

A New Fiscal Framework for Ireland

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Abstract: Pro-cyclicality in Irish fiscal policy has contributed to macroeconomic volatility over recent decades. Accordingly, this paper seeks to identify institutional mechanisms that can improve the performance of fiscal policy in macroeconomic stabilisation in Ireland. We propose a new fiscal framework for Ireland that combines the adoption of a rules-based approach to budgetary policy with the appointment of an independent fiscal policy council that will be formally involved in the fiscal process. Finally, we also advocate a set of ancillary reforms that will further improve the coherence of Irish fiscal policy with membership of European Monetary Union.

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1. INTRODUCTION

A central feature of the current Irish economic crisis is that the government has been compelled to undertake a sizeable fiscal correction in the midst of a severe recession. While this route may well have been conditionally optimal given the situation faced by the government, it begs the question of whether a different path for fiscal policy during the pre-crisis period may have permitted a less onerous fiscal response to the crisis.

This debate about the cyclical behaviour of fiscal policy is especially important in view of Ireland's membership of European Monetary Union (EMU). As a member of EMU, Ireland shares a common monetary policy with the other member countries of the euro area. Accordingly, fiscal policy is the main macroeconomic instrument available to deal with country-specific shocks. However, the indicative evidence is that the pattern of Irish fiscal policy has not been a force for cyclical stabilisation.

The goal of this paper is to assess whether a new fiscal framework could deliver a superior cyclical pattern for Irish fiscal policy. If a new fiscal institutional setup could enhance macroeconomic stability for Ireland, it would improve the policy coherence of EMU membership and generate substantial benefits to Irish workers, households and firms in terms of less volatile employment and income levels.

Moreover, the establishment of an improved fiscal framework should also deliver short-run benefits. To the extent that a new fiscal framework improves the prospects for long-term fiscal sustainability, it should also improve Ireland's reputation in international debt markets, helping to reduce the currently-high spreads on Irish sovereign debt.

In terms of timing, it is widely appreciated that crisis periods can often foster institutional innovation, since the inertial forces that preserve the incumbent institutional structures are weakened by large, disruptive shocks.² In

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² The importance of designing a fiscal process that guards against procyclicality was also highlighted in an earlier wave of research (see, amongst others, Lane 1998a, 1999, 2000 and Fitzgerald 2001a, 2001b). However, the boom conditions during that period overshadowed the need for a structural re-design.

relation to the fiscal framework, there is some (qualified) evidence that economic crises raise the likelihood of the reform of budgetary institutions (Fabrizio and Mody 2009).

In designing a fiscal framework, there are two primary components. First, a fiscal framework may include the codification of a set of fiscal rules that would impose restrictions on annual budgetary choices.³ Second, a fiscal framework may involve the establishment of an independent fiscal policy council that would take a formal role in the formulation and assessment of budgetary policies and monitors compliance with the set of fiscal rules. In general, both components may have a useful role in improving the conduct of fiscal policy.

Finally, it is important to appreciate that a domestic fiscal framework is complementary to the EU-level system of fiscal restraints, as expressed in the Stability and Growth Pact (SGP). The main focus of the SGP is in the avoidance and resolution of excessive deficits and debt levels, since the primary cross-border risk spillovers relate to these factors. However, in the event that fiscal adjustment is required (whether the correction of an excessive deficit or the accumulation of larger surpluses during boom times), the domestic ownership of the adjustment process is enhanced if the guiding fiscal framework is domestic in origin rather than conducted from Brussels. Moreover, the EU system of fiscal surveillance is essentially a second read of nationally-developed fiscal plans, such that it is inevitably weaker than a domestic fiscal framework that continuously guides the formulation of the domestic fiscal strategy from the point of inception.

The structure of the rest of the paper is as follows. In Section 2, we outline the theoretical debate concerning fiscal cyclicity. We review the cyclical pattern in Irish fiscal policy and provide a selective comparative review with the fiscal experience elsewhere in Section 3. In Section 4, we describe the fiscal rules and fiscal institutions that have been adopted in other EU countries and selected countries elsewhere. In Section 5, we outline some proposals for a new fiscal framework in Ireland. We make some supplementary recommendations for reform in Section 6. Finally, some concluding remarks are offered in Section 7.

2. FISCAL CYCLICALITY

In order to contribute to macroeconomic stability, it is desirable that fiscal policy moves in a counter-cyclical pattern. During boom periods, fiscal surpluses are accumulated which in turn enables the running of fiscal deficits during downturns without threatening long-term fiscal sustainability.

Behind the overall fiscal balance, this requires that the non-cyclical steady-state components of government spending grow at rate of trend income growth, such that the ratio of public spending to income falls during booms and increases during recessions. (Unemployment benefit payments are mechanically cyclical in nature but most other components of public spending do not have a direct cyclical component.) By the same token, the non-cyclical steady-state components of revenue should grow at the same rate as trend incomes. However, since there is a substantial cyclical component in tax revenues, such revenues should grow relative to incomes during expansions and fall during contractionary episodes.

Such principles are easy to state. However, their application is not so straightforward. In particular, decisions about the appropriate stance for fiscal policy must be taken in a fog of uncertainty. First, it is non-trivial to decompose output between cyclical and trend components. Second, prudent policy must take into account the distribution of risks around the central forecast, rather than focusing exclusively on the expected path for output. Third, risks to the fiscal position do not only arise from developments in aggregate output but also are connected to the emergence of sectoral imbalances and mis-pricing in asset markets.

In relation to the first point, the identification of the trend output path for a small and highly open economy is bound to carry a large standard error band. The high mobility of capital and labour in and out of Ireland means that the potential level of production can shift quite rapidly. In particular, international factor mobility means that persistent positive shocks are likely to endogenously increase the productive capacity of the economy, while persistent negative shocks will induce a downward shift in potential output. In related fashion, permanent trend shocks have an amplified impact through the endogenous movement of capital and labour across borders.

³ There is also a considerable literature that focuses on budgetary procedures (see, amongst others, Fabrizio and Mody 2006). In this research, the processes by which the budget is prepared, authorised and implemented are evaluated according to whether the fiscal common pool problem is controlled. I do not explicitly discuss such procedural rules in what follows.

Such trend volatility combines with cyclical fluctuations. Cyclical shocks can be driven by temporary production or demand shocks. In addition, the impact effect of current or anticipated trend shocks is also to induce cyclical fluctuations since the associated inter-sectoral or international resource reallocations do not occur instantaneously. Regardless of their source, cyclical shocks generate temporary shifts in wages, prices and employment levels that may depart from efficient levels due to a variety of nominal and real rigidities.

Accordingly, it is extremely challenging to obtain a precise estimate of the relative contributions of cyclical and trend factors in determining macroeconomic outcomes in a given period. Still, the joint analysis of a variety of wage, price and activity indicators may provide a reasonable projection of the cyclical condition of the economy. However, in relation to policymaking, it is essential to incorporate the distribution of risks around such a central forecast. In particular, a macro-prudential approach to setting fiscal policy would recognise the importance of providing insurance against downside risks.

One particular type of risk relates to cyclical drivers that are prone to sudden stops. Most obviously, activity levels that are driven by a combination of rising asset prices and a credit boom are typically characterised by a boom-bust cycle in which rising collateral values stimulate new credit-financed investment projects that deliver a sustained expansion phase until a trigger event leads to a revision in expectations and a sustained decline in investment that is amplified by a fall in collateral values and an increase in the cost of credit (see, amongst others, Geanakoplos 2009). During the expansion phase, the reversal risk may be low for a given planning period but is cumulatively large over a longer horizon. For this reason, the fiscal strategy should take into account macroeconomic risks over a range of horizons, not just vis-a-vis the next annual budget cycle.

However, beyond the technical difficulties in correctly assessing the cyclical state of the economy and the distribution of fiscal risks, it is apparent that the discretionary components of fiscal policy have a procyclical bias in many countries (see, amongst others, Lane 2003; Agnello and Cimadomo 2009). Accordingly, even if the government is fully aware of the current cyclical position, political economy factors may induce it to act in a procyclical manner.

There are two main types of explanation for fiscal procyclicality. One line of research highlights that the cost of public debt may co-vary negatively with the state of the business cycle - under these conditions, a government may be compelled by conditions in the capital market to tighten fiscal policy during a recession. A second series of contributions has focused on distortions in the political system that may generate a procyclical pattern in the fiscal position.

