

## POLICY PAPER

# Ireland's Fiscal Framework: Options for the Future

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*Abstract:* The Fiscal Responsibility Act of 2012 established fiscal policy rules and an independent fiscal watchdog, the Irish Fiscal Advisory Council (IFAC) – patterned after the new EU template for fiscal rules and the Swedish fiscal council, respectively. These elements, along with budgetary procedural rules, comprise the core of Ireland's fiscal framework. Although the present framework meets most criteria of international good practice, there is considerable scope for improvement to meet Ireland's future needs, especially for restoring public debt sustainability – as it is no longer under the direct tutelage and protection of the EU and IMF. To this end, the paper outlines a set of options to strengthen the fiscal framework consisting, among others, of (a) a binding public debt rule; (b) an indicative structural budget balance rule; (c) a pay-go rule, and (d) steps to broaden the mandate and amplify the resources of IFAC. It is argued that these options should help pave the way to further gains in credibility in financial markets, and ultimately, to higher economic growth and stability.

## I INTRODUCTION

The financial crisis that hit Ireland in 2010 has left a heavy legacy of public sector indebtedness that poses a formidable challenge for policymakers in the years ahead. As part of the ongoing adjustment programme and in accordance with the strengthened EU fiscal governance, the Fiscal Responsibility Act, supported by existing budgetary practices and norms,

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currently serves as the core of the framework for fiscal policymaking. This paper evaluates the usefulness of the framework for Ireland and explores options for improvement, with a view to contributing to the country's future economic stability and growth. It is not intended to provide an exhaustive treatment, but rather to highlight key areas with scope for improvement.

The paper is organised as follows. Section II is a brief review of past fiscal developments in the broader macroeconomic and financial landscape. Section III evaluates the current fiscal framework from the perspective of international good practice and of the country's future needs. Section IV seeks to identify a set of options to strengthen the framework in the light of Ireland's present circumstances and future prospects and Section V concludes.

## II BACKGROUND

Following two decades of almost uninterrupted high growth, beginning in 2008 the Irish economy suffered an extraordinary setback. Benefitting from major structural reforms launched since the late 1980s – reversing ill-fated measures adopted earlier in that decade – real per capita income peaked at nearly 150 per cent of the EU average, while public debt declined to 25 per cent of GDP on the eve of the financial crisis. Prominent among fiscal reform steps were the rationalisation of budget expenditures, as well as reduction and simplification of the regulatory and tax burden. These steps contributed to improved fiscal performance, reflected in headline indicators. With fiscal accounts recorded to being close to balance, Ireland was one of a handful of Euro Area members that had remained outside the EU's excess deficit procedure until the onset of the financial crisis.

However, by the turn of the century, the favourable fiscal indicators masked a worsening structural budget imbalance. The economic boom led to complacency in policymaking and to the adoption of an expansionary fiscal stance, despite both internal and external warnings against the risks of procyclical action.<sup>1</sup> Thus, the mistakes in policymaking were committed in the context of a relatively sound fiscal structure, as compared to other EU members facing a financial crisis where policy mistakes took place within a failed structure.

Underneath the surge in the real economy lay the seeds of its unravelling in the vulnerability of the financial system. Lax banking regulation and supervision, and absence of a macroprudential framework, paved the way to an unchecked financial and real estate asset bubble, fueled in large part by

<sup>1</sup> For a critical review of the conduct of fiscal policy in the decade leading up to the crisis, see Wright (2010).

loose monetary policy<sup>2</sup> and speculative capital inflows. The bubble was accompanied by a widening external imbalance that reflected loss in competitiveness and depressed private domestic savings. The upshot was a banking crisis and a sudden stop in access to international capital markets. The resulting collapse of major commercial banks was remedied almost entirely with recapitalisation from public funds. Thus, the brunt of the adjustment was shifted to the public sector.

In several respects, Ireland's financial crisis resembles similar episodes that had taken place for example in Chile in the early 1980s and in East Asia in the late 1990s.<sup>3</sup> In these countries, unbridled credit expansion that had fueled financial and real estate bubbles, mostly from short-term capital inflows, which, coupled with an appreciated exchange rate, precipitated a major banking and currency crisis. To contain the crisis, besides floating the exchange rate, governments extended *ex post* guarantees on bank liabilities and recapitalised impaired balance sheets. However, the dramatic scale of the ensuing buildup of public debt in Ireland (quintupling as a ratio to GDP since 2008) surpassed by far the jump in the debt ratio experienced in the other crisis countries.<sup>4</sup>

In addition to the large debt service obligation assumed by the public sector, Ireland's adjustment burden was exacerbated by the hard exchange rate peg<sup>5</sup> and stagnation in export demand from trading partners that were also beset by the great recession. The situation was further aggravated by a procyclical fiscal contraction adopted under the adjustment programme (as in several other EU countries), which degenerated into a vicious race to the bottom.

These conditions stand in stark contrast with those prevailing under other adjustment programmes supported by the IMF in the past, which included

<sup>2</sup> For Ireland and other peripheral Euro Area members, until the onset of the crisis, the ECB base interest rate was negative in real terms and significantly below the rate suggested by the Taylor rule; see Mayer (2012).

<sup>3</sup> See Diaz Alejandro (1985) for a documentation of the Chilean crisis and Bulir *et al.* (2002) for an overview of capital account crises, including in East Asia, in the 1990s.

<sup>4</sup> In comparison, the increase in the public debt ratio between the pre-crisis and post-crisis period, though significant, was much smaller in Indonesia (78 per cent), the Philippines (55 per cent), Thailand (53 per cent) or Korea (45 per cent); see Kopits (2004). The rise in the debt ratio cannot be entirely attributed to bank recapitalisation, as a significant portion of the increase – more than one half in the case of Ireland – stems from the decline in economic activity. Also, cross-country comparability may be impaired by lack of reliable information on public assets and reserves, which prevents derivation of uniform estimates of net government liabilities.

