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

Challenge of designing effective fiscal rules

Flexibility vs. Credibility

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

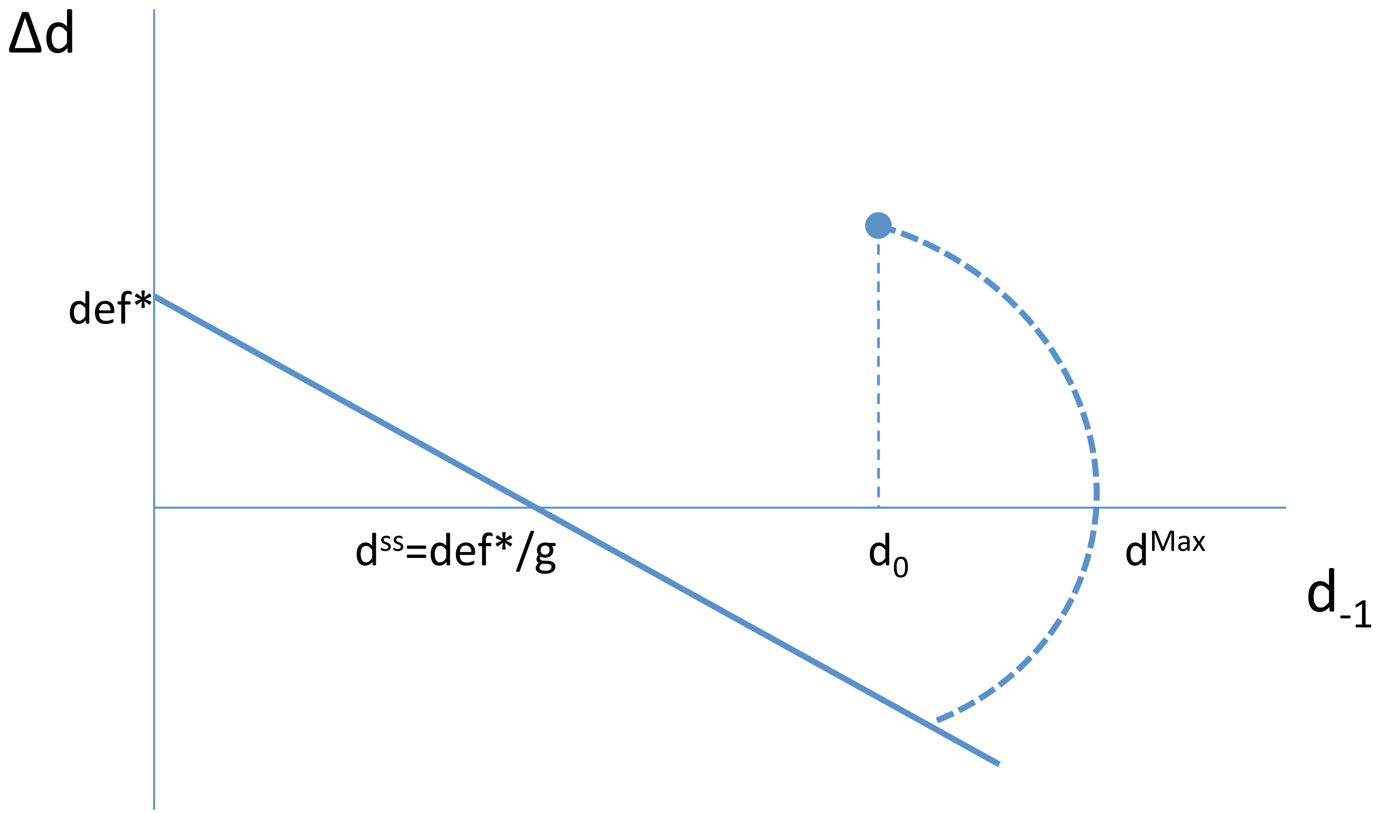