Regarding the former mechanism, researchers have largely focused on developing countries that may periodically suffer sovereign debt crises. However, the current financial crisis has underlined that funding costs and funding risks may also increase during recessionary periods even for high-income countries. A fundamental weakness with the funding hypothesis is that a far-sighted government would run sufficiently-large surpluses during good times in order to avoid reliance on issuing debt during downturns.

Accordingly, more weight is placed on theories that focus on distortions in the political system as the source of fiscal procyclicality. Tornell and Lane (1999) highlight the voracity effect mechanism. In a political system with fragmented political power, a positive income shock leads to more intense lobbying by each powerful group. Since any individual group does not internalise the impact of its spending/tax demands on the overall fiscal situation, the collective outcome is that spending patterns are procyclical - an X percent increase in resources leads to a greater than X percent increase in spending. In contrast, a coordinated fiscal system does not exhibit such a procyclical pattern and spending is less volatile than income under this first-best benchmark.

Talvi and Vegh (2005) provide a complementary explanation. In their model, a budget surplus unleashes intense lobbying pressures to increase public spending or raise taxes. Facing such pressures, the government chooses to raise spending and cut taxes. In contrast, the lower level of lobbying during deficit periods means that the government restores fiscal health by cutting spending and raising taxes. Overall, the fiscal position exhibits a procyclical pattern.

Whereas Talvi and Vegh (2005) model the political distortion as exogenous, Alesina et al (2008) provide a theoretical model that explains the existence of this distortion. These authors identify an agency problem by which the electorate knows that governments like to divert resources towards politically-favoured elites or 'rents' for politicians but cannot observe the true level of government borrowing (for instance, the government may hide liabilities in off balance sheet entities). Accordingly, voters require the government to cut taxes or raise spending on public goods during booms, in order to constrain the political temptation to divert boom-year revenues towards transfers for politically-favoured elites or 'rents' for politicians. In this way, the solution to the agency problem is

for voters to call for a procyclical pattern in fiscal policy. While this is suboptimal in terms of the volatility of consumption, it is efficient in terms of limiting the waste of public resources on socially-useless political rents.

A feature of these political economy models, is that when the procyclicality bias tends to be more severe, the greater is the level of macroeconomic volatility. In a relatively-stable economy, the amplitude of the business cycle may be sufficiently low that it is sufficient to run a surplus in the low single digits during boom periods. However, in a more volatile economy, the higher amplitude of the cycle may call for substantially larger surpluses during expansion phases. Macroeconomic volatility tends to be higher in smaller, more globalised economies due to the limited level of domestic diversification and the elasticity of international factor flows. Accordingly, procyclicality bias is a more serious problem for a country such as Ireland relative to larger, more diversified economies.

Across the research contributions on fiscal procyclicality, a common refrain is that such political distortions can be mitigated by the existence of effective fiscal rules and fiscal institutions. If fiscal policy is determined in an institutional environment that insulates the common interest from the adverse impact of sectoral lobbying or political rent seeking, such distortions can be neutralised and an optimally counter-cyclical fiscal policy can be implemented. Indeed, the empirical evidence is that fiscal procyclicality is less pronounced in countries with stronger institutions (Woo 2003, Alesina et al 2008). More generally, many countries have taken purposeful steps in order to develop fiscal rules and fiscal institutions that are designed to improve the cyclical behaviour of fiscal policy. We turn to these initiatives in Sections 4 and 5. However, we first briefly review the pattern of fiscal cyclicality in Ireland during recent years.

3. FISCAL CYCLICALITY IN IRELAND: RECENT EXPERIENCE

Our focus in this section is on the cyclical conduct of Irish fiscal policy in the period since Ireland joined EMU in 1999.⁴ While EMU marked a fundamental shift in the macroeconomic policy environment, it is also important to appreciate that the late 1990s was a remarkable period in Irish economic history, with very rapid output growth far in excess of historical averages and the attainment of effective full employment. Moreover, there were further important structural shifts in the nature of the Irish economy, most notably associated with the increased integration of the European labour market with the EU accession of the ten Central and Eastern European new member states in 2004. In common with other countries, the structure of the Irish economy has also been altered over the last decade through the increasing economic role of the emerging market economies and the growth in international financial flows.

For these reasons, the accurate assessment of the cyclical state of the Irish economy has not been an easy task over this period. However, by the same token, these structural factors also raised the level of uncertainty about the appropriate cycle-trend decomposition, which reinforced the importance of adopting a prudent fiscal stance. This consideration is especially relevant in assessing fiscal policy during the 2003-2006 credit and housing boom, in view of the historical frequency of credit/housing booms being succeeded by severe recessions.

ESRI (2009) have provided a set of estimates for the fiscal stance. This approach follows the method described in Kearney et al (2000) and compares the actual budget balance in each year to the budget balance that would have transpired under a simple indexation rule by which the previous year's expenditure and revenue plans are passively updated by assuming that revenues and cyclical expenditure items will grow in line with actual output growth while non-cyclical expenditure items will grow in line with trend output growth. The difference between the actual and indexed balances captures the discretionary change in the fiscal position. By this method, it is calculated there were substantial pro-cyclical fiscal expansions during the 1999-2002 and 2003-2008 periods of relatively-high output growth.

Another perspective is obtained by conducting an ex-post review of the cyclicality of fiscal policy, using the current European Commission estimates of the output gap during these years. Over the 2001-2007 period, the average value of the general government surplus was just one percent of GDP despite an average GDP growth rate of 5.6 percent and an average positive output gap of 2.1 percent. The failure to run larger surpluses during this period meant that the sizeable swing in the fiscal position in 2008-2009 drove the overall fiscal balance into a deep deficit position. In turn, the average cyclically-adjusted budget balance was approximately zero during this period.

⁴ See Lane (1998a) and Hunt (2005) for econometric studies of fiscal cyclicality in Ireland over longer sample periods.

Moreover, the standard OECD method to calculate the cyclical component of the budget balance is narrowly defined to just refer to those revenue and expenditure items that systematically vary with aggregate GDP.

In particular, it does not take into account revenue windfalls that are attributable to asset price booms or sectorally-concentrated output expansions (such as a construction boom). That the normal cyclical adjustment is misleading under such conditions has been well established for some time (Eschenbach and Schuknecht 2004, Girouard and Price 2004). Accordingly, the true state of the structural budget balance was worse than reported under the standard methodology. Moreover, taking the reported structural balance at face value, the inherent potential volatility of the Irish economy plus the well-documented risks associated with rapid expansion in credit and housing prices meant that a target of substantially positive structural balance during expansionary periods would have been more prudent in order to allow for greater flexibility in the event of a sharp downturn.

In relation to the structural balance, there are two more factors to consider. In one direction, the relatively-high level of public investment during this period may have justified running a lower structural surplus. However, in the other direction, the predictable future growth in ageing-related public spending calls for the running of larger structural surpluses in order to minimise the distorting impact of a higher future tax burden. Moreover, a detailed assessment of the optimal financing of public investment also requires a quantitative evaluation of the return on the public investment and the economically-relevant split between public capital replacement (due to past depreciation of the existing public capital stock) versus net additions to the public capital stock.

