BOX F: SETTING FISCAL RULES IN THE PREVENTIVE ARM OF THE SGP

This box summarises the procedures for setting the key fiscal targets under the Preventive Arm of the *SGP* and highlights some of the main issues related to their assessment. To a large extent processes governing the operation of the European rules have been made public through, for example, the *Vade Mecum on the Stability and Growth Pact* (EC, 2013) and subsequent clarification documents. At a national level, the *Medium-Term Budgetary Framework* (Department of Finance, 2014) document outlined the operation of the domestic framework. However, there remain a number of procedures that have not yet been published in detail, some of which can have significant impacts on the interpretation of the rules. The approach to 'freezing' minimum fiscal requirements under the rules at the time of the spring assessment has yet to be formally published despite being key to establishing the fiscal parameters for *Budget 2016*.[1] While giving a broad overview of the Preventive Arm, this box focuses mainly on the more recent developments to the framework, the details of which have yet to be formally made public by the EC.

The **Medium-Term budgetary Objective** (MTO) is a structural balance target that aims to (i) provide a safety margin against the EDP limit, (ii) ensure the sustainability of public debt, and (iii) allow room for manoeuvre particularly for investment needs. The MTO is set by Member States every three years but is subject to a minimum MTO calculated by the EC. This minimum MTO formalises the three aims of the MTO (see IFAC, 2013).[2] The minimum MTO is due to be revised before the end of this year but aspects of the calculation have yet to be finalised and published. The final MTO to be targeted for the 2017 to 2019 period will subsequently be decided by Government and published in next year's *SPU*. The EC allow a range of ±0.25 per cent when assessing whether countries have reached the MTO to allow for uncertainties in estimation.

If a country is not yet at its MTO the *SGP* requires that fiscal policy ensure an **appropriate change in the structural balance toward MTO**. Under the Fiscal Compact, the standard structural balance adjustment for a country not at MTO is an annual improvement of 0.5 per cent. However this adjustment is varied according to country specific economic conditions, the debt level and fiscal sustainability.

The various possible annual improvement requirements are formalised in the matrix published by the EC on 13 January 2015, and are presented in Figure F.1.[3] The planned adjustment is set out by countries in their annual *SPUs* and subsequently assessed by the EC. Countries with a debt of greater than 60 per cent of GDP must improve their structural balance by an annual amount greater than 0.5 per cent of GDP in normal economic times. This requirement for an improvement of greater than 0.5 percentage points has been operationalised within EC assessments as at least 0.6 percentage points.

FIGURE F.1: MATRIX FOR SPECIFYING THE ANNUAL FISCAL ADJUSTMENT TOWARDS THE MTO UNDER THE SGP

	Condition	Required minimum annual structural balance adjustment	
		Debt below 60% of GDP and no	Debt above 60% or sustainability risk

[1] The failure to publish details of the approach to 'freezing' targets in Spring of each year has also been specifically noted by the Advisory Division of the Dutch Council of State (see *Budget Supervision September Report 2015 of the Advisory Division of the Council of State*, 14 September 2015 (W06.15.0305/III/B).

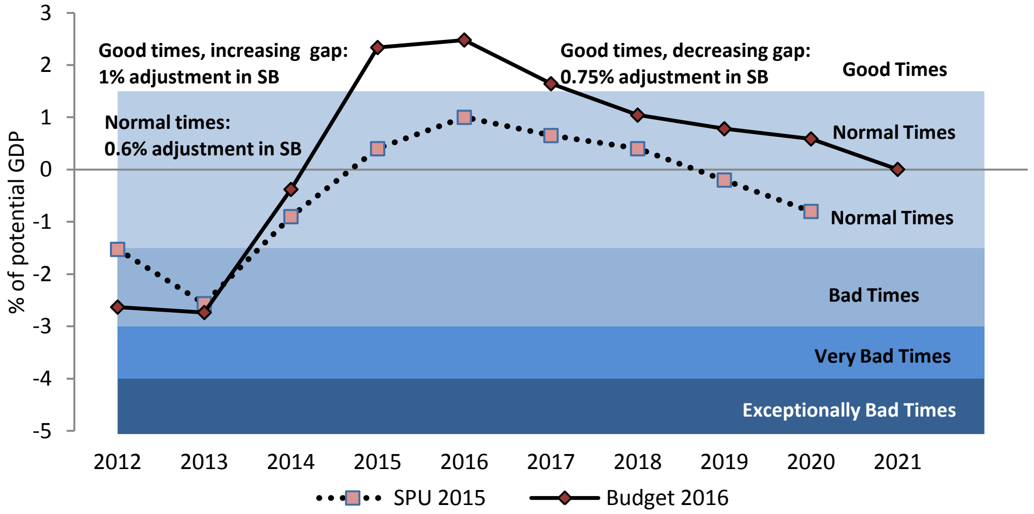
[2] A key input into this minimum MTO is the analysis undertaken by the EU Economic Policy Committee's Ageing Working Group.

