of its mandate under the Fiscal Responsibility Bill (FRB), the Council is required to provide an assessment, at least once a year, of compliance with the Budgetary Rule or (if applicable) the Correction Mechanism set out in the FRB.[48] More broadly, under the FRB, as part of its assessment of the fiscal stance, the Council is expected to provide its assessment with "reference to the provisions of the Stability and Growth Pact".[49]

This chapter sets out some background for the Council's planned future assessment of compliance with the rules. The Council's approach to meeting this part of its mandate will be further developed in future reports, which will follow the expected enactment of the legislation later this year. Section 5.2 introduces the fiscal rules, which would come into force under the FRB, and already exist under the EU framework. In an illustrative exercise, Section 5.3 considers how the *SPU 2012* projections would comply with fiscal rules and also the implications of the rules under a scenario that extends beyond the 2015 horizon of the *SPU*. Section 5.4 summarises the main conclusions.

5.2 The Fiscal Rules

Ireland has been subject to a set of fiscal rules for many years via the Stability and Growth Pact (SGP) of the EU Treaty, which was adopted in 1997. This Pact was reformed in 2005 and again in 2011. The most recent reforms, the so-called "six pack", came into force in late 2011. At the same time, the "Fiscal Compact" Treaty[50] requires countries to have rules requiring that the budget position be "balanced or in surplus" that are included in national law of "binding force and permanent character, preferably constitutional". A further set of essentially procedural rules would be put in place under the so-called "two pack" of regulations currently under consideration by the EU. In Ireland, the FRB is designed to meet the Fiscal Compact requirement by putting in place the required fiscal rules, as well as putting in place the formal establishment of the Irish Fiscal Advisory

[48] See Part 3, Section 8._(2) of the FRB which is available here: http://www.finance.gov.ie/documents/pressreleases/2012/mn109append.pdf

[49] See Part 3, Section 8._(2).

[50] Treaty on Stability, Coordination, and Governance (TSCG).

Council. Analysis undertaken by the Council has suggested the value and oversight such fiscal rules could have for Ireland (Hagemann, 2012; IFAC, 2012b).

The EU and FRB requirements are complex, both in terms of the procedures around them and the exact provisions and wording. While the original legal texts provide the definite statement of the rules, they are essentially built around three fiscal rules:

- The EU SGP requirement for the General Government deficit to be less than 3 per cent of GDP.

- The EU SGP requirement and FRB **Budgetary Rule**, which in essence requires that the budget, in structural terms, be in balance or surplus, but can be achieved through reaching an EU agreed country-specific Medium Term Budgetary Objective (MTO) for the structural balance.[51] The Budgetary Rule would apply from the coming into force of the FRB.

- The EU SGP requirement and FRB **Debt Rule** that a General Government debt ratio in excess of 60 per cent of GDP should be reduced according to a formula that requires approximately a 1/20th reduction of the excess over 60 per cent per year.[52] This requirement does not apply for 3 years following the ending of the Excessive Deficit Procedure, which should mean after 2018 for Ireland.[53]

[51] The MTO for Ireland is currently set at the lower limit allowed by the EU rules of an annual structural balance of -0.5 per cent of GDP. This EU lower limit can be reduced to -1.0 per cent of GDP if debt is significantly smaller than 60 per cent of GDP and long-term sustainability risks to the public finances are low.

[52] The exact benchmark formula for the allowable debt to GDP ratio is: *Benchmark = 60 per cent + 0.95/3*$(b_{t-1}$ *- 60 per cent) +* $.95^2/3$ $(b_{t-2}$ *- 60 per cent) +* $0.95^3/3(b_{t-3}$ *- 60 per cent)*, where b is the debt to GDP ratio. The requirement can also be met on a forward-looking basis based on EC forecasts for the benchmark at t+2. The effect of the cycle is taken into account.

[53] To see why the rule is referred to as the 1/20th rule, note that if the benchmark formula only uses a one-period lag, then the formula becomes: *Benchmark = 60 per cent + 0.95*$(b_{t-1}$ *- 60 per cent*). Now setting the current-period debt to GDP ratio equal to the benchmark, the formula can be written as: b_t *= 60 per cent +* $(1 - 0.05)(b_{t-1}$ *– 60 per cent)*. Rearranging, this can be written as: $b_t - b_{t-1}$ *= 0.05(60 per cent –* $b_{t-1})$. The required change in the debt to GDP ratio is equal to 1/20th (or 0.05) of the difference between last period's debt to GDP ratio and 60 per cent. If the debt to GDP ratio is above 60 per cent, then the rule requires the percentage point fall in the debt to GDP ratio is as given by the formula. Thus, the actual benchmark formula with up to three-year lags can be viewed as an extension to a simple 1/20th rule.