Table 1. Fiscal Plans and Fiscal Outcomes

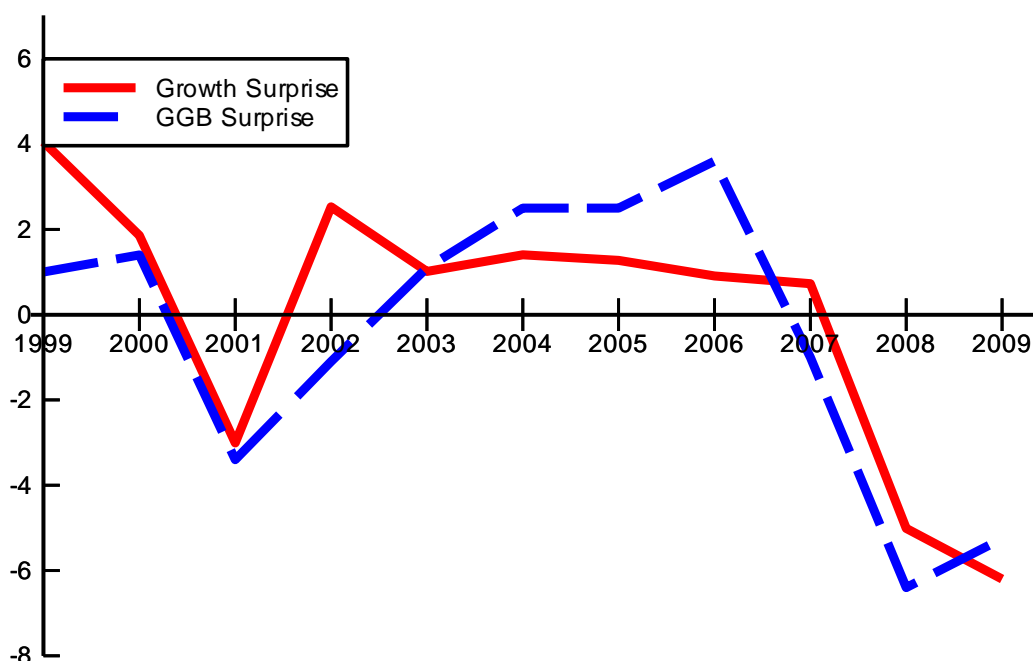
	Projected Growth	YGAP	GGB	CAB
1999	6.7	3.7	1.7	0.6
2000	7.4	2.7	3.3	2.6
2001	8.8	5.4	4.3	2.9
2002	3.9	3.0	0.7	-0.1
2003	3.5	-0.9	-0.7	-0.4
2004	3.3	-1.5	-1.1	-0.5
2005	5.1	-1.9	-0.8	0
2006	4.8	-2.3	-0.6	0.1
2007	5.3	-1.5	1.2	1.8
2008	3.0	-1.5	-0.9	-0.3
2009	-0.8	-4.2	-6.5	-4.8
	Actual Growth	YGAP	GGB	CAB
1999	10.8	2.6	2.7	1.5
2000	9.3	3.8	4.7	3.0
2001	5.8	2.3	0.9	-0.2
2002	6.4	2.3	-0.4	-1.5
2003	4.5	1.2	0.4	-0.3
2004	4.7	0.6	1.4	0.9
2005	6.4	1.7	1.7	0.8
2006	5.7	2.5	3.0	1.9
2007	6.0	4.4	0.2	-1.7
2008	-2.0	0.1	-7.3	-7.1
2009	-7.0	-4.5	-11.8	-9.6

Note: YGAP is output gap, GGB is general government balance, CAB is cyclically-adjusted balance.

Further insights into the conduct of fiscal policy during this period can be obtained by comparing ex-ante fiscal plans to the ex-post fiscal outcomes, where the ex-ante projections for GDP growth, the output gap and the general government balance can be obtained from each year's budget documents (available from the website of the Department of Finance). The projected and actual values for these variables are shown in Table 1.

One basic problem was the ex-ante projection for the output gap averaged -1.6 percent of potential GDP during 2003-2007, whereas the ex-post retrospective estimate for the average output gap for this period is +2.1 percent. In effect, this over-stated the cyclically-adjusted budget balance by an average of 1.5 percent of potential GDP (based on a 0.4 elasticity of the budget to the cycle under the standard method). (We leave aside the further adjustments that are required on account of the sectorally-unbalanced nature of growth during this period and the boom in asset prices.)

Figure 1. Growth Surprises and Fiscal Surprises, 1999 to 2009
Growth Surprises and GGB Surprises
 1999 to 2009



It is useful to examine the co-movement between growth surprises and fiscal balance surprises where each is defined as the difference between the realised value and ex-ante expected value. These are charted in Figure 1. During 1999-2007, the growth surprise was positive in each year, with the sole exception of 2001. In two of these years (2002 and 2007), the fiscal surprise was negative despite the positive output surprise. Moreover, in 1999, the positive fiscal surprise was mild relative to the strongly positive growth surprise, falling below the level indicated by the standard cyclical adjustment.

However, the fiscal surprise exceeded the growth surprise during 2003-2006, such that the level of surpluses exceeded expectations during this period. These strong fiscal surprises reflect the revenue windfalls collected during this boom phase (see also Addison-Smyth and McQuinn 2009).⁵ While these unplanned additional fiscal surpluses narrow the gap between planned and optimal fiscal balances, the low average ex-post surpluses remained insufficient to allow a counter-cyclical discretionary fiscal response to the 2008-2009 (and ongoing) crisis.

Put differently, the ex-ante fiscal plans during 1999-2007 were insufficiently prudent. While the pro-cyclical stance of fiscal policy during 1999-2001 was criticised at the time in the annual European Commission opinion on the Irish stability and convergence programme, it is important to acknowledge that the ex ante fiscal plans were generally well received by Brussels during the 2003-2007 period.⁶ However, both sides also routinely acknowledged that the cyclical position of the Irish economy was chronically difficult to ascertain. Under such conditions of uncertainty, the bias in fiscal policy needs to err on the side of caution.

Finally, in terms of comparative performance, it is worth noting that that some other countries during the boom period were able to run larger surpluses, despite having lower growth rates. For instance, Lane (2010) notes that the level of budget surpluses throughout the pre-crisis cycle were systematically higher in Finland than in Ireland.

⁵ In addition, the 2004 fiscal surprise is in part attributable to the substantial one-off proceeds from Revenue investigations during that year.

⁶ The 2001 budget was sufficiently pro-cyclical in its planned stance that the European Commission issued a formal recommendation against Ireland under Article 99.4 of the Maastricht Treaty, to much controversy at the time.

4. FISCAL RULES AND FISCAL INSTITUTIONS: INTERNATIONAL TRENDS

In this section, we review the international experience with fiscal rules and independent fiscal institutions. While we primarily focus on EU member countries, we also draw on evidence from other countries.

Fiscal Rules

There is tremendous variety in the types of rules that have been implemented in EU member countries. Some focus on the budget balance, whereas others operate as limits on expenditure growth (there are few revenue-target rules). Moreover, there is substantial variation in terms of the monitoring and enforcement of these rules.

Accordingly, the European Commission has also constructed a numerical fiscal rules index that is intended to capture the strength of each rule. As is described in European Commission (2009), each fiscal rule is evaluated along several dimensions. First, the statutory base of the rule is ranked, with a constitutional base superior to a legal act which in turn is stronger than a non-statutory political commitment. Second, the capability to revise the rule's objectives is assessed - the smaller the margin for revising the objective, the stronger the rule. Third, the strength of the rule is positively related to the independence of the body in charge of monitoring compliance with the rule. Fourth, a rule is stronger if an independent body is in charge of enforcement of the rule. Fifth, rules are ranked according to the clarity and severity of the sanctions for failure to comply with the rule. Sixth, a rule is stronger if rule observance is closely monitored by the media. The overall index is a weighted average of the scores across the different criteria.

Among the highest-scoring rules are the rules governing the deficit and debt levels in the United Kingdom and Sweden's structural balance rule. While Ireland's NPRF rule receives a middling grade, the rule governing multi-annual capital spending envelopes receives a very low score, reflecting its marginal status.

The FRI is correlated with fiscal performance. European Commission (2009) reports regression estimates that show that those countries that adopt stronger fiscal rules are more successful in improving the structural fiscal balance.

A similar result is also obtained by Fabrizio and Mody (2006), using a different index for the strength of budget institutions and a different sample of countries. In related fashion, Beetsma et al (2009) also find that stronger fiscal rules are associated with more positive planned fiscal balances; moreover, these authors find that countries with stronger fiscal rules are also more assiduous in actually implementing fiscal plans.⁷

However, the overview provided by European Commission (2009) also highlights some limitations and some common flaws in the design of fiscal rules. One basic problem is that ex-post independent monitoring of compliance with a rule is rare and there is little by way of sanctions in the event of non-compliance. In relation to central governments, many of the rules focus on expenditure growth, whereas the main cyclical problem in most economies is how to handle unexpected revenue windfalls. Accordingly, the European Commission advocates the adoption of revenue rules that specify how revenue windfalls will be allocated (for example, to debt reduction).

The current crisis has also illustrated the brittle nature of many of these rules, since the specification of the rules typically did not cater for the occurrence of major non-standard shocks. An important lesson is that fiscal rules typically should include escape clauses that make clear the conditions under which the normal operation of a rule is suspended (see also Mody and Stehn 2009). However, it is important that such deviations are only triggered in the event of genuine shocks, in view of the obvious potential for abuse.