<sup>5</sup> This is not meant as a criticism of membership in the Euro Area. Indeed, the latter, if accompanied by fiscal discipline and sound banking regulation and supervision, confers major benefits to the member country in terms of stability and welfare; otherwise, it can lead to financial crisis and economic contraction.

exchange rate flexibility in the face of a benign external environment characterised by growth and stability in major trading partners. Although those programmes called for a procyclical stance *ex ante*, as soon as specific adjustment measures were implemented and even before formal completion of the programme, they elicited a favourable response from abroad in terms of a favourable turnaround in trade flows and in market financing, resulting in a broadly neutral or countercyclical stance *ex post*. Today such conditions are missing within the Euro Area.

A positive difference from other adjustment programmes in the Euro Area is that the Irish adjustment consisted mostly of frontloaded measures, two-thirds in expenditure cuts and only one-third in tax hikes – phased even before the start of the arrangement under the extended Fund facility.<sup>6</sup> In addition, the authorities did not attempt to compensate for missed deficit targets attributable to a lower than projected growth rate.<sup>7</sup> Other adjustment programmes in the area were implemented at a much slower pace – often following a wasted period of denial by government leaders – and relying excessively on stop-gap tax increases, public sector wage freeze, and other one-off measures, including in some cases privatisation of state assets or nationalisation of some private pension funds, all endorsed by the EU and the IMF.

As it regains access to international markets, following completion of the three-year extended arrangement, Ireland must seize the opportunity to consolidate the progress attained so far and enter a steady path of public debt reduction relative to economic activity, while breaking away from the vicious circle of serial procyclical adjustment programmes. The task ahead is to anchor expectations of economic agents and investors at home and abroad through the pursuit of a predictable fiscal policy geared to restoring debt sustainability. In the event, enhanced policy credibility will allow sufficient latitude for a cyclically neutral (or perhaps even countercyclical) fiscal stance. This is indeed the principal argument for setting up a rules-based fiscal framework, particularly for a highly-indebted government, as a signalling device to regain policy credibility.<sup>8</sup>

<sup>6</sup> In this regard, the Irish programme is comparable to the composition and time path of other relatively successful fiscal adjustment episodes in high-debt countries. For a recent survey and cross-country evidence, see Baldacci *et al.* (2012).

<sup>7</sup> For a review of macro-fiscal performance during 2008-12, see FitzGerald (2012b). Notably, instead of focusing on the headline deficit target, as in other programmes, in the Irish case the Fund accepted cyclically induced shortfalls.

<sup>8</sup> See Kopits (2004) on lessons for rules-based fiscal frameworks from adjustment programmes implemented in the 1990s under conditions of high capital mobility. See also Leeper (2010) on the need for anchoring fiscal expectations with such frameworks.

A rules-based fiscal framework is a composite of *policy rules*, *procedural rules*, *transparency norms*, and a *surveillance mechanism*. Contrary to popular misconception, such a framework need not be a rigid toolkit that pre-empts the conventional functions of fiscal policy, namely, stabilisation, income distribution, and allocative efficiency. On the contrary, a well-designed framework – in essence, a framework of *constrained discretion* – facilitates such functions in the path to a sustainable level of indebtedness. Furthermore, it should be stressed that a fiscal framework is in essence *commitment technology* that provides the context for policymaking; not to be mistaken for actual fiscal policy. Over time, ironically, steady observance of such a framework can confer a high degree of fiscal sovereignty to Ireland.<sup>9</sup>

### III PRESENT FRAMEWORK

Although encompassing a wide diversity of practices, the four key components of a rules-based framework can be found to a greater or lesser degree in an increasing number of countries. In the European Union, the basic policy rules envisaged in the Economic and Monetary Union, and specified in the *Stability and Growth Pact*, have evolved recently into a comprehensive framework under the so-called six-pack and two-pack innovations. The latter are intended to serve broadly as the template for each member's own framework.

Specifically, in an attempt to strengthen and fine-tune the Pact into an effective vehicle of fiscal governance across the Union, and particularly, in the Euro Area – drawing on the lessons from the debt and financial crises of the past few years – the two packs have been enshrined respectively in the Treaty on Stability, Coordination and Governance of 2012, and Regulation No. 473/2013 on monitoring draft budgetary plans, adopted by the European Council and ratified by the European Parliament. In essence, the new statutes call for restrictions on the general government structural budget balance and on public indebtedness (fiscal policy rules), a medium-term stability programme (procedural rule), adherence to ESA95, and its successor ESA2010, accounting conventions, and independent fiscal forecasting (transparency), and establishment of an independent fiscal council or its equivalent (surveillance).

Ireland's Fiscal Responsibility Act of 2012, along with the *Medium-Term Budgetary Framework* of 2013, is closely aligned to the new EU fiscal governance.<sup>10</sup> It remains to be seen whether it is appropriate to tackle future

<sup>9</sup> For a discussion and evidence, see Kopits (2012).

<sup>10</sup> See Lane (2010) and Department of Finance (2011).

challenges beyond the current adjustment programme, when the Irish government is no longer under the direct tutelage and protection of the EU and IMF. This section conducts such an assessment primarily from the perspective of the country's future needs, while drawing on internationally accepted standards of good practice.

### 3.1 *Policy Rules*

For starters, let us examine to what extent the Irish fiscal policy rules meet criteria of good practice: definition, transparency, adequacy, consistency, simplicity, flexibility, enforceability, and efficiency.<sup>11</sup> However, as no existing policy rule can meet fully all criteria, every country has to make a strategic choice, taking into account its own circumstances and long-run policy goals. At best, any design under consideration can only approximate these criteria of good practice.

