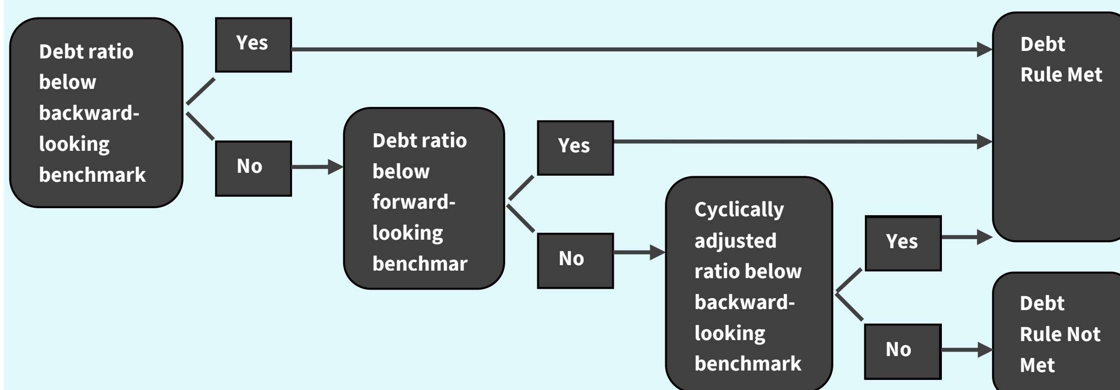
Box F: Introductory Guide to the Debt Rule

This Box outlines how the Debt Rule will apply once it becomes fully applicable to Ireland in 2019. The Debt Rule is one of the EU fiscal rules set out in the *Stability and Growth Pact* and is part of the "six-pack" of reforms implemented in 2011. The Debt Rule came into force in Ireland with the adoption of the *Fiscal Responsibility Act 2012.* Following the exit of the *Excessive Deficit Procedure* (EDP) in 2015, Ireland entered into a transition period from 2016-2018, which limited the legal requirements for adherence to the Debt Rule. From 2019 onwards, the Debt Rule will apply in full.

The Debt Rule in Operation

The core of the Debt Rule effectively requires that the debt-to-GDP ratio be below 60 per cent of GDP or sufficiently falling towards this upper limit. In essence, if the debt-to-GDP ratio is above 60 per cent of GDP, the rule requires that the ratio falls by, on average one-twentieth of the excess between the actual debt-to-GDP ratio and 60 per cent of GDP. This requirement is expressed as a benchmark debt-to-GDP ratio.

There are three criteria used when assessing progress towards the 60 per cent of GDP ceiling value, with the least stringent of these criteria being used to assess compliance with the Debt Rule. The three criteria are: (1) the backward-looking benchmark, (2) the forward-looking benchmark, which is compared to $t + 2$ forecast of the debt-to-GDP ratio, and (3) a cyclically adjusted debt-to-GDP ratio, which is compared to the backward-looking benchmark. The criteria are applied sequentially, as outlined in the flow chart below:



Formally, these are calculated as:

Backward looking Benchmark

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t-1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_{t-2} - 60\%) + \left(\frac{0.95^3}{3}\right)(b_{t-3} - 60\%)$$

Forward looking Benchmark

$$= 60\% + \left(\frac{0.95}{3}\right)(b_{t+1} - 60\%) + \left(\frac{0.95^2}{3}\right)(b_t - 60\%)$$

$$+ \left(\frac{0.95^3}{3}\right)(b_{t-1} - 60\%)$$

$$Cyclically\ Adjusted\ ratio = \frac{B_t + \sum_{j=0}^{2} C_{t-j}}{Y_{t-3} \prod_{h=0}^{2}\left(1 + y_{t-h}^{pot}\right)(1 + p_{t-h})}$$

where b_t is the debt-to-GDP ratio at time t, B_t is the nominal debt level at time t, C_t is the cyclical component of the budget balance at time t, Y_t is the nominal GDP at time t, y_t^{pot} is the potential output at time t, and p_t is the price deflator at time t.[1]

In the event that the Commission deems that the debt-to-GDP ratio is in breach of all three criteria, the Commission will prepare a report, which takes a number of factors into account before coming to a conclusion as to whether the debt criterion has been breached, which can in turn lead to the Commission recommending the launch of an *Excessive Deficit Procedure*.[2,3]

Once the debt-to-GDP ratio falls below the 60 per cent of GDP ceiling value, this limit becomes the binding criteria. Breaching the 60 per cent of GDP ceiling limit from below automatically triggers a report from the Commission, unless the debt-to-GDP ratio returns below the ceiling value over the Commission's forecast horizon.[4]

Compliance with the Debt Rule over the forecast horizon

Figure F.1 shows the forecasted compliance with the backward-looking and forward-looking benchmark. Over the period 2014–2023, both the backward-looking benchmark and the forward-looking benchmark were complied with. The debt-to-GDP ratio is forecast to fall below the 60 per cent of GDP ceiling in 2020 (Figure F.1A), for the first time since 2008.