In addition to observing fiscal behaviour in other advanced economies, it is also instructive to learn about institutional developments in other small, open economies. Chile provides an especially relevant case study (see, amongst others, Ffrench-Davis 2010). It adopted a new fiscal framework in 2001, which was subsequently codified in the 2006 Fiscal Responsibility Law. Under this framework, the Chilean government must run a structural fiscal surplus. Moreover, the state of the business cycle is evaluated by an expert committee such that the government must operate under this independently-determined constraint. During 2004-2008, Chile ran a cumulative fiscal surplus of 28.5 percent of GDP, with the Treasury becoming a significant net creditor (fiscal liabilities were small, while the assets accumulated were substantial). By building up a war chest during the boom years, Chile was able to meet the 2009 recession with a vigorous counter-cyclical policy: there was a 14.5 percent real growth in public spending in 2009, despite a 28.5 percent fall in fiscal revenue. (The projected 2009 overall fiscal balance was a 4 percent deficit.)

⁷ The empirical work is still far from conclusive. In particular, as is emphasised by Debrun and Kumar (2007), it is difficult to identify the line of causality between good fiscal outcomes and fiscal rules, since the adoption of a rules-based approach may be more likely under a well-behaved fiscal regime.

Finally, it is instructive to note that there is some empirical evidence that a rules-based approach is more effective in controlling the budget balance in countries where fiscal authority is centralised (Debrun and Kumar 2007). This is arguably the case in Ireland, since the Minister of Finance plays the leading role in setting out the aggregate budgetary stance, even if final decisions are ultimately the collective responsibility of the cabinet. Debrun and Kumar (2007) also find that fiscal rules are more effective in more volatile economies - again, this reinforces the relevance of rules for Ireland, in view of the inherent volatility of small, globalised economies.

Fiscal Institutions

The preceding discussion of fiscal rules has underlined that such rules are more effective if independent agencies play an active role in the fiscal policy process. More generally, the key to insulating the fiscal process from procyclicality pressures is to find institutional devices that enable governments to maintain the cyclically-appropriate fiscal stance.

In the typical case, an independent agency may play an advisory role in the budgetary process. However, at least so far, there are very few cases in which an independent institution has more formal powers to influence the setting of fiscal policy. It is also common that multiple independent agencies play a role in the fiscal process. It is increasingly standard to have an independent Court of Auditors to measure the integrity and quality of public spending - this role is played in Ireland by the office of the Comptroller and Auditor General. It is also common to incorporate a role for an independent agency in developing the macroeconomic forecasts that guide the setting of fiscal policy -- the ESRI may be interpreted as informally fulfilling this role in Ireland, even if there is no statutory requirement for the government to follow this independent forecast. However, these partial fiscal mandates are not an adequate substitute for a more fully-fledged independent fiscal agency that influences the overall stance of fiscal policy.

As has been highlighted by Wyplosz (2008), there are so far relatively few examples of effective Fiscal Policy Councils. One interpretation is that the concept is relatively new and that such councils will become increasingly prevalent in the coming years, with the rate of adoption stimulated by the current fiscal crises in many countries.

Another is that there may be resistance among lobby groups to the establishment of a Fiscal Policy Council, since a shift towards a more long-sighted fiscal process would limit the access of such groups to debt-financed tax breaks or spending programmes. However, the current crisis presents a window of opportunity to make such institutional reforms, since it has revealed in dramatic fashion the costliness of the discretionary approach to fiscal policy that was practised during the pre-crisis years.

An especially advanced model is provided by Sweden. The Swedish Fiscal Policy Council was established in August 2007 and consists of eight members, which is assisted by a small secretariat.⁸ Its mandate is to provide an independent evaluation of the Swedish fiscal policy. To this end, it evaluates whether the government is achieving its stated fiscal objectives: long-run sustainability; the budget surplus target; the ceiling on central government expenditure; and that fiscal policy is consistent with the cyclical situation of the economy. The council also evaluates whether the development of the economy is in line with healthy long-run growth and sustainable high employment. Additional tasks are to examine the clarity of the Government's budget proposals and to review its economic forecasts and the economic models used to generate them. Finally, the Council seeks to stimulate public debate on economic policy.

The Council publishes an annual report, which is used by the Swedish Parliament in evaluating the Government's fiscal policy. Although the Council is created by the Government, there is an explicit expectation that Parliament (Riksdagen)---and particularly the Standing Committee on Finance---will take an interest in the report.⁹ It is also active in organising conferences and publishing papers on various aspects of fiscal policy. The Council is intended to complement the the existing institutions involved in evaluating macroeconomic and fiscal development.¹⁰

⁸ In terms of membership, it consists of six academics (including two from Denmark) and two former policy officials.

⁹ This section draws on the blog post *Sweden's New Fiscal Council -- helping assure credible fiscal policy* from the IMF's Public Financial Management Blog (<http://blog-pfm.imf.org/pfmblog/2007/10/swedens-new-fis.html>)

¹⁰ These include: The National Institute for Economic Research (Konjunkturinstitutet)---an independent agency under the Government---publishes macroeconomic forecasts, analyses the cyclical development, and regularly comments on the Government's fiscal policies; The National Financial Management Authority (Ekonomistyrningsverket)---also an agency under the Government---publishes independent medium-term forecasts for central government revenue and expenditure five times per year, which enables a second opinion on the fiscal development and the quality of the Government's official forecasts; The National Audit Office (Riksrevisionen), under Parliament, has recently set up a division for government finances, concentrating on the Government's institutional capacity to pursue sustainable policies, and the transparency of budget reports.

5. A NEW FISCAL FRAMEWORK

The quality of Irish fiscal policy would benefit from the adoption of a new fiscal framework. Such a framework should have two key elements: (a) a set of fiscal rules; and (b) an independent fiscal policy council.

Fiscal Rules

In relation to the former, the over-riding principle in designing fiscal rules for Ireland should be to preserve medium-term fiscal sustainability. The already-established fiscal rule to pay in one percent of GNP each year into the National Pension Reserve Fund contributes to this goal but there is no rule guiding the evolution of the overall budget balance.

It is appropriate to target an annual surplus in the structural fiscal balance for several reasons. First, Ireland faces the prospect of higher future public spending needs on healthcare and pensions due to the ageing of the population, such that the distortions associated with a higher future tax burden can be mitigated by prefunding part of this expenditure growth (the NPRF fund is only designed to make a partial contribution to future pensions spending). Second, the public debt of Ireland will be quite substantial by the end of the current fiscal adjustment process: returning the level of public debt to be below the 60 percent ceiling specified in the SGP will require a sustained period of structural surpluses. Third, the skewness of the fiscal risk distribution means that it is appropriate to target a structural surplus during normal times in order to provide a buffer against the occurrence of a major negative macroeconomic shock.

In tandem with the last point, the structural balance fiscal rule should contain an escape clause by which a structural fiscal deficit is permitted in the event of a sufficiently large negative shock. Such an escape clause provides the flexibility to address major recessions, which may require extra fiscal measures beyond the automatic stabilisers that are part of the passive cyclical component of the budget. In terms of defining the conditions that would activate the escape clause, this could be delegated to an independent fiscal policy council in order to ensure that it is only triggered by truly exceptional shocks (see discussion below).

This main fiscal rule could be augmented by some ancillary rules. One candidate ancillary rule could relate to the establishment of a rainy-day fund that could finance a structural deficit under the exceptional circumstances outlined in the previous paragraph. By holding a buffer stock of liquid assets, the financing of exceptional deficits by such a fund could avoid the need to seek fresh borrowing during those periods in which funding costs and funding risk are least favourable. The rainy-day fiscal rule could specify a target steady-state value for the fund (as a ratio to GNP). Moreover, the rule could specify that surprise revenue windfalls should be paid into the fund and surprise revenue shortfalls paid out of the fund. In this way, the rainy day fund could play a leaning against the wind role in dealing with unanticipated revenue fluctuations. Moreover, a rules-based approach to dealing with revenue surprises is strongly advocated by European Commission (2009).

In many ways, such a rainy day fund plays an analogous role to that fulfilled by the stock of foreign-currency reserves during the pre-EMU period (see also Lane 1998, 2010b). While national currency risk disappeared with EMU, the utility of holding a gross stock of liquid assets to cope with macroeconomic shocks did not.¹¹

Other ancillary rules could include procedural rules such as a formalisation of the principal role taken by the Minister for Finance in determining the overall budgetary position, even if decisions on the composition of public spending and revenues remain the collective responsibility of the Cabinet (see also Fabrizio and Mody 2006). Through such a clear allocation of responsibility for the overall budgetary strategy, the ability of the Minister for Finance to control the fiscal stance would be enhanced.