Ireland's two basic rules track closely the template prescribed for EU member countries. The structural balance rule, a copy of the Swiss "debt brake", has been adopted with minor differences by several countries (including Germany, France, Austria and Spain). The debt rule calls for a steady reduction to the 60 per cent of GDP reference value.

The Irish policy rules are *well defined* in terms of performance indicators (structural balance, debt ceiling), time frame (annual), basic operational scope (with margins), and institutional coverage (including local governments and most quasi-fiscal activities).

The rules are as *transparent* as similar rules introduced in other EU member countries. However, experience with these rules has been mixed – given some latitude for creative accounting and forecasting. Although in the past the structural balanced-budget rule has been prone to manipulation,<sup>12</sup> there are a few successful applications as well.<sup>13</sup> Compliance with the debt rule in its present form has likewise been subject to mis-reporting and inefficient application.<sup>14</sup>

<sup>11</sup> Kopits and Symansky (1998) formulated these criteria, discussed and endorsed by the IMF Executive Board. For an early application to the EU Stability and Growth Pact, see Buti and Giudice (2002).

<sup>12</sup> The Netherlands (the first country to apply such a rule) in the 1970s and the United Kingdom in the past decade offer examples of overestimates of potential output. See Wellink (1996).

<sup>13</sup> The structural budget surplus rule established in Sweden and Chile in 1998 and 2000, respectively, and the Swiss debt brake, launched in 2002, stand out as successful cases. See Geier (2011) on Switzerland and Marcel (2013) on Chile.

<sup>14</sup> Mis-reporting in coverage and valuation has taken place in Poland in the early years of implementation, beginning in 1999. More recently, the government introduced a return from defined-contribution private pensions to the pay-as-you-go defined-benefit public pension largely in order to help reduce the public debt ratio in the short run, at the cost of worsening debt sustainability in the long run.

Given Ireland's enormous public debt burden, the rules are *less than adequate* in addressing the goal of restoring debt sustainability over a realistic time horizon. To correct this shortcoming, the Fiscal Responsibility Act should have assigned priority to the debt rule over the structural balance rule.

The rules are broadly *consistent* with each other as well as with other policy instruments. In fact, for a low-debt country, the structural balance is the binding rule. For a high-debt country, like Ireland, the relevant binding rule should be the debt ceiling.

At a very superficial level, the rules are *simple* enough to be understood by legislators, educated citizens and market participants. However, deeper comprehension of the structural balance concept and its implementation requires a grasp of the technical aspects, such as output gap estimates, their interplay with automatic stabilisers, and the distinction between temporary and permanent fiscal measures. This is a reason why governments (as well as European Commission officials) still tend to communicate mostly in terms of the much simpler, albeit misleading, headline budget balance target.<sup>15</sup>

By design, the structural budget balance is *flexible* to absorb cyclical and other shocks, as it allows the operation of automatic stabilisers. On the other hand, the debt rule tends to be pro-cyclical, as it is tied to fluctuations in GDP.

The rules *do not seem sufficiently enforceable*, without an operational target under the control of the authorities. In particular, it is doubtful that estimates of potential output, necessary to measure the output gap underlying the structural balance, can be applied with confidence in real time<sup>16</sup> – a shortcoming that can be especially pronounced in the case of small open economies exposed to significant macroeconomic volatility. Hence, the main task at hand is to select a rule, or set of rules, that meets both the adequacy and enforceability criteria, while maintaining sufficient flexibility.

The *efficiency* of rules hinges on the government's ability and willingness to anticipate the need to introduce structural measures on time to ensure compliance with the rules. However, given the sharp adjustment necessary to halve the debt ratio to the target reference value, Ireland may inevitably have to resort to improvised ad hoc measures to abide by the annual debt ceiling.

<sup>15</sup> Perhaps as an exception, in Switzerland, members of the parliamentary budget committee display familiarity with technical issues in discussions of the debt brake. Interestingly, in Chile, the finance minister communicates almost solely in terms of the structural budget balance.

<sup>16</sup> Barrell, Hurst and Mitchell (2007) report considerable errors in real-time estimates of cyclically adjusted budget balance in advanced economies. Similarly, Ley and Misch (2013) found that output and output gap revisions, on a large country data set, may have substantial effects on the ability of governments to correctly estimate the structural balance in real time.

### 3.2 *Procedural Rules*

In recent years, the Irish authorities have embarked on a significant effort at identifying and implementing budgetary procedures in line with international best practice – discussed in detail in various official reports, including in a comprehensive expenditure review.<sup>17</sup> Major innovations have been launched on several interrelated fronts. First, the traditional bottom-up approach to expenditure allocation is being replaced by a top-down approach, in principle, subject to government-wide hard budget constraint. Second, a regular in-depth expenditure review has been introduced, applying the value-for-money principle. Third, a shift has been under way from input-driven budgeting to performance-based budgeting. And fourth, the annual budget has been cast into a rolling multi-year budget plan, very recently formalised under the Medium-Term Budgetary Framework,<sup>18</sup> recognised as key to the successful enforcement of policy rules. All told, while budgetary procedures in Ireland conform for the most part to good practice, full and routine implementation of those procedures has yet to be realised.

### 3.3 *Transparency*

Ireland compares favourably with most other EU member countries in the transparency of institutional arrangements, accounting practices, and forecasting in the public sector, broadly according to international standards of good practice.<sup>19</sup> There is timely and frequent public disclosure of information on budgetary and financial cash flows, as well as selected balance sheet information. Also, the government provides some estimates of the budgetary impact of new measures.

However, as in most other Euro Area member countries, official macro-fiscal forecasts reflect an optimistic bias.<sup>20</sup> In addition, there is still adherence to the tradition of conducting budget debates and decision making on the basis

<sup>17</sup> During the last change in government, in early 2011, the Department of Finance (2011) published a White Paper containing proposals for far-reaching reform in budget procedures, in addition to fiscal policy rules and an independent fiscal council. This was followed by a government-mandated set of reform measures described in Department of Public Expenditure and Reform (2011). Partly in response to the White Paper, the Irish Fiscal Advisory Council (2012a) provided an overview of the main issues within a broad fiscal policy context.