i = nominal interest rate

g = nominal growth rate

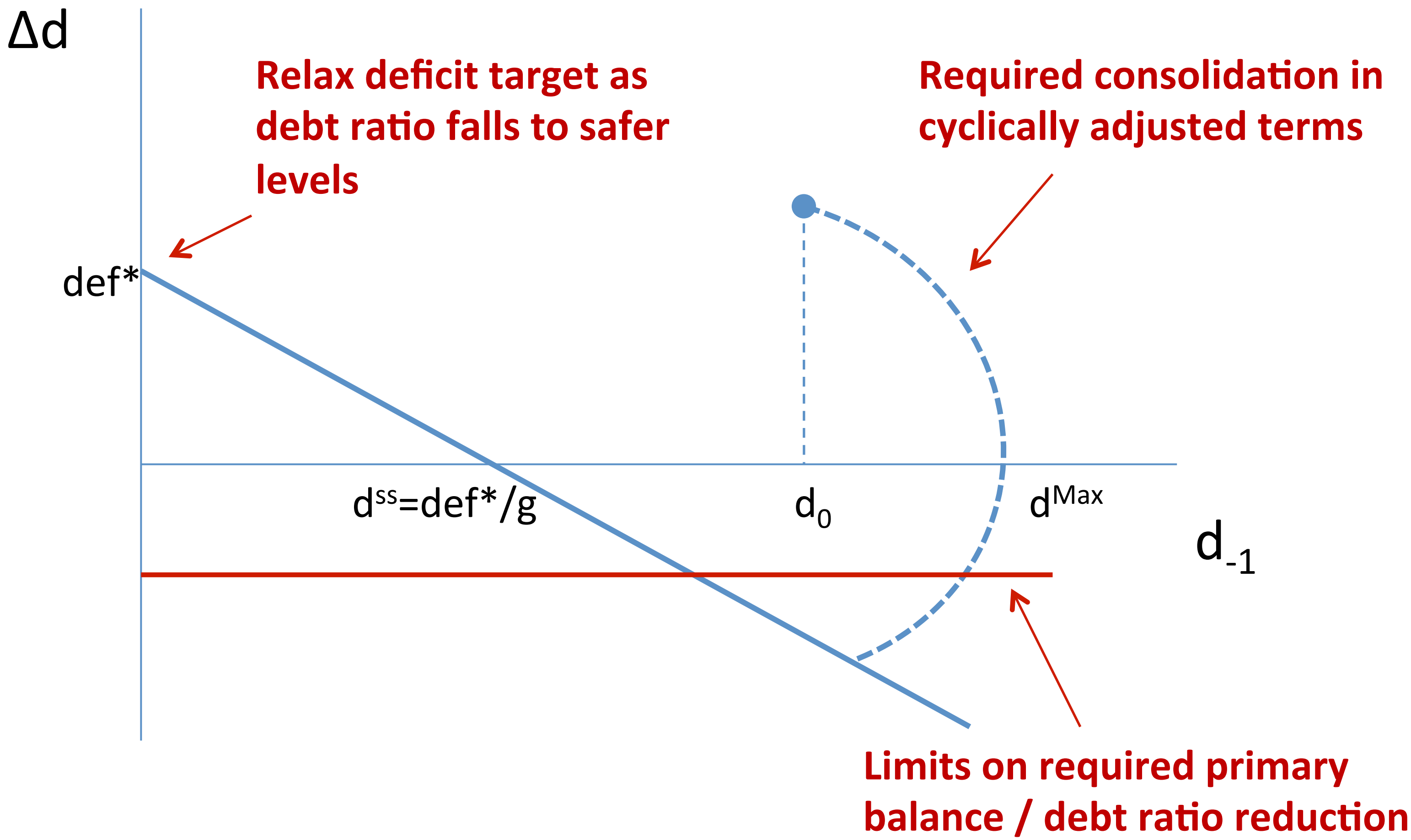
pb = primary balance

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

Debt ratio dynamics: The "Grim Reaper"