An Irish Fiscal Policy Council

In relation to the latter, the establishment of an independent fiscal council offers a myriad of potential benefits.¹² First, such a council can play a role in identifying the cyclical state of the Irish economy and the distribution of macroeconomic risk factors. Second, given the macroeconomic environment, it could make recommendations

¹¹ While the NPRF has been deployed as a substitute rainy-day fund, this has diverted the NPRF from its long-term investment strategy and the equity-concentrated composition of its portfolio was not designed to fulfill a short-term liquidity function.

¹² It is helpful to realise that Ireland has already delegated a significant component of national fiscal policy. In many countries, public debt management remains the responsibility of the Treasury; in Ireland, this function has been successfully outsourced to the NTMA over many years.

concerning the overall budgetary stance that would be consistent with medium-term fiscal sustainability. Third, it could monitor compliance with the specified fiscal rules and make recommendations concerning the appropriate adjustment path in the event of non-compliance. Fourth, in related fashion, it could make an ex-post evaluation of the conduct of fiscal policy over the preceding year.

In addition to these direct budgetary roles, an independent fiscal council could also perform additional roles. It could contribute to the transparency of the fiscal process by acting as an independent monitor of the quality and availability of the fiscal data; it could conduct or sponsor research on the underlying characteristics of the taxation and expenditure systems and the optimality of the public debt management strategy; and it could promote the level of public debate about fiscal policy through engagement with Oireachtas committees, media and the organisation of policy workshops.

It is important to emphasise that the establishment of a fiscal framework does not constrain the fundamentally political nature of decisions over public spending and taxation. In particular, medium-term fiscal sustainability is consistent with a wide range of public spending levels - it just requires that the trend component of public spending is matched by a corresponding level of trend revenue streams. Accordingly, if the politically-supported ratio of public spending to GDP shifted from one level to another, this can be accommodated by the specification of a transition plan that specifies how revenues will be adjusted to match the new desired level of government expenditure.

In terms of scale, the Swedish Fiscal Policy Council provides a reasonable model -- indeed, the membership of the council could be smaller than the eight that are included in the Swedish case. Moreover, it would be desirable to match the Swedish practice by including some non-nationals in the membership of the Irish council, since this expands the range of potential members and provides a mechanism for Ireland to learn from the fiscal experience in other countries. In addition, the professional secretariat to the Council could be the natural home for a small number of professional economists that would be focused on research and analysis related to Irish fiscal policy. In this way, the specialist staff of the Council could be complementary to the skills of the generalist/managerial civil servants that mainly populate the Department of Finance.

In terms of setup, it is important that the fiscal policy council is an independent institution, for the same types of reasons that justify the independence of central banks. However, it is also vital that the fiscal policy council is accountable. Accountability can be made effective by a two-track process. First, the members of the fiscal policy council should testify before the relevant Oireachtas committee(s) on a regular basis and explain clearly any errors in the projections made by the council. Second, the technical quality of the work produced by the fiscal council should be audited by regular reviews carried out by an international expert group. In this way, such a group would perform the same type of role as played by the Independent Evaluation Office of the International Monetary Fund.

Finally, it is important to emphasise the complementarity between a rules-based approach to fiscal policy and the role of an independent fiscal policy council, since the latter can play a role in ensuring adherence to the fiscal rules, while the fiscal rules provide an anchor for the work of the fiscal council. Debrun and Kumar (2007) provide some suggestive evidence that fiscal rules are more effective in controlling the budget balance in the presence of independent fiscal institutions.

6. OTHER INSTITUTIONAL REFORMS

While the main focus of this paper is on the core elements of the fiscal framework described in the previous section, it is also important to acknowledge that the adaptation of national fiscal policy to EMU membership also requires further shifts in some fundamental practices. In this section, I briefly outline two important fiscal reforms that would improve the coherence of Ireland's membership of the monetary union.

Pay Determination in a Monetary Union

For a variety of reasons, there is deep resistance to downward flexibility in nominal wages (see Lane 2009 for a more detailed discussion). However, in the event of a major negative macroeconomic shock, the absence of the currency devaluation option means that downward flexibility in wages (and prices) is required if the adjustment process is to be timely and avoid persistent increases in unemployment. However, the establishment of EMU did not lead to any re-design of employment contracts, despite the fundamental shift in the macroeconomic policy environment. In relation to the public sector, the substantial nominal pay reductions that have occurred represent a marked shift from previous pay policies.

Looking to the future, it would be better to adopt an approach to public sector pay determination that explicitly incorporates the risk that pay levels may occasionally need to be reduced in response to macroeconomic events. In particular, a two-part pay scheme may be efficient. Under such a system, part A of a salary would be fully protected against downward adjustments - this component would provide the employee with a level of income insurance for planning purposes. In contrast, part B of a salary would be a state-contingent payment. Under an adverse shock, the part B payment could be reduced or eliminated in response to a set of defined trigger events, such as a contraction in GDP or tax revenues beyond given threshold levels.

A trade off exists. The larger the share of total compensation that is allocated to the part A component, the greater is the stability of nominal incomes but the lower is the degree of nominal flexibility. In exchange for greater stability, the average level of pay should be set at a lower level since the employer is in effect providing income insurance to employees and will need to build up a precautionary reserve fund to smooth out fluctuations. In contrast, average pay can be set at a higher level if the part B component represents a more significant fraction of total compensation, since total pay can be downwardly adjusted in the event of a negative shock.

If such a pay system were introduced for public sector workers, this would make fiscal policy a more effective instrument for macroeconomic stabilisation, in view of the key role for wage adjustment in minimising persistent unemployment. In relation to the private sector, similar multi-part payment contracts may spread in reaction to such an innovation in the public sector or as part of a new type of social partnership agreement. While the prevalence of bonuses and other types of discretionary payments in some private-sector industries means that there is already some scope for downward pay flexibility, these are typically linked to firm- or industry-specific performance indicators rather than to macroeconomic factors. From an economy-wide perspective, a state-contingent component in private sector pay deals that is linked to national macroeconomic conditions would facilitate macroeconomic adjustment.

Index-Linked Government Bonds

Under EMU, the medium-term average inflation rate for the aggregate euro area should be close to two percent. However, for an individual member country, the national inflation rate may deviate from this target for substantial periods. In the case of Ireland, inflation was substantially above the euro area average for most of the first decade of the monetary union; it is plausible that we are now undergoing a period of sustained under-shooting in line with the real devaluation process.

One consequence of such fluctuations in inflation is that the inflation-adjusted real interest rate in Ireland has been quite volatile under EMU. The availability of bonds that are indexed to the national price level would allow savers and borrowers to insure against the local component in nominal volatility. Accordingly, it would improve risk management capabilities if such products were issued. While the potential market for such bonds may be limited by liquidity factors, it would be worthwhile from a broad policy perspective to evaluate the benefits and costs of establishing a programme of index-linked bonds or savings products. (Within the euro area, France already issues bonds that are indexed to the French inflation rate.)

7. CONCLUSIONS

This paper has argued that the cyclical performance of Irish fiscal policy can be improved by the adoption of a new fiscal framework. The new framework should have two, complementary dimensions: the adoption of fiscal rules that codify the route to fiscal sustainability; and the establishment of an independent fiscal policy council that plays a central role in the determination and enforcement of the appropriate cyclical stance for fiscal policy. In addition, other fiscal reforms have been proposed that relate to the determination of public sector pay and the design of public debt securities. Such a re-design of the fiscal process can provide a mechanism that strengthens the coherence of Ireland's membership of EMU.

The scope of this paper has been necessarily limited to providing a very broad-brush description of this new fiscal framework. A full-scale study would be required to work out the details of the optimal fiscal rules for Ireland and the optimal design of the independent fiscal policy council. In addition, the adoption of such a framework requires buy in from the political system and the policy officials in the Department of Finance.

Accordingly, this type of institutional transformation is a non-trivial task. However, it offers substantial medium-term benefits by improving Ireland's ability to deal with macroeconomic shocks. Moreover, by improving the foundations of future fiscal policy, it will further help to improve Ireland's current fiscal reputation.