<sup>18</sup> The Framework and related procedural rules were promulgated December 19, 2013, under ministerial Statutory Instrument No. 508; see Department of Finance (2013).

<sup>19</sup> The IMF Code on Fiscal Transparency enumerates good practices, developed on the basis of Kopits and Craig (1998).

<sup>20</sup> Frankel and Schreger (2013) find that, over the past decade, Ireland's actual budget balance on average exceeded one-year-ahead forecasts by more than 2 per cent and two-year-ahead forecasts by more than 3 per cent of GDP; a larger excess was observed only in Greece. For contrary evidence on absence of optimistic bias, see IFAC (2012b). Also, forecast errors may overstate the optimistic bias to the extent they are due, particularly during the Great Recession, to a sharp unanticipated fall in output.

of cash accounts for the central government, instead of accrual-based general government accounts.<sup>21</sup>

In a recent IMF report, it was noted that initiatives are under way to correct deficiencies in fiscal transparency.<sup>22</sup> Four of these deficiencies are worth highlighting. Fragmentation of the non-financial public sector, into a large number of government and quasi-governmental activities, results in some uneven and incomplete reporting of financial accounts. The quality of forecasts of medium-term projections is less than satisfactory and the underlying methodology is rather opaque and subject to frequent modification. Long-term policy scenario calculations are less than suitable to conduct satisfactory assessment of public debt sustainability.<sup>23</sup> Despite the availability of data on off-budget and contingent liabilities, a comprehensive analysis of fiscal risk is lacking.

### 3.4 *Surveillance*

Ireland has taken an important step by creating an independent fiscal watchdog, ratified under the Fiscal Responsibility Act. The Irish Advisory Fiscal Council (IFAC) has already gained a reputation of professional competence and independence since it was launched in 2011. Its structure and advisory role seem to have been inspired by the Swedish Fiscal Policy Council. More generally, its remit, focused on assessing the transparency, adequacy and sustainability of fiscal policy, as well as compliance with fiscal policy rules, conforms to a considerable extent with the recently unveiled international guidelines of good practice.<sup>24</sup> The OECD Principles for Independent Fiscal Institutions are grouped under nine headings: local ownership, independence and non-partisanship, mandate, resources, relationship with the legislature, access to information, transparency, communication, and external evaluation.

The Council is *locally owned* since it was established on the basis of a broad cross-party consensus, and not merely at the behest of the Commission or the Fund. Also, its *modus operandi* seems to take in the existing legal and cultural setting. It remains, however, open to question whether IFAC's staff size and its role fully meet local needs. By contrast, in Sweden, where detailed real-time evaluation of the budget bill, including through fiscal forecasts, is performed by already existing specialised independent institutions, the Fiscal Council can devote itself entirely to providing analysis and advice on broad

<sup>21</sup> See FitzGerald (2012a).

<sup>22</sup> See International Monetary Fund (2013), and more recently, Department of Finance (2013), including Statutory Instrument No. 508 of 2013.

<sup>23</sup> Long-term baseline simulations in IFAC (2012a) have yet to incorporate explicitly the effect of demographic changes on actual old-age and health-care benefits.

<sup>24</sup> See OECD (2012).

macro-fiscal issues. In this respect, the Irish case differs markedly from the Swedish framework.<sup>25</sup>

IFAC's *independence and non-partisanship* are guaranteed by statute and observed in practice. The head and members of the Council, as well as staff, are selected on the basis of professional expertise, without regard to political affiliation. But the fact that the Chair is a non-remunerated part-time position, as in Sweden, poses a potential distraction and conflict of interest (especially in the case of a non-academic appointment) that may undermine the institution's independence.

The Council's *mandate* is clearly defined and monitoring tasks include compliance with fiscal rules, but exclude actual preparation of macro-fiscal projections. The latter omission can hardly be compensated by the recent extension of the remit to provide "endorsement" of the government's macroeconomic forecasts – <sup>26</sup> adopted to conform to the EU regulation on requiring independent forecasts. Most recently, IFAC has made an effort at underpinning the endorsement role with some quantitative work, reflected in fan charts for the macroeconomic outlook, and then discussing their implications for the budgetary outcome.<sup>27</sup> However, the endorsement function – subject to a very narrow interpretation and excluding fiscal variables – and the limited resources at its disposal, inhibit IFAC's capacity to generate its own comprehensive macro-fiscal projections, possibly including feedbacks from the fiscal components to macroeconomic aggregates.<sup>28</sup>

A major deficiency of the IFAC is the lack of sufficient *resources* to monitor in a timely manner for informed legislative debate and action on the budget and the medium-term budgetary plan. By any standard, the annual funding of €800,000 is inadequate for this purpose. (Again, the apparent attempt to emulate the Swedish fiscal council is predicated on the questionable assumption that budgetary surveillance is shared with other independent public institutions.)

The Council's *relationship with the legislature* is characterised by both independence and accountability. IFAC submits its reports to parliament and its budget is subject to close legislative scrutiny. The Chair appears at legislative committee hearings as requested. Nonetheless, it is doubtful that

<sup>25</sup> The Economic and Social Research Institute does not prepare detailed and regular medium-term fiscal projections.

<sup>26</sup> The endorsement function, formalised effective July 2013 in an amendment of the Fiscal Responsibility Act and a Memorandum of Understanding between the Department of Finance and the Council, specifies five macroeconomic variables for this purpose.

<sup>27</sup> See IFAC (2013).