The FRB does not mandate a specific statutory role for the Council in monitoring compliance with the Debt Rule, although the equivalent SGP requirement is one of the references for its overall fiscal assessment in the draft legislation.

In addition, the adjustment path where the structural balance does not meet the MTO and FRB Budgetary Rule requires:

> ...steps to achieve it over the cycle... [and]... adjustment effort should be higher in good times; it could be more limited in bad times. .... [countries] should pursue an annual adjustment in cyclically adjusted terms, net of one-off and other temporary measures, of 0.5 of a percentage point of GDP as a benchmark (European Commission, 2012c p. 5).[54]

If the EC or the Government believes that there is failure to abide by the Budgetary Rule, the FRB provides for a Correction Mechanism, which the Council would be required to assess. The rules are explained in more detail in Box D.

Box D: Fiscal Rules set out in the Fiscal Responsibility Bill

The FRB states that the Government would "endeavour to secure" compliance with two fiscal rules: the Budgetary Rule and the Debt Rule.

The Budgetary Rule sets out that for each year:

- The "budget condition" is met. This is satisfied if the General Government budget is in balance or surplus or, if not, failure to be so is "...only as a result of exceptional circumstances and the failure to meet it does not endanger fiscal sustainability in the medium-term". This is deemed to be respected if the Medium-Term Budgetary Objective (MTO), specified in terms of the structural balance, is met. It is currently set at a structural deficit of up to 0.5 per cent of GDP, which is the lower limit allowed by the SGP (except where the public finances are in very good health).

- The "adjustment path" condition is met. This is satisfied if the annual structural

[54] Part 2 3._(4)(b) of the FRB allows this requirement not to be met in "exceptional circumstances" and if the "failure to meet it does not endanger fiscal sustainability in the medium-term".

balance of the General Government is converging towards the MTO in line with the timeframe set in accordance with the 1997 EU Regulation on Surveillance and Coordination.[55] If this convergence is not achieved, the adjustment path condition is still met if this failure is "...only as a result of exceptional circumstances and the failure to meet it does not endanger fiscal sustainability in the medium-term".

The annual structural balance of the General Government is defined as the balance cyclically adjusted, i.e., adjusted to take account of effects estimated to be due to the operation of the economic cycle, and net of one-off and temporary measures, expressed as a percentage of GDP at market prices.

Related to the Budgetary Rule is a **Correction Mechanism**, which is a requirement of the Fiscal Compact and the accompanying Common Principles (European Commission, 2012a). If the EC addresses a warning to Ireland about a significant observed deviation from the adjustment path towards the MTO or if the Government considers that there is a significant deviation from the Budgetary Rule:

- the Government shall, within two months, prepare and lay before Dáil Éireann a plan specifying: (1) the period over which compliance with the Budgetary Rule is to be achieved (if that period is longer than a year, it will specify annual targets to be met in moving towards compliance), (2) the size and nature of the revenue and expenditure measures that are to be taken to secure compliance, and (3) how any revenue and expenditure measures relate to different subsectors of the General Government.

- The plan shall be consistent with the rules of the SGP and recommendations made in the context of the SPU.

- If the Government considers that exceptional circumstances have arisen during the period specified in the plan, these requirements would no longer be binding but would come back into operation when the Government considers that the

[55] Council Regulation (EC) No 1466/97. Available from: http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1997/R/01997R1466-20050727-en.pdf