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**FIRST VOTE OF THANKS PROPOSED BY JOHN FITZGERALD,
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This paper makes an important contribution to the debate in Ireland on ‘never again’. It also has wider significance because it addresses an issue which potentially affects all regional economies in EMU. It brings together a number of suggestions that he has made before and the paper combines them with some new ideas to provide a possible blueprint for policy reform in Ireland.

In my comments I first want to reflect on how Ireland and other countries, such as Spain, have got into the mess they are now in. I will then consider the question, that Lane raises, of the appropriateness of rules to prevent or discourage a repeat performance of unwise fiscal policies. Finally, I will consider the issue of the institutional innovations which are suggested in Lane’s paper to improve the policy making process.

For many, the advent of EMU meant an end to concerns about balance of payments deficits in what were now the ‘regional’ economies of individual member states.¹ The argument was that so long as these deficits did not reflect borrowing by government, the growing private sector liabilities, which would be the counterpart to such a deficit, would not represent a risk to the economy. Private sector default was treated as unimportant. We have seen how this assumption was seriously defective as the ‘private liabilities’ of the banking system have metamorphosed into public sector contingent liabilities. A second serious danger arising from inappropriate fiscal policy has been the encouragement of ‘speeding’ by economies such as Spain and Ireland where excessive growth of the non-tradable sector (in the case of Ireland and Spain the building and construction sector) has crowded out activity in the tradable sector. In failing to prevent this “speeding” inappropriate fiscal policy has facilitated a real appreciation in both Spain and Ireland, a real appreciation which was unsustainable and which will be costly to unwind. In turn, the resulting growing balance of payments deficit was a symptom of the underlying malaise and should have been taken seriously.

Many models assume rational behaviour by economic agents such that bubbles cannot occur. What we have seen is that markets did not behave ‘rationally’ in that sense and housing market bubbles grew and grew in Spain and Ireland. Under such circumstances fiscal policy was potentially rendered more powerful and more necessary as a weapon to prevent the occurrence of overheating. It was just that governments failed to adopt wise policies, not that such policies were unavailable.

The result of the demand shock arising from the boom in housing has been that the tradable sector, in both Ireland and Spain, has been ‘crowded out’ by the building and construction sector (FitzGerald and Morgenroth, 2006 and FitzGerald *et al.*, 2008 discuss the mechanisms whereby the crowding out happened in Ireland). Both countries have seen a rapid decline in market share for their exports and the result has been a rapidly rising balance of payments deficit. This was a symptom of an overheating that was not only facilitated by, but also was actually promoted by, the stance of fiscal policy. This process is very similar to that where a major expansion in the public sector crowds out the (tradable) private sector.

This process is described in Blanchard (2007) where he models the potential problems caused by this crowding out in regional economies in EMU and he concludes that government action may be required to moderate this process even in a perfect market (Blanchard, 2007). In the imperfect market of the last decade, with “irrational” behaviour leading to serious bubbles, such government action was all the more necessary.

Since the mid-1990s there has been considerable debate about how fiscal policy should be used within EMU (Butti *et al.*, 2003). A lot of attention has been given to the Stability and Growth Pact (SGP) and the need to prevent government deficits exceeding 3 per cent of GDP. As Lane says, the SGP was designed to control deficits and debt to avoid resulting cross-border spillovers within EMU. However, in practise, because of its singular focus, the SGP permitted unwise fiscal policies in Ireland and Spain, allowing a property bubbles to happen. The result of the bursting of this bubble is exactly the problem that the SGP was theoretically designed to avoid.

¹ The comments here on the past performance of fiscal policy in Spain and Ireland are based on a paper published last month (FitzGerald, 2010).

Much less attention has been given to how fiscal policy should be used to manage individual regional economies than how it should be managed to control spillovers from excessive government borrowing. In particular, the potential problems that may arise for regional economies in EMU from local asset market bubbles, primarily in property, did not receive much attention in the international literature. We know now that the costs of failing to control such phenomena are very high and can be magnified by the damage done to the regional financial system.² It may even have been the case that the existence of the SGP rule allowed policy makers to neglect the importance of tailoring domestic fiscal policy to the needs of the regional economy, needs which the SGP was never designed to deal with.

While little attention has been given internationally to the design of appropriate regional fiscal policy within the EMU as a whole, in Ireland the dangers that the economy faced were early identified. With the benefit of hindsight, the diagnosis was correct and the required medicine was prescribed.³ It was just this medicine was never taken. Lane discusses some of the reasons for this failure.

Generally, where substantial bubbles do occur they are reflected in a significant balance of payments deficit. In the case of Spain, the rising balance of payments deficit went back to the early years of EMU, whereas for Ireland it only manifested itself from 2003 onwards. In both cases, the balance of payments deficit was a symptom of the domestic crowding out of the tradable sector due to the dramatic increase in building activity beyond its sustainable level. The consequence was a rapid rise in domestic costs, pricing the tradable sector out of its world markets.

The advent of monetary union has not absolved governments from the duty to manage domestic inflationary pressures using fiscal policy. Instead of focusing on the SGP target of “not running a deficit” it may, instead, be appropriate for some countries to run substantial and increasing surpluses for a period of years to continually deflate an overexcited economy. Note that a continuing structural surplus has a neutral impact on the economy. It is only as the structural surplus rises, and as increasing sums of money are taken out of an economy, that the impact of fiscal policy is to reduce (excessive) demand. Thus what was required in Ireland to prevent overheating over a sustained period was a steadily increasing surplus.

For Ireland, Lane argues the need for a new measure of the appropriateness of fiscal policy. The objective should be to preserve medium-term fiscal sustainability. He argues that it is appropriate to target a structural surplus during “normal times” in order to provide a buffer against the occurrence of a major negative macroeconomic shock. However, I would argue that the objective for fiscal policy is broader than this limited objective. It needs to manage the economy to prevent bubbles, to prevent serious imbalances between sectors and, most important, to manage the real exchange rate. In the circumstances of the period 2001-7 this would have called for a steadily increasing structural surplus. Lane, in recognising that other objectives may be important, also argues that there must be escape clauses in all rules to deal with unseen events.

‘The current crisis has also illustrated the brittle nature of many of these rules, since the specification of the rules typically did not cater for the occurrence of major non-standard shocks.’

The measure he suggests would not really have tackled the real danger to the Irish economy from unsound fiscal policy pursued over the 2001-2007 period. A small constant structural surplus would not have been adequate to stop the growth of a building sector bubble crowding out the tradable sector of the economy. An “escape clause” would have been needed for much of this period “permitting” the government to take more stringent action.

Over the period 2001 to 2007, analysis using sophisticated economic models did point to the growing danger to the economy. As outlined in FitzGerald (2009), our own research in the ESRI pointed to the growing danger to the economy from the housing bubble. In particular, the extent to which the domestic tradable sector was being crowded out by the building sector was described in detail in many

² The potential damage done to regional economies from bursting property market bubbles is also significant for regions in the US. However, in the US the attention has focused more on using financial regulation rather than fiscal policy to manage property markets. In the UK it can be argued that excessive growth by the financial sector crowded out the rest of the tradable sector.

³ FitzGerald (2009) lists a range of publications which analysed the problems of the Irish economy over the period 2001-8 and diagnosed the appropriate fiscal medicine.

reports. The fact that unwinding the resulting loss of competitiveness would take a long and painful period of adjustment was also highlighted. Other prominent economists provided similar analysis. These warnings were not heard.

Part of the problem was that Ireland generally did comply with the SGP and this was frequently pointed out by government spokespersons. Having raised concerns in 2001, the EU and the IMF then went silent, presumably because of broad compliance with a totally inappropriate rule for Ireland (see O’Leary, 2009). Absent the SGP, the government and international agencies would have had to use more sophisticated models to assess the suitability of domestic fiscal policy. This may have been a case where the presence of a rule was no help at all to good policy making and may have provided cover for policymakers to avoid making the appropriate decisions.

Could there be another more appropriate fiscal rule for a regional economy within EMU which would supplement the SGP? In the case of the Irish and Spanish debacles a key indicator of the dangers the economies were running was the growing balance of payments deficits in the two countries.