[1] For legal compliance with the Debt Rule, assessment of compliance with the forward-looking benchmark is based on European Commission forecasts of future debt-to-GDP ratios based on unchanged policies. Similarly, assessment of compliance with the cyclically adjusted ratio is based on the Commission's CAM estimates of potential output.

[2] The factors taken into account include among others, an assessment of the overall economic environment, adherence to the MTO, or adjustment path towards it, implementation of structural reforms and pension reforms, the expected timeline for compliance with the debt rule and the contribution of stock-flow adjustments to the breach.

[3] Should the European Council adopt the Commission's recommendation to launch an EDP, this would involve a requirement to adhere to annual targets for the nominal and structural deficits so that the by the end of the correction period, the debt-to-GDP ratio is compliant with the Debt Rule. Non-compliance with the EDP may lead to a sanction of a non-interest bearing deposit of maximum 0.2 per cent of GDP being lodged with the Commission. Further non-compliance with the EDP may lead to suspension of commitments — or payments — of the European Structural and Investment funds and/or fines of up to 0.5 per cent of GDP, which may be supplemented by the European Investment Bank reconsidering its investment policy towards the Member State.

[4] In addition to the factors outlined above, one of the relevant factors that the Commission take into account when coming to a conclusion as to whether or not to recommend launching an *Excessive Deficit Procedure*, when the 60 per cent of GDP ceiling value is breached from below, is the cyclically adjusted debt-to-GDP ratio.

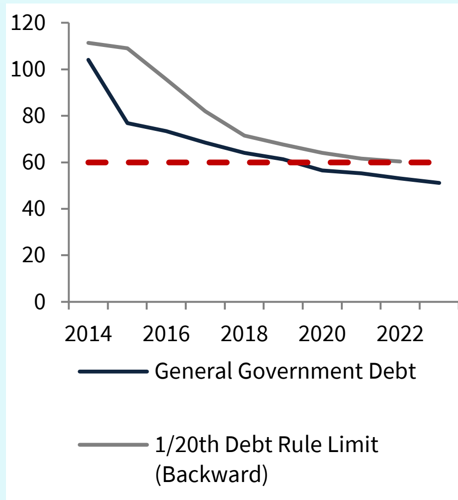
Implications of the Debt Rule for Ireland

The Debt Rule as currently formulated has a number of flaws. Essentially, the Debt Rule requires significant frontloading of consolidation, if the debt-to-GDP ratio is substantially above 60 per cent of GDP, or it imposes minimal fiscal effort, if the debt-to-GDP ratio is relatively close to the 60 per cent of GDP ceiling value (Barnes *et al.,* 2016).

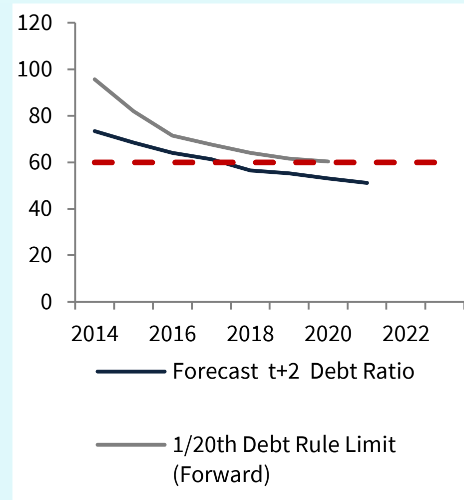
In addition, due to the nature of the distortions in the GDP figures for Ireland, relating to the multinational sector, this rule is not expected to be a binding constraint on medium-term fiscal policy for Ireland. The sustainability of Ireland's debt levels should not be assessed on the basis of the debt-to-GDP ratio due to these distortions. Sustainability of Ireland's debt levels should be judged on a more appropriate measure of national income than the GDP figures, like GNI*.[5]

Figure F.1: Compliance with the Debt Rule

A. Backward-looking Benchmark
Per Cent of GDP



B. Forward-looking Benchmark
Per Cent of GDP



Sources: CSO; Department of Finance; and internal IFAC calculations.
Note: The figures show the Department of Finance's forecasts of the debt ratio from *Budget 2019.* Legal compliance with the forward-looking benchmark is assessed on the basis of the European Commission forecasts.

The Council assesses that a more appropriate debt commitment should be chosen by the Government. The commitment should better reflect sustainability concerns — like a debt-to-GNI* ratio, rather than a debt-to-GDP ratio — and should be time limited with a specific date by which the objective should be achieved.[6] It should be clearly specified whether the commitment would be a target or a ceiling. Further, it should be specified whether it is a steady-state debt target to be achieved on average over the cycle or whether it is intended to be maintained permanently.

[5] See Box A of the June 2017 FAR (IFAC, 2017c) for details on ratios other than the debt-to-GDP ratio to assess sustainability on.

[6] The Government previously set a debt target of 55 per cent of GDP. This target was not well specified, not time-bound and was not set against an appropriate denominator. As a result, this was not an appropriate target.