> exceptional circumstances have ceased to exist.
>
> If the Government considers that a failure to comply with the Budgetary Rule is likely to occur, the Government may, within two months, prepare and lay a statement before Dáil Éireann outlining the steps the Government intends to take to avoid such a failure.
>
> Under the proposed mandate, the Fiscal Council would assess: (a) whether exceptional circumstances exist or have ceased to exist; (b) whether there is a failure to comply with the Budgetary Rule that constitutes a significant deviation according to SGP rules; and (c) whether progress towards securing compliance with the Budgetary Rule is being made in accordance with the Government's plan under the correction mechanism.
>
> The FRB contains a "comply or explain" provision:
>
> > If the Government do not accept an assessment of the Fiscal Council in relation to any of the[se] matters ..., the Minister shall, within two months of being given a copy of the assessment ...., prepare and lay before Dáil Éireann a statement of the Government's reasons for not accepting it.
>
> The **Debt Rule** states that, when the General Government debt-to-GDP ratio exceeds 60 per cent, the ratio should be reduced in accordance with the 1997 Excessive Deficit Regulation.[56] This amounts to around 1/20th of the percentage point gap per year, relative to a formula for the benchmark that is applied on a forward and backward looking basis. The EU requirement does not bind for the first three years after the current Excessive Deficit Procedure is closed.

5.3 Future Implications of the Fiscal Rules

Over the horizon covered by *SPU 2012* until 2015, the FRB and EU rules would be complied with in the sense that it is currently agreed that Ireland will be under an Excessive Deficit Procedure until 2015, by which time the General Government deficit would be below the 3 per cent of GDP ceiling under the SGP. The EU and FRB debt rules would not apply for a further three years, well beyond the *SPU* horizon.

[56] See Council Regulation (EC) No 1467/97. Available from: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997R1467:EN:NOT

Furthermore, the planned improvement in the structural budget balance over the years to 2015 is sufficient to meet the FRB Budgetary Rule and comply with the SGP. However, the structural budget balance of -3.5 per cent for 2015 in the *SPU* would be far from the current MTO of -0.5 per cent of GDP, although there is great uncertainty about the structural position so far into the future.

To illustrate the future impact of the rules, a “long-term scenario” is constructed based on the *SPU 2012* projections to 2015 and extended to 2020. These are purely illustrative and do not represent projections. The key assumptions are:

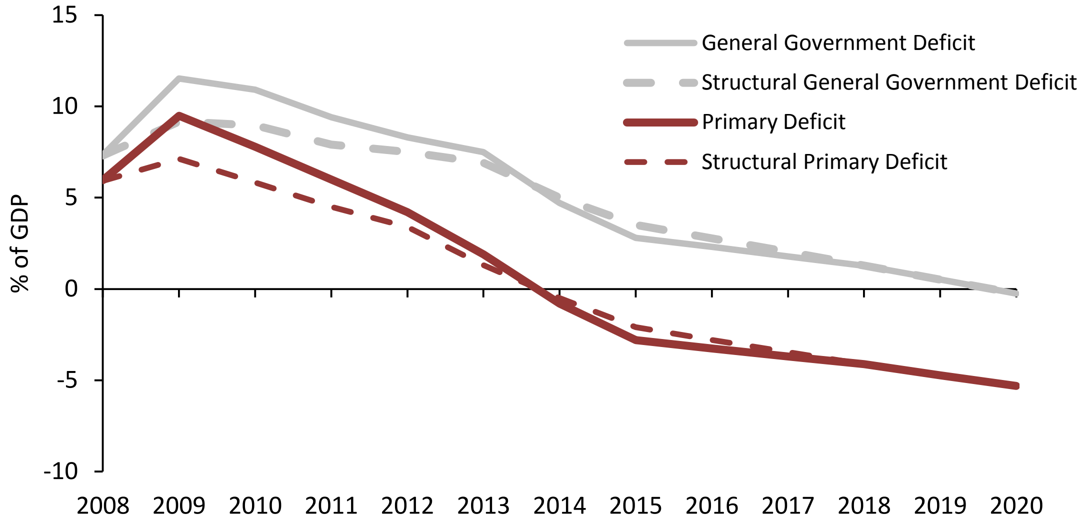
- All assumptions are as in *SPU 2012* for the period to 2015.
- Potential GDP grows at a rate of 4 per cent per year from 2016 to 2020 (2 per cent real growth and 2 per cent inflation).
- Based on the EC’s methodology, *SPU 2012* projects a positive output gap of 1.8 per cent in 2015. The scenario assumes that the output gap closes in equal 0.6 percentage point increments in 2016, 2017 and 2018, thus eliminating the gap by 2018. This results in a nominal GDP growth rate of approximately 3.4 per cent per year over this period. Nominal GDP grows at the same rate as potential GDP (4 per cent) in 2019 and 2020, thus maintaining a zero output gap for these years.
- The change in the structural primary deficit is equal to 0.2 times the change in potential nominal GDP for 2016 to 2020. This can be interpreted as only half of the increase in tax revenues derived from economic growth being spent, while the remaining half is added to the structural budget balance.[57]
- The nominal interest rate on outstanding debt remains constant at its projected 2015 level of 4.9 per cent for 2016 to 2020.