Looking at Ireland and Spain in 2001, Blanchard (2001) suggested that the significant balance of payments deficit then apparent in Spain suggested a need to tighten fiscal policy whereas for Ireland, running a balance of payments surplus, a real appreciation of the exchange rate was still appropriate. The danger with this recommendation for Ireland was that the “safe stopping distance” for a real appreciation through wage inflation is quite long. However, even on this basis, as Ireland moved into balance of payments deficit in 2003, a similar prescription would have been appropriate. While both countries complied with the rules of the Stability and Growth Pact, running small surpluses for a number of years, this was not adequate to protect their own economies from the risk of overheating. Instead, what was required was a policy, similar to that adopted in Scandinavia, where fiscal policy ran a substantial surplus preventing serious overheating.

The result of the demand shock from the growing housing bubbles in Ireland and Spain was that the tradable sector in the two countries has been “crowded out” by the building and construction sector. This process was very similar to that where a major expansion in the public sector crowds out the (tradable) private sector. This process is described in Blanchard (2007) where he illustrates the potential problems caused by this crowding out and concludes that government action may be required to moderate this process even in a perfect market.

Of course, balance of payments deficits can occur even where there are no asset market bubbles and a growing balance of payments deficit is also not, of itself, a certain guide to the sustainability of fiscal policy. For example, if the government sector were compliant with the SGP rules (in surplus) and if the counterpart to the increasing foreign liabilities of the private sector were an increase in the productive capital in the economy, then such an eventuality would be clearly sustainable. However, it was very clear in the Spanish and the Irish cases that the addition to the private sector capital stock was disproportionately taking the form of domestic dwellings, which would not add directly to the productive capital of either economy.⁴

While an additional rule (to the SGP) along the following lines might be quite appropriate for regional economies within NAMA, it would not be that easily understood by the public and hence would be unlikely to command respect.

Even where fiscal policy is compliant with the SGP, if the country is running a balance of payments deficit above x% of GDP fiscal policy should be tightened progressively, unless it can be shown that the deficit is financing productive investment.

Also it would not be easy to establish the position on productive investment in real time.

⁴ To the extent that the new dwellings in Spain were for foreigners, and that they were apartments on the coast where they can be stacked ever higher and higher, they are closer to an export. To the extent that the Spanish balance of payments deficit was funded by a capital inflow through foreigners buying such produce the deficit may have been sustainable over a long period. However, this element of the capital inflow accounted for only a small part of the deficit at its peak. By contrast in Estonia, where the foreign investment in property took the form of purchases of medieval dwellings in Tallinn, this was not sustainable. It takes longer to build a medieval house than an apartment in Ibiza!

My conclusion is that it is very difficult to establish a simple rule that will apply to a sufficiently high percentage of cases to make it worthwhile. If it were appropriate to invoke Lane's suggested "escape clause" (ignoring the rule) reasonably often then the process would lose validity. It would certainly have been appropriate to have invoked the "escape clause" over the period 2003-7.

If appropriate simple rules are not obviously available, then one is thrown back on the importance of undertaking suitable analysis of the fiscal policy on a country by country basis. As indicated earlier, in the case of Ireland this country specific analysis carried out by my colleagues and other respected Irish economists came up with the right answer. However, that was not reflected in policy action. This raises the second very important point that Lane makes in his paper – are there institutional changes that could be made that would increase the probability of national virtue?

Lane proposes an Irish Fiscal Policy Council. This approach was tried before. In 1981 the coalition government appointed three economists to constitute the "Committee on Costs and Competitiveness": the late Terry Baker, Brendan Walsh and Dermot McAleese. Terry and his colleagues were immediately dubbed the "Three Wise Men" by the *Irish Times* – reflecting the fact that they were the most respected independent experts on the Irish economy. However, Terry referred to himself and his colleagues as the "three foolish virgins". This latter appellation may have reflected the relative lack of success that the Committee had in getting its prescriptions accepted.

However, just because it failed in what were very contentious times in the early 1980s, does not mean that it would have to fail again. If such a Council were established on an all party basis it would have a greater chance of being listened to than if it was established by an individual government. Other important examples of bodies that command all party respect and, as a result, a higher chance of being listened to are the Netherlands Central Planning Bureau and the National Institute for Economic Research in Sweden.

In his paper Lane suggests that the Council undertake its own research. There would be a possibility that such a Council would thus come to duplicate the ESRI, albeit probably on a smaller scale. It might be better if the Council established its own research agenda and if that research agenda were then implemented as appropriate by researchers in the ESRI or the universities.

Finally, over the last eighteen months it has become increasingly clear that there is no simple model to measure appropriately the stance of fiscal policy in a regional economy within EMU and to diagnose the required fiscal medicine. The EU methodology for estimating the cyclical and structural deficits can not cope with the shock to potential output experienced in many EU members that has resulted from the current crisis (see Bergin *et al.*, 2009). As argued in Barrett *et al.* (2009) and Kearney (2000), a structural economic model is needed to analyse the stance of fiscal policy. For the Eurozone as a whole the development of a more sophisticated approach to monitoring the stance and appropriateness of fiscal policy is a task that needs to be addressed urgently.

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DISCUSSION

Patrick Honohan: Thanks to both the author and the discussants for bringing life back into a topic which had become for me somewhat jaded. Among the several points that occur to me let me confine myself to three. First, I would mention the importance in Irish experience of another feature of the fiscal landscape, namely the increasing reliance since the 1990s on what can be called fair-weather taxes (corporation taxes, capital gains taxes and stamp duty). This reliance heightened the sensitivity of total tax revenue and the budget deficit to deterioration in economic conditions. Indeed, I notice from the material presented that the cumulative favourable tax revenue "surprise" (outcome less expected) in the period 2003-2007 was greater than the well-known negative surprise of 2008. This type of element, influencing fiscal volatility would also need to be considered by a Fiscal Council, and might be more important than other aspects.

Indeed, while I agree with John FitzGerald that the balance of payments cannot be neglected as an indicator (as it was during the early years of the euro) in practice Ireland's current account deficit was not really very high in those years (partly because some of the foreign borrowing was being reinvested abroad in property developments). And of course the fiscal accounts were in surplus.

Turning to what existing agency might be performing many of the functions envisaged for an Irish Fiscal Council, I wondered whether the ESRI might not be considered to be playing this role. Or is it the Central Bank, often a critic of past fiscal excesses? It cannot really be the Department of Finance, which, as a Civil Service Department, cannot readily be a critic of Government policy. Perhaps (bearing in mind the example given of the Swedish Council which includes non-nationals) now that we are in the euro area, the function can be, and to some extent is being, performed by the Euro-group.

Joe Durkan: This is a very useful paper, full of ideas that makes one think. Maybe out of this we might get a better approach to fiscal policy. I have several points to make.

First, I thought we had a working rule in relation to fiscal policy viz. that we let the automatic stabilisers work and run through the middle of booms and recessions. With this rule discretionary policy is to be avoided. Only in the last two years, with the huge falls in output in many economies, would the restrictions on discretionary policy be relaxed - but here we are not trying to fine-tune economies but pull them out of recession. However, even before the crisis, there were serious problems in relation to the application of this rule, as, since 2004, with the opening up of the labour market to the new accession states it is not obvious what potential output is. The Department of Finance and the Commission now use a production function approach, as opposed to the time-series approach used previously. I had always favoured the former, but this approach now suffers from the fact that the labour force is now endogenous. Hence, we can no longer be clear what potential output is. The recently released data on the capital stock, with over half the capital stock accounted for by housing is also a worry in relation to the production function approach. This is an area where a great deal of additional work is needed.

I have some concerns about the proposed Council. I have no doubt it would do valuable work. My concern would be that politicians would politely say "Thank You" and then do what they want anyway. During the early part of the last decade the Opposition parties in the Dáil were calling for more expenditure and tax cuts when the surplus was bigger than expected. The media also attacked government for failing to spend, and this played no small part in the behaviour in later years. Indeed, those who called for bigger surpluses were ridiculed by politicians, the media and even some economists. The "need" to spend and reduce the surplus led to a much laxer approach to pay increases and the development of new Quangos. The consequences are difficult, but as we have seen recently, not impossible to reverse.