<sup>28</sup> An added limitation of the endorsement function is that failure to endorse the government's forecasts would be tantamount to a no-confidence indictment, a very serious step that IFAC would probably take only in a most extreme case.

the Council can satisfy – including through sufficiently detailed quantitative estimates of each proposal – the needs of the legislature for in-depth consideration of the budget bill and of other specialised bills with potential budgetary implications, and thus contribute effectively to effective legislative oversight.

Thus far, *access to information* by the Council seems to have been timely and unrestricted. However, cooperation by government agencies in providing detailed data and estimates for in-depth and detailed surveillance remains to be tested. In the foreseeable future, the Council may encounter, as some independent fiscal institutions elsewhere, stumbling blocks in the availability of information from certain agencies.

From the very beginning, the Council has exercised a high degree of *transparency*, as evidenced by the detailed information, analyses and reports issued on its website, over its relatively brief life span.

IFAC has had a good start in relations with the media, as demonstrated by relatively favourable press coverage overall. Although it has overcome the usual difficulties faced by such institutions in gaining immediate name recognition and sufficient attention in parliament and with the general public, it is too early to assess the effectiveness of the Council's *communication* skills.

There is neither an explicit statutory requirement for some form of *external evaluation* of the Council's activities, nor an impediment to establish eventually a periodic evaluation by a competent outside entity. At this stage, anyway, such an evaluation might be premature.

## IV SCOPE FOR IMPROVEMENT

The present section explores various options for debate and consideration to strengthen the existing fiscal policy framework, so as to enhance its relevance and usefulness for Ireland as it faces major challenges, and foremost, the need to restore public debt sustainability over a realistic time horizon. It should be noted that all the options outlined herein are compatible, at least in spirit, with the existing statutes promulgated under the new EU fiscal governance. In fact, in several respects, they go beyond in securing fiscal discipline without dampening economic growth.

### 4.1 *Binding Public Debt Rule*

As discussed above, Ireland needs an *enforceable* policy rule, *adequate* above all to reduce a staggering public debt burden most *efficiently*, that is, at the least possible sacrifice in terms of output foregone. For this purpose, it would be necessary to specify a policy rule that sets a constraint on the gross

debt of the general government with the overarching objective of reducing it over a predetermined time path.<sup>29</sup> Let us examine three basic options, introduced in other countries, which may be considered for possible adoption in the future.

The first option is a simple debt rule, enshrined in Poland's constitution since 1998, which imposes a *ceiling on the stock of government liabilities* at 60 per cent of GDP. As a preventive measure, the government must take action when the debt ratio surpasses 55 per cent. Local governments are subject to comparable limits. The rule offers no guidance to the government at what pace to reduce the debt ratio if it exceeds the prescribed limit. In all, the main advantage of the rule is simplicity, but at the cost of excessive rigidity plus enforcement difficulties.

Upon approaching the limit, the rule tends to be procyclical as the government is compelled to match an apparent economic downturn with a fiscal contraction. Conversely, it is tempted to accompany a surge in activity with an expansionary stance. In any event, as noted, it is difficult to observe fluctuations in GDP in real time. While the debt ratio is not immune to manipulation – especially in terms of valuation and coverage of the debt statistics – perhaps the weakest feature of this rule is that it cannot be linked to an operational target under the direct control of policymakers.

The second option is a more sophisticated debt rule, introduced in Brazil in 2000,<sup>30</sup> which provides for a derivation from a target debt ratio to a *minimum primary surplus ratio* as an operational target. Specifically, the primary surplus target is determined by the differential of the average interest rate on government debt and the medium-term growth rate, augmented by the yearly reduction in the debt ratio necessary to reach the policy target debt ratio over a predetermined convergence period. This step toward enforceability, including a lesser susceptibility to manipulation, is an important advantage over the simple debt rule. An added advantage is that, in principle, the inherent procyclicality of this rule could be partially corrected by specifying the primary surplus target in structural terms, much like in the case of the structural balanced budget rule. However, this would entail having reliable estimates of the output gap and of transitory budgetary components.

A third option, adopted in Hungary in 2008, is the real debt rule that obviates altogether reliance on estimates of the output gap or of fiscal elasticities, and specifies an operational target entirely under real-time

<sup>29</sup> Several alternative policy rules (balanced-budget and expenditure rules) proposed by the Department of Finance (2011) are critically assessed in Hagemann (2012) and IFAC (2012a). Despite their merits, those proposals fail to address the need to reduce Ireland's public debt ratio at an adequate pace.

<sup>30</sup> For a detailed discussion, see Goldfajn and Guardia (2004).

control by the authorities. Derived from the target debt level, the operational target is essentially a *ceiling on discretionary budget deficit*. Thus, the decision maker is bound only by this ceiling and can be held fully accountable for compliance. It is understood that the actual level of tax revenue, mandatory outlays and macroeconomic developments are beyond his control.<sup>31</sup>

The rule is anchored on the target stock of government liabilities set three years in advance of the test year, adjusted for the expected rate of inflation. Given the targeted change in the value of the debt and the projected net interest payments, the required primary balance obtains also in advance. The latter, reduced by the projection of mandatory components of the primary balance yields the binding limit on the discretionary deficit (comprised almost entirely of discretionary expenditures, net of nontax revenue) for the third subsequent year – all stated in nominal terms, instead of percentage of GDP. The exercise is repeated every fiscal year in preparation of the budget.<sup>32</sup> Key elements are the projection of interest payments, tax revenue and mandatory spending – mainly on social entitlements plus other government programmes – subject to the pay-go rule, discussed below.

The real debt rule has several advantages over the other two options. First, it is much easier to enforce since the locus of decision-making responsibility is identified with the operational target, instead of the policy target. Second, since compliance is measured *ex post* in terms of a flow variable (discretionary deficit) rather than a stock variable (gross liabilities), it is far less amenable to statistical manipulation. Third, the rule is neutral with respect to the cycle since it allows for the operation of automatic stabilisers – without attempting to measure a neutral stance – in the face of economic shocks or stagnation of unknown duration. Fourth, the actual decline in the debt ratio is not only determined by compliance with the rule, but is also influenced by fluctuations in the growth rate, which in part depends on the debt level. Lastly, the rule is versatile in accommodating any predetermined pace of debt reduction, set by the authorities.