Potential flexibilities



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Enforcement

Soft —————————————————— Hard

“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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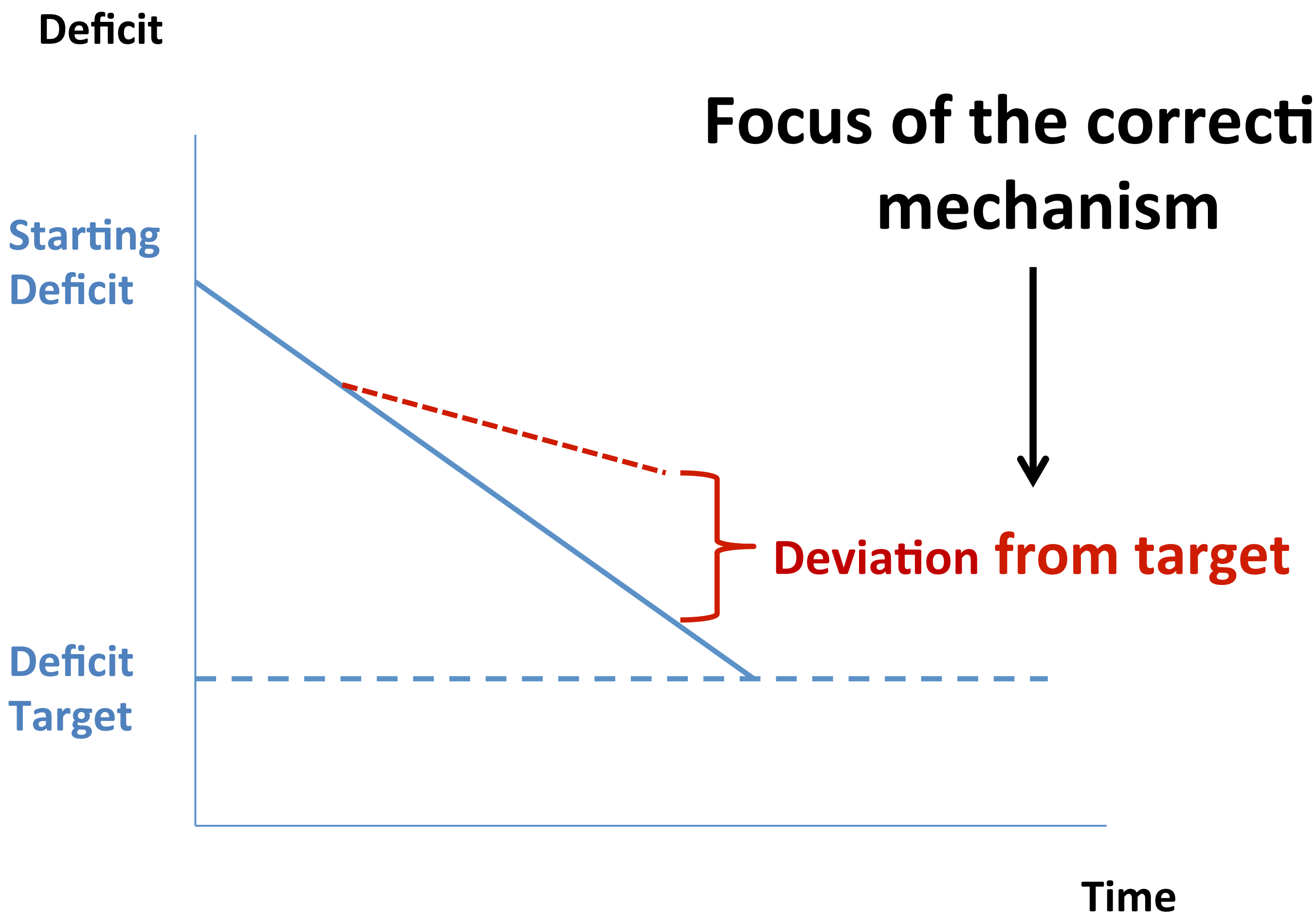
Proposed rules in treaty



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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

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Most recent draft

National law

Correction mechanism:

Binding force + permanent character

(preferably constitutional)

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