Third, the paper makes the point that there is possibly some systemic procyclicality in our system. This is so for the reasons mentioned above, but there is another dimension to this, in that it is not symmetric. Expansionary policies are pursued with vigour when the public finances are buoyant, but the contractionary phase is resisted and designed to correct the excesses. The one exception to this was the approach adopted by Mr. McCreevy when Minister for Finance, when the objective seemed to be to prevent the automatic stabilisers from working in both directions. Given this and the points made earlier, should we instead be trying to reduce the cyclicality of the budget. This would force households to provide more directly for the effects of adverse shocks. Even with the welfare system

the degree to which households are protected once unemployment occurs is very limited and when there is also a fiscal correction the situation is much worse. The present recession has shown how limited are the resources of households once unemployment occurs and correcting this is one lesson from the recession. Too much of people's wealth is taken up by property and pension funds, neither of which are very liquid. The paper calls for a "rainy day" fund created by Government, but I would much rather see personal rainy day funds. The impact of large accumulated surpluses by the state on private behaviour must also be considered, as they may reduce the incentive for more prudent private behaviour. Ideally, we need both private and public accumulated surpluses to deal with shocks.

Finally, I would like to make a comment about the two tier payment system proposed in the paper. This idea was floating around in the 1980s as a means of providing wage flexibility, based on the Japanese employment for life and bonus systems model. It seems to offer almost perfect wage flexibility, with earnings falling as profits decline, so that firms can maintain employment in the face of a recession. The idea was also seen as having merit in the late 1990s as a mechanism for dealing with asymmetric shocks in the monetary union, but fell foul of the observation that flexible wages slowed down the inevitable restructuring that Japan needed from the mid-1990s and is still undergoing. Nevertheless it could provide much needed flexibility that would have been invaluable over the past two years.

John Bohan: *Calculation of the structural deficit* It seems to me that one of the assumptions underlying the very interesting paper is that fiscal policy making can be improved over the cycle if the structural deficit can be determined in a way which is *both* best practice in a scientific sense (based on an analysis which is likely to be country specific in terms of the parameters determining potential output) *and* also politically agreed (that is accepted by the international economic community and specifically by the Commission as guardian of the SGP). This, it seems to me, creates the possibility of a permanent tension in interpreting the macro-fiscal stance which has to be resolved in any more rigorous rules based system. In the interest of fairness for instance, it may be necessary for similar long term TFP estimates to be used or common budgetary elasticities, but the lack of economic convergence may mean that this does not reflect the real situation in a country. It might be useful to minimize this potential for tension if the macroeconomic aspects of the calculation of potential output are separated from the determination of the budgetary elasticities. The structural growth modeling of the Irish economy was part of a Europe wide effort where a common approach based on factor input and TFP as far as I recall. However, given (a) the size of investment in the Irish economy in recent years and (b) the growth in the LF without taking into account the fact that we had a highly mobile inflow, this mechanism was probably fine for Germany but if it did not overstate potential growth then it ignored the potential variance of growth. Secondly, budget elasticities (that is an estimation of the impact of the growth on both taxes and spending) was also conducted centrally by the OECD which were in my recollection country specific as determined by the nature of automatic stabilizers in the economy. My point is that for better modeling of the structural deficit there needs to be more decentralized determination of potential output but in a way which ensures that it is not manipulated by member states but not overly driven by the need for consistency between member states.

Response of Commission to fiscal stance around 2000 and later in 2004-8

In Robert Watt's response, he seemed to be inferring that the Commission did not make any particular negative inference to Ireland's fiscal stance in the latter period (as opposed to the criticisms in the earlier period). This seems to me to be an oversimplification. The Commission's stance was presumably based on the fact that potential output was considerably higher than it actually was which was based on Europe wide estimates linked with very strong labour force growth and investment in Ireland. This together with historically driven budget elasticities (which did not catch the distortion of property related taxes) seemed to produce relatively small structural surpluses. However, the Commission in its technical assessments did draw attention to the likely problems with these structural estimates (to which it was bound by the need to have consistent approaches across countries) and clearly advised the government to put windfalls into debt reduction rather than additional spending (see eurogroup recommendations for various years). The assessment in 2008 produced an analysis showing that this was not the case even if this was hotly disputed by the Department of Finance. Earlier analysis by the Commission emphasized the susceptibility of the public finances to a property sector crash (the 2006 or 2007 assessment as far as I recall).

Paul Sweeney: I found the paper stimulating and it has some very some interesting ideas which are worth exploring in more depth.

I would say that more work might be done on two specific areas when one is attempting to calculate the cyclicity of fiscal policy. I would suggest that both are complex areas. One of them would be especially difficult to estimate the cost and its impact on fiscal policy outcomes, until retrospectively, some years later. Nonetheless, both should be factored into the calculations/estimates.

The first area to be aware of is the structure of the taxation system and the impact of “tax shifting” by governments. We saw this in Ireland from the late 1990s when there was considerable change in the structure in of taxation in Ireland. Direct taxes were reduced substantially on incomes and on profits and the government became increasingly reliant on revenue from indirect taxes. These indirect taxes were not increased but, with the domestically generated boom, the reliance on taxes from property and related areas grew substantially. Ultimately as we now know, this was not sustainable.

Had the government maintained direct taxes at somewhat higher levels from around 1999/2000, policy would have been less pro-cyclical. Thus the boom/bust would not have been as great. I do not think that it was myopia that guided this policy, but it was the political philosophy of the then Minister for Finance, Mr McCreevy and of the government.

The second area which should be considered is the more difficult one of the impact of “tax expenditures,” also called “tax incentives” or “tax breaks” on fiscal policy. It is more difficult to estimate because the cost and the impact of these are not known. Tax expenditures become (a) diffused, (b) are costly and (c) have unintended consequences. The Department of Finance does try to estimate them, but it cannot foretell the take-up, in many instances. Thus the estimates are often incorrect.

For example, Section 84 leasing was an anti-avoidance measure – a curb on directors’ loans, in the 1980s which became widespread and costly. As a result of this unintended tax break, none of the Irish banks paid any corporation tax, when the nominal rate was 50% for these companies. Public anger led to the introduction of the Bank Levy, but this tax expenditure/tax break was retained for many years. Certain state agencies, eg the IDA, supported S84 as a way of subsidising investment in capital equipment. As a respondent to a paper to the Society in 1992,⁵ I estimated its cost at around £800m in current prices in tax foregone, in the decade to 1990/91.

It should be said that there were some voices in opposition to the tax expenditures over the past fifteen years, including the Congress of Trade Unions and the National Competitiveness Council. The latter advisory body was in favour of a property tax and was critical of the many property tax expenditures/incentives.

In December 2006, Congress decided to object to a considerable extension the Business Expansion Scheme to draw attention to the cost of tax expenditures and in an effort to get all of them subject to a prior cost/benefit analysis by making a formal complaint to the European Commission under competition rules. Congress was not just unsuccessful, but it was excoriated in the media for doing so. Further, not one economist support us – even those who would be strongly against state intervention.

The estimation of the costs and impacts of tax expenditures is important to factor in because, when combined with regular fiscal policy instruments, they can distort the outcome of fiscal policy substantially.

The idea of a Fiscal Policy Council has merit, but the legal framework is vital. So too is its composition. Some are critical of the narrowness of the rules of the European Central Bank with its focus on curbing inflation. Such a Council would needed to be guided politically on the broad economic parameters around the size of the state. For if a government aspires to European levels of public provision, it must ensue that such a Fiscal Policy Council does not contravene its policies, over the medium term.

⁵ Sweeney, Paul. 'Symposium on the findings of the Industrial Policy Review Group'. *Journal of the Statistical and Social Inquiry Society of Ireland*, Vol. XXVI No. 4, 1991/1992, pp191-211. The estimates for most tax expenditures were calculated in the paper for the 1980s. These were the gross estimated costs.

Jim Stewart: I was surprised that the paper “A New Fiscal Framework for Ireland” focussed exclusively on GDP in terms of growth and fiscal balance (Figures 1 and 2). One feature of the current crisis is the growing divergence between GDP and GNP -which excludes repatriations by the multinational corporate sector.

It is likely that a focus on GDP rather than GNP has exaggerated growth rates in the Celtic Tiger years, and underestimated the extent of the recession.

The issue of the size of the MNC sector also draws attention to tax payments by MNC's. To some extent these tax payments are discretionary as they result from profit switching transfer pricing (one example the 'surprise' €300 million single corporate tax payment in 2009 see “‘Worst may be behind us’ as tax and jobless worries ease”, *Irish Independent* September 3 2009).

In addition tax payments by non-residents are also to some extent discretionary. Unfortunately, non-residents have decided by and large not to pay tax in Ireland, a situation the recent Finance Bill does little to address.

Discretionary and negotiable tax payments, in addition to factors mentioned by other speakers, mean that fiscal management can never become a 'technocratic exercise' contrary to what is argued in the paper.