#### 4.2 *Indicative Structural Balanced Budget Rule*

As indicated above, in Ireland, the structural balanced budget rule seems to be neither adequate nor enforceable without difficulty, notwithstanding its

<sup>31</sup> The design of the real debt rule under Hungary's Fiscal Responsibility Act of 2008 can be traced to two sources. One is the approach suggested by Coricelli and Ercolani (2004) of assigning responsibility for compliance with the *ex ante* target rather than fulfillment of *ex post* performance influenced by unanticipated macroeconomic developments beyond the control of the decision-maker. The other source is the U.S. Budget Enforcement Act of 1990 which places compliance on the discretionary component of the budget and the pay-go rule on the mandatory component – see below.

<sup>32</sup> See the Appendix.

well-known conceptual virtues. It is not likely to help reduce the public debt ratio as rapidly as a debt rule. In addition, it is exposed to real-time measurement problems as regards the underlying macroeconomic developments. For these reasons, the structural budget balance should be applied as an indicative rule, rather than as a binding commitment.<sup>33</sup> The structural balance would be calculated on a periodic basis to serve as a metric to gauge the extent of the ongoing adjustment under the debt rule. Over time, having built a track record of satisfactory estimation of the structural balance and of a significant debt reduction, consideration could be given to shifting from a binding public debt rule to a binding structural balance rule.

#### 4.3 *Pay-go Rule*

An effective procedural rule to enforce fiscal discipline at the legislative stage is based on the pay-go rule, developed and implemented successfully in the United States by consecutive administrations during the 1990s. Under this rule, any deficit-enhancing proposal of a mandatory nature must provide for its own financing. Thus, a legislative proposal (whether in the budget bill or a specialised bill) involving an expenditure increase or tax revenue loss must contain an offset of the budgetary cost, by means of an equivalent tax increase or expenditure reduction, so as to leave the overall budget balance unchanged over a specified period – of, say, up to five years. It was in the context of the pay-go rule that the distinction between mandatory and discretionary budget components gains traction. Consequently, it serves as a useful complement to the ceiling on the discretionary spending, which is the operational target of the real debt rule.<sup>34</sup> But the rule can be a valuable disciplining tool in any event, and especially as political leaders may be tempted to launch tax cuts or raise social benefits following the conclusion of an adjustment programme.<sup>35</sup>

#### 4.4 *Multi-year Budgetary Planning*

The need to extend the budgetary horizon beyond the current or the forthcoming fiscal year is, by now, well known in Ireland. Multi-year macro-budgetary planning is an essential ingredient of a rules-based fiscal framework. It alerts the authorities and financial markets as regards future

<sup>33</sup> For Australia, McDonald *et al.* (2010) caution against committing to estimates of a structural budget balance.

<sup>34</sup> According to Reischauer (1993), the success of the Budget Enforcement Act of 1990 as a tool of fiscal discipline can be attributed to the combination of discretionary spending caps with the pay-go rule.

<sup>35</sup> Such a legally binding pay-go rule is compatible with the EU template that in principle calls for matching any new expenditure by a corresponding revenue increase.

policy adjustments or reform measures – instead of relying on ad hoc improvised decision making, as has been the case in the recent past – that may be necessary for efficient compliance with policy rules. Equally, it provides information about the fiscal space available to the government over time for the pursuit of various policy objectives, while adhering to policy rules. However, for the Medium-Budgetary Framework to serve as a useful policymaking tool, the government must commit to its implementation and ready to explain or correct deviations from the initially formulated plan. Such medium-term planning involves a more rigorous exercise than the medium-term stability programme required from each government within the Euro Area for review and approval by the European Council.

#### 4.5 *Independent Fiscal Forecasting and Risk Analysis*

Unbiased fiscal forecasting has long been recognised as a critical element of fiscal transparency.<sup>36</sup> In Europe, a number of countries have suffered an optimistic bias in official forecasts, under Goodhart's law, as fiscal rules become binding and governments increasingly feel the pressure of compliance in order to meet (or preferably avoid altogether) the excess deficit procedure. Typically, medium-term stability programmes have been based on official projections underpinned by biased growth and interest rate assumptions and opaque methodology. This provides the backdrop for the prescription, under the new EU governance for each member country, of preparing independent macro-fiscal forecasts.

Although in Ireland fiscal projections may have been immune from a severe optimistic bias – despite the opacity of official fiscal forecasts, subject to considerable error – there is no guarantee that in the future, under continued adjustment pressure, governments might not succumb to such bias. More important is the potential usefulness for policymakers, the general public and financial markets to have access to independent, competent and transparent medium-term macro-fiscal projections, so they may gauge the true extent and pace of adjustment needed to comply with the rules and meet the targeted debt reduction. Indeed, the quality of the projections influences the credibility of the multi-year budgetary programme. Specifically, baseline projections – assuming no policy change – can provide a useful reality test for the medium-term budgetary plan, insofar as it can flag changes in fiscal space for discretionary spending against the constraint of the debt rule over the projection horizon. Hence the need to extend IFAC's terms of reference beyond merely the endorsement function as regards official projections.

<sup>36</sup> See Kopits and Craig (1998).

In addition to independent short- and medium-term fiscal projections, Ireland's high public indebtedness warrants continuous monitoring through long-term quantitative no-policy change scenarios on the basis of realistic macroeconomic and demographic assumptions. Such scenario calculations permit periodic assessments of debt sustainability and of the need to anticipate measures over time in order to comply with the debt rule.