[3] The EC publication (EC, 2015a) *Making best use of the flexibility within the existing rules of the Stability and Growth Pact* is available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52015DC0012.

		sustainability risk	
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0.5
Good times	output gap ≥ 1.5	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

The structural balance adjustment as defined in the matrix above is effectively frozen based on the EC spring forecasts and sets the minimum requirement in all subsequent assessments of that year, including the subsequent Budget and for *ex post* assessments. For example, the minimum required structural balance improvement of 0.6 percentage points for the change between 2015 and 2016 that was set based on EC Spring 2015 Forecasts provides the basis for assessing compliance for 2016 now and in the future. However, the revised estimate of the output gap in *Budget 2016* implies this would have increased to 1 per cent in the absence of the 'freezing' requirement.[4]

FIGURE F.2 REVISION TO OUTPUT GAP ESTIMATES
SPU 2015 AND *BUDGET 2016*



Note: The figures above relate to a country with a debt-to-GDP ratio of greater than 60 per cent.
Source: IFAC presentation based on EC publication *Making best use of the flexibility within the existing rules of the Stability and Growth Pact*

The choice of freezing the target at spring rather than the autumn assessments in the year

[4] The EC's latest forecast (EC, 2015c) is for an output gap of 1.3 per cent in 2016 (published in their Autumn 2015 Forecasts in November 2015) and would mean the economy remains in 'normal times'.

prior to the budget year implies a greater emphasis on the need for certainty over the benefits of incorporating more up-to-date information in setting budget targets. This ‘freezing’ treats upward and downward revisions to the output gap differently as it can allow for a slower improvement in the structural balance but not for any increase.[5] The details of this ‘freezing’ procedure have not yet been formally made public by the EC.

The **Expenditure Benchmark** complements the adjustment path assessment with an analysis of expenditure growth. While it was originally reset every three years, it is now reset on an annual basis. Details of this new procedure have yet to be made public by the EC. Consistent with the structural balance adjustment, the permitted real expenditure growth rate for the following year is set based on the EC Spring forecasts. The real expenditure growth rate is set using a reference rate calculated using a forward and backward looking ten year average of potential growth. Where a country is not at its MTO, a convergence margin is applied based on the required annual adjustment in the structural balance.

In calculating allowable nominal growth the GDP deflator is applied to the volume growth allowed under the rule to achieve a nominal spending figure. This is calculated for the following year using an average of the spring and autumn EC forecasts and this averaged deflator is fixed or ‘frozen’ for all subsequent assessments. There remains some uncertainty surrounding the nominal permitted rate of expenditure growth when the budget is announced as the EC’s autumn forecasts are typically published the following month. For a small open economy such as Ireland’s, changes in the terms of trade arising from exchange rate developments can have a large impact on the GDP deflator. This may cause significant fluctuations to allowed expenditure growth under the EB that are not appropriate to sustainable and prudent fiscal management. This later issue will be considered by the Council in its analysis of the EB as part of the *ex post* assessment of the Budget Rule.[6]

Complexity and transparency

Eyraud and Wu (2015) recently concluded that one of the main challenges to the European fiscal governance system is the increasingly complex design of the fiscal rules. Given that these rules continue to evolve and their design is subject to constraints, simplifying the framework is likely to be a medium- to long-term objective. However, to minimise this perceived complexity, the methodologies, definitions and processes underpinning the rules must be published. An announcement by the EC on 21 October goes some way to addressing concerns about transparency in the operation of the *SGP.* Positive developments in this regard are the announcement that the *Vade Mecum on the Stability and Growth Pact* is to be updated annually and furthermore that the EC will share the data underpinning its surveillance decisions with Member States, national Fiscal Councils and, following consultation with Member States, with the public.[7]

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[5] Where economic conditions are seen to worsen between the Spring and Autumn assessments such that the revised output gap is less than -3 per cent or less (‘very’ or ‘exceptionally bad’ times), the required adjustment would reflect the more up-to-date lower structural balance requirement. Furthermore, where data has been revised so that the Autumn assessment indicates the MTO has been met, this assessment will prevail over the frozen requirements. In either of these cases where a later assessment indicates a higher adjustment should have been required, the lower ‘frozen’ requirement prevails. However, the EC have indicated it would be desirable for a country in such a position to step up the pace of adjustment towards MTO in their budgets.

[6] For example, if the EB applied in 2015, the deviation based on the average of the EC’s Spring and Autumn 2014 Forecasts would be 0.8 per cent of GDP. Applying the latest GDP deflator estimate for 2015 and leaving all other things equal would imply additional space under the EB of 0.4 per cent. While the scale of this change is unusual it demonstrates the importance of the GDP deflator in setting nominal expenditure growth under the EB.

[7] As set out in the October 21 2015 Economic and Fiscal Governance Proposals. See http://ec.europa.eu/priorities/economic-monetary-union/docs/single-market-strategy/communication-emu-steps_en.pdf

If there is to be full ownership of the fiscal framework at a national level, then information key to setting budgetary targets must be available prior to the national budget process. This would remove any ambiguity related to the status of procedures. The timely publication of information is particularly important given EC plans, also outlined on 21 October, to simplify the EU framework without changing its legal basis, which will lead to further procedural changes in future.