The post-2015 scenario is consistent with nominal expenditure growth, albeit at a much lower rate than the increase in the size of the tax base and revenues. The scenario would thus imply tight control on expenditure, especially given the demand-driven pressures for increased government services (such as those arising from population ageing), as total expenditure would be close to flat in real terms and would be declining as a share of GDP.

[57] Assuming that structural tax revenues increase at 0.4 times the change in nominal potential GDP.

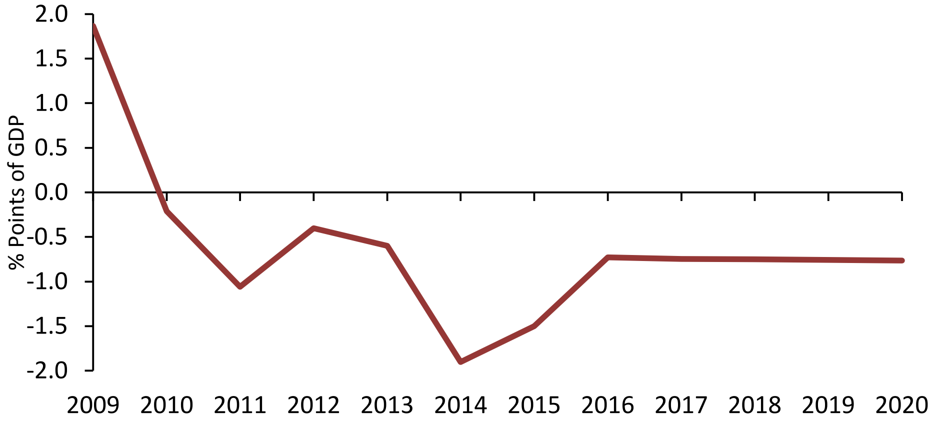
Figure 5.1a shows the evolution of the main deficit aggregates (as shares of GDP) for the long-term scenario. The General Government deficit remains well under 3 per cent of GDP, although the margin is quite small until well after 2015. Figure 5.1b shows the *change* in the structural budget balance. The structural budget balance improves because of the implied tightening of the fiscal stance due to expenditure restraint as well as the closing of the output gap. The change in the structural budget balance is more than the minimum 0.5 percentage points required by the EU SGP and would, therefore, be consistent with the Budgetary Rule. Under this scenario, the current MTO (a deficit of 0.5 per cent of GDP) is reached around 2019.

Figure 5.1a: Evolution of the Deficit: Various Measures



Source: SPU 2012 and IFAC calculations.
Note: See text for assumptions for extended projections 2016-2020.

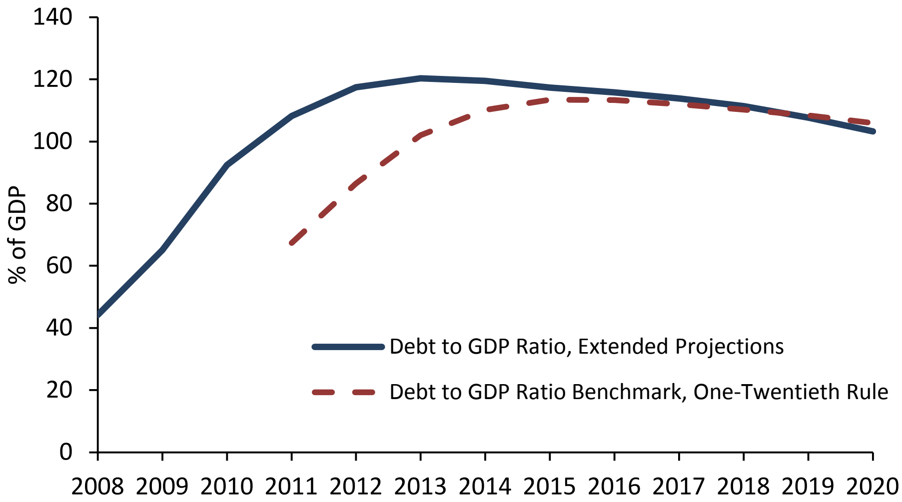
Figure 5.1b: Change in Structural General Government Budget Deficit, Extended Projections



Source: SPU 2012 and IFAC calculations.