As Ireland's public sector has accumulated significant contingent liabilities in the face of a high degree of potential macroeconomic and financial volatility, sound fiscal planning requires a thorough analysis of the exposure to fiscal risk. Thus, instead of relying on various arbitrary stress tests (depicted in fan charts), with limited useful information, it would be preferable to select and develop a comprehensive and analytically sound methodology<sup>37</sup> that permits quantification of major sources of risk and the computation of the probability of sovereign default.

#### 4.6 *Strengthening the Fiscal Council*

Thus far, over its short lifespan, IFAC has displayed independence, professional excellence, solid communication skills, and responsiveness to the needs of the executive as well as the legislative branches of government. But above all, it has made a valiant effort in meeting its remit with meagre resources. Given the fiscal challenges in the period ahead and lacking any other independent institution that might perform the real-time surveillance functions that IFAC should perform, there is considerable scope for *broadening the remit* as well as *amplifying the resources* commensurate with the expanded responsibilities. IFAC's statutes could be amended so that it may rise to the forthcoming challenges, when Ireland is no longer under direct IMF or EU tutelage. More generally, it is widely recognised that an effective independent fiscal council can make a major contribution to restoring public debt sustainability.<sup>38</sup>

In other words, IFAC's remit warrants a broader interpretation to encompass the tasks associated with the above options to strengthen the fiscal framework.<sup>39</sup> Specifically, the Council should prepare its own (preferably model-based) short- and medium-term macro-fiscal projections to assess the realism of the official projections.<sup>40</sup> No-policy-change baseline projections

<sup>37</sup> The Value-at-Risk approach, applied to the public sector balance sheet, seems potentially useful for Ireland; see Barnhill and Kopits (2004). For a start in this endeavor, see Barnes and Smyth (2013).

<sup>38</sup> See the analysis and country studies in Kopits (2013).

<sup>39</sup> Instead of merely broadening the interpretation of the existing mandate, for legal reasons it may be necessary to amend the Fiscal Responsibility Act.

<sup>40</sup> For example, in Hungary, detailed macro-fiscal projections were prepared on the basis of a DSGE model, developed by Benk and Jakab (2012), supplemented with expert opinion in specific areas.

should precede the budget bill and the draft medium-term stability programme so as to facilitate evaluation of these documents – along with quantitative estimates of the budgetary impact of major policy proposals – as a timely input in the legislative debate and decision-making. Ideally, as an alternative, the official forecasting function should be transferred from the government to IFAC, as done in a number of countries (including Canada, Netherlands and the United Kingdom), thereby buttressing the government's credibility.

IFAC should also prepare and periodically update a long-term baseline fiscal scenario, reflecting explicitly the effect of major entitlement programmes, along with future demographic trends and key macroeconomic assumptions. This would provide the basis of an ongoing analysis of debt sustainability and fiscal risk, as outlined above.

The importance of medium-term projections and long-term scenarios is underscored by IFAC's surveillance function which encompasses monitoring not merely of compliance with policy rules in the current fiscal year, but also of ability to comply with rules over a long time horizon. In addition, at the micro level, the need for estimates of the impact of proposed changes in mandatory expenditures and taxation is necessary in order to verify compliance with a pay-go rule.

It seems unreasonable to expect IFAC to fulfil the present remit unless it remains narrowly interpreted, at the risk of eroding its effectiveness. Moreover, a broader interpretation of the remit – to include preparation of semi-annual medium-term projections, periodic debt sustainability scenarios, fiscal risk assessments, and budgetary and economic impact estimates for major legislative proposals – would entail significant capacity expansion and attendant increase in funding. Experience of similar fiscal watchdogs suggests that, at a minimum, staff size should be raised to 20-30 professionals (consisting mainly of economists, budget specialists, lawyers, administrative support). The Council Chair should be a full-time position and remunerated accordingly (for example, at a level equivalent to the salary of the Central Bank of Ireland Governor or the Comptroller and Auditor General), while the members, though appointed on a part-time basis, should be remunerated as well (say, at half of that salary).

There is ample evidence worldwide to confirm that an independent fiscal institution, charged with the tasks to be assigned to IFAC, can make a major contribution to sound fiscal management, and over time, toward regaining public debt sustainability. In the first instance, the resulting gain in policy credibility will be felt in a decline in the sovereign risk premium. In the case of Ireland, the benefit of a mere one basis point tightening of the average spread on government bonds (equivalent to about €20 million in annual

budgetary saving) would exceed almost tenfold the annual cost of funding IFAC at a realistic level (at least €2 million) and fully justify the suggested remuneration and increase in staffing.

## V SUMMARY AND CONCLUSION

An evaluation of the current fiscal framework suggests that Ireland has made considerable progress in establishing the basis for securing public debt sustainability. The Fiscal Responsibility Act represents a major step in this regard, as it enshrines fiscal policy rules and an independent fiscal council into a formal statute. Equally important are a number of ongoing innovations in budget procedures. However, following conclusion of the adjustment programme supported by the EU and IMF, Ireland needs to build on this progress to enhance and preserve the confidence of financial markets – already rather favourable as reflected in the investment grade awarded by all major credit rating agencies – and eventually to achieve sustained growth and welfare, by strengthening the existing framework.

Laudable as its positive attributes may be, a necessary condition for durable success of any fiscal framework is that it be *home-grown* and *home-owned*. Although Ireland was the only EU member country to hold a referendum to approve the Treaty underlying the adopted fiscal rules, the present framework does not appear to fully meet this condition. Political leaders and the citizenry, acting under some duress, may have been too eager to please the official creditors. Key features have been imported from abroad, apparently without sufficient attention to Ireland's foremost challenge of reducing the ratio of public debt to GDP. To be sure, it is not too late for the Irish political leadership to revisit the design of the framework and forge an informed and broad-based consensus around an option that would serve better the future needs of the country.