Figure 5.2 shows the projected evolution of the debt-to-GDP ratio to 2020 and the backward-looking benchmark debt ratio that is consistent with the EU SGP and the FRB Debt Rule. As noted above, the rule does not come into force until after 2018. However, under the illustrative scenario, Ireland would be in compliance with the debt rule.[58]

Figure 5.2: Debt to GDP Ratio and Debt to GDP Ratio Benchmark for 1/20th Rule

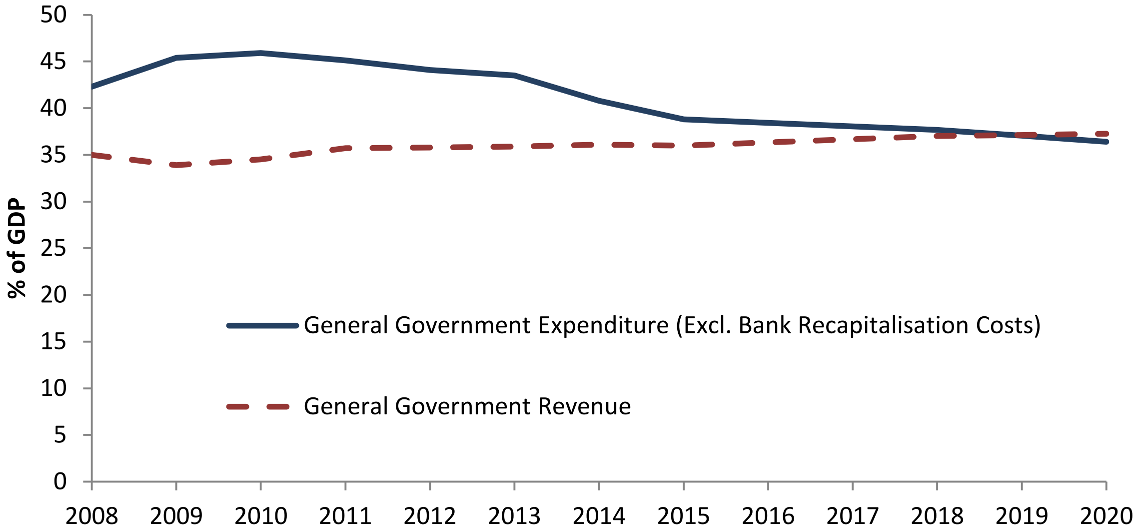


Source: SPU 2012 and IFAC calculations.

To get a sense of what the assumed scenario implies for the trends in Government expenditure and revenue, Figure 5.3 shows each as a share of GDP. The scenario involves a significant reduction in the Government expenditure share and a gradual rise in the revenue share. Of course, this balance could be altered through additional discretionary revenue increasing measures matched with additional increases in structural expenditure, while maintaining the same trajectories for the various fiscal aggregates and thus compliance with the fiscal rules.

[58] See Section 5.2 for a discussion of the relationship between the backward-looking debt rule and a simple 1/20th rule.

Figure 5.3: Total Government Expenditure and Revenue



Source: SPU 2012 and IFAC calculations.

5.4 Summary

- Ireland has an obligation to comply with the EU SGP, which was revised in 2011, and the EU "Fiscal Compact" which is being implemented in national law through the FRB. Under the FRB, the Council would have both an explicit mandate to assess compliance with the Budgetary Rule (and Correction Mechanism) and would be required to make reference to the full range of EU rules, including the debt requirement. While the details are complicated, the rules in essence relate to the budget balance, a structural budget balance (MTO) and the debt reduction requirement (Debt Rule).

- The *SPU* projections to 2015 show that the projected adjustment to the structural balance would be more than in line with the adjustment path under the Budgetary Rule. The Debt Rule would not apply until after 2018.

- Further ahead, under an illustrative long-term scenario starting from the *SPU 2012* projections and going to 2020, the MTO/Budgetary rules are met and the Debt Rule is met after 2018. This scenario allows for very low expenditure growth and would require strict expenditure restraint in the absence of discretionary tax increases, with spending continuing to fall as a share of GDP.