A sufficient condition for success is that the framework be *technically well designed* to serve the goal of debt reduction, and that public finances be *subject to effective surveillance*. While the structural balance and debt rules in place are conceptually appealing, in practice, their adequacy, enforceability and efficiency for Ireland are open to question. During its brief track record, IFAC has demonstrated independence and competence in carrying out a narrowly interpreted mandate. But the very meagre resources at its disposal can impair its effectiveness.

Consistent with the paramount goal of regaining debt sustainability, Ireland would benefit from a fiscal policy rule aimed primarily at reducing the public debt ratio. Three options for a binding debt rule are examined to this

end: a *limit on the debt ratio*; a *minimum primary budget surplus ratio*, derived from the debt ratio; and a *discretionary deficit ceiling*, derived from a real debt limit. While the debt ratio is simply a policy target, the latter two options provide operational targets, without procyclicality. But only the real debt rule, translated for operational purposes into a discretionary deficit ceiling, is directly amenable to enforcement. Such a *binding debt rule* may be accompanied by an *indicative structural balanced budget rule*. Over time, the latter could become binding – and replace the debt rule – after having accumulated sufficient experience and having reached the debt ratio threshold prescribed under EU treaty obligation.

Two procedural rules are suggested for consideration, to complement and support the policy rules: a *strengthened multi-year budgeting plan* and a *pay-go requirement*. Observance of these procedural rules and of the policy rules depend, in turn, on unbiased and *realistic independent medium-term macro-fiscal projections*. In addition, especially for a high-debt country, periodically updated long-term baseline scenarios are necessary for the analysis of debt sustainability and fiscal risk.

In order for IFAC to exercise effective oversight of fiscal policymaking, including of compliance with policy and procedural rules, it is necessary to *broaden its remit*. Notably, the Council should be entrusted with preparation of independent macro-fiscal projections, long-term baseline scenarios, sustainability and risk analysis, in time for the legislative debate and decision making. This would entail beefing up significantly IFAC's *human and material resources*, with adequate funding, while ensuring full and timely access to information.

In view of IFAC's pivotal role in reducing Ireland's debt burden and in contributing to policy credibility in the financial markets, there is a strong case for elevating its status to a level comparable to other well-established independent institutions, such the Central Bank of Ireland and the Office of the Comptroller and Auditor General. A direct implication is that the Council, headed by a full-time Chair, should be appropriately remunerated.

Implementation of a rules-based fiscal framework which is home-owned, home-grown, and well-designed, with a view primarily to reducing public indebtedness, would catalyse a virtuous circle in Ireland. Compliance with the framework, supported with reforms of age-driven entitlements – especially public pensions and health-care programmes – should help regain policy credibility, anchor expectations, reduce the sovereign risk premium, induce investment and work effort, and enable Ireland to resume a path of high and sustained growth. Failure to abide by such a framework would, under the present debt burden, continue to inhibit growth – as documented in an

increasing body of empirical literature.<sup>41</sup> Overall, the process of debt reduction should be supported with full-fledged macroprudential oversight and sound banking regulation and supervision.

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<sup>41</sup> Notwithstanding the recent controversy over the quality of empirical estimates, the depressing effect of public debt on output growth in high-debt countries found by Reinhart and Rogoff (2010) has been corroborated by Cecchetti *et al.* (2011) with robust estimates on a homogeneous sample of OECD countries over a recent period and encompassing a broader institutional coverage of the public sector.

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## APPENDIX: MECHANICS OF THE REAL DEBT RULE

In the initial year of application of the debt rule – according to Hungary's Fiscal Responsibility Act of 2008 – the government is under obligation to set the target debt limit two years in advance of the test year ( $t$ ), as shown in the timeline below. Given the pre-set debt target, the government is required to set benchmarks for the primary balance two years in advance of the test year and the discretionary component one year prior to the actual test year. In the test year, the government is obliged to meet the pre-set limit on the discretionary balance of the central budget.

A major advantage in monitoring of compliance with the debt rule is that the decision-makers at the finance ministry become aware two years in advance of the actual limit on the discretionary budget deficit, regardless of intervening macro-fiscal developments. Setting this deficit ceiling against the baseline projection, the independent fiscal council helps anticipate for the government and its institutions the latitude for discretionary action or the extent of the fiscal stress that is likely to emerge in the future. In this sense, the council plays an early warning role, whereby the government can engage in medium-term budget planning and in formulating the necessary fiscal reforms, consistent with the path of the debt target under the rule, and thus avert the need for relying on unanticipated stop-gap measures.

In essence, once the government submits the budget bill to parliament, the legislative debate is focused on the allocation of discretionary items within a pre-set overall limit. The overall limit on discretionary expenditure, in turn, has been already derived as a technical exercise from the projected mandatory primary outlays (which is subject to the pay-go rule) plus interest expenditures. The latter task can be outsourced to the fiscal council, thereby strengthening the government's credibility, without any loss of decision-making power or responsibility.

Key variables for the mechanics of the debt rule are defined as follows.

*Public debt* is the stock of gross liabilities of the general government. The change in the debt stock allowed for calculating the required primary balance is measured net of valuation changes and one-off windfall gains or losses (including privatisation receipts).

*Mandatory primary expenditures and revenues* are determined by specialised statutes (e.g., public pensions, tax revenues) and by macro-economic and demographic developments, beyond the scope of the annual budget legislation.

*Discretionary expenditures and revenues* are non-mandatory items (e.g., one-off investment projects, non-tax revenues), subject to appropriations under the annual budget legislation. After subtracting mandatory components

(including net interest expenditures) from the overall balance, the remaining primary revenues and primary expenditures are discretionary.

Observance of the debt rule is to be supported by a number of procedural and disclosure rules: a pay-go rule, rolling three-year indicative budgetary planning, preparation of budgetary impact assessments, accounting rules for public-private partnership projects, and comprehensive profit/loss accounts for state-owned enterprises.

*Timeline For Implementing The Real Debt Rule*

