Forthcoming, Irish Banking Review, Winter 1998.

Irish Fiscal Policy under EMU

Philip R. Lane
Trinity College Dublin
October 1998

Abstract

EMU means the loss of monetary independence, raising the importance of fiscal policy in macroeconomic management. In this paper, the conduct of optimal fiscal policy under EMU is considered. Tax/spending policies, public debt management, the creation of a fiscal "reserve fund" and the politics of fiscal policy are discussed in turn. It is recommended that fiscal policy should be more strongly countercyclical, the public debt portfolio be redesigned to hedge macroeconomic risk and a fiscal reserve fund be considered. In addition, the budgetary process should be redesigned to better enable the finance minister to implement the optimal fiscal policy.

Introduction

The imminent arrival of EMU makes it an appropriate time to reappraise the role of fiscal policy in macroeconomic management. Under EMU, Ireland no longer has the option to independently set interest rates or devalue its exchange rate, leaving fiscal policy as the sole instrument of macroeconomic intervention at its disposal.

Moreover, implementing an optimal fiscal policy is especially vital for Ireland, since our economy has diverged from other EMU member countries. This means that the monetary policy that is appropriate for "euroland" as a whole may actually exacerbate cyclical fluctuations in the Irish economy.[1] The current situation provides a good illustration: at a time of possible overheating, EMU membership requires Irish interest rates to sharply decline. When monetary policy is potentially destabilising, it is all the more important to ensure that fiscal policy is optimally deployed.

Accordingly, in this paper, some principles of optimal fiscal policy under EMU are discussed. The design of tax/spending policies, public debt management and the potential role of a fiscal "reserve fund" are analysed in turn. The political factors that influence the implementation of fiscal policy and institutional reforms that may lead to an improved operation of fiscal policy are also discussed.

Finally, it is important to appreciate that EMU is not the only stress factor placing strain on the traditional fiscal policy process. In parallel with the EMU process, the making of fiscal policy under conditions of sustained prosperity is a novel problem for the Irish economy. In particular, incipient sectoral labour shortages requires us to think more carefully about the impact of taxation and public spending on resource allocation. Yet another consideration is the interaction between fiscal policy and the social partnership arrangements. Since 1987, a cooperative approach between the government, trade unions and employer federations has

[1] See also Lane (1997) and Obstfeld (1998).

been at the heart of Irish economic policy formation. Now that the economy is facing labour shortages and profits are growing rapidly, it is unclear that this consensual system can be sustained for too much longer.[2] In itself, the potential collapse of the social partnership system compels us to reconsider the operation of fiscal policy in Ireland.

Taxation and Public Spending

The guiding principle in making taxation and spending decisions is that a long-term perspective should be adopted. Unless tax reductions or spending increases are sustainable in the long-run, concessions today may have to be clawed back in the future. Moreover, the ratchet effect means that it is politically difficult to put fiscal policy into reverse, so that current fiscal expansion may lead to future debt accumulation problems. Knowing this, a prudent government will be slow to reduce tax rates or raise spending in order not to tempt fate. Moreover, it exacerbates fluctuations to cut tax rates during a boom only to be compelled to raise them again during a slump: expansions are prolonged but at the price of deeper recessions. It should be noted that cyclical fluctuations in tax rates are particularly destabilising in a highly open economy, since international capital and labour mobility increase the sensitivity of the economy to alterations in tax rates.

Following similar reasoning, a procyclical pattern in public spending only serves to inefficiently amplify the business cycle. Of course, a central difficulty in deciding the appropriate volume of public spending is in correctly distinguishing between trend shifts and cyclical fluctuations in output. Although some information can be gleaned from data on factor utilisation rates, much uncertainty remains in apportioning output movements between trend and cyclical components. In view of this uncertainty and the difficulty in reversing spending increases, it is appropriate to adopt a conservative approach, updating only gradually estimates of potential GDP in the wake of a succession of positive output realisations. This consideration provides further motivation to adopt fiscal restraint during apparent boom periods.

The IMF has recently recognised that avoiding procyclicality in fiscal policy is especially important for Ireland among the EMU members (IMF, 1998). Three reasons are cited: the asynchronisation of the domestic and European business cycles, a greater vulnerability to external shocks and the expected reduction in EU structural funds over the next decade. On this basis, the IMF recommends a structural (cyclically-adjusted) budget surplus of 1-2 % of GDP, implying a much larger surplus during upswings. Relative to this target, the current fiscal stance remains inappropriately procyclical.

Having set tax rates and public spending at their appropriate long-run levels, it is typically unwise to attempt further to employ activist fiscal policies to finetune the economy. Aside from the difficulty in correctly timing such interventions and the cumbersome nature of many public spending programmes, such fiscal innovations have only a limited impact on the level of production in a highly open economy such as Ireland. However, in the event of an especially severe recession, some discretionary fiscal stimulus

[2] See also Lane (1998a).

may be useful.[3] Again, to make such an intervention feasible, it is desirable to retain flexibility in fiscal policy by guarding against excessive structural deficits.

In recent years, wage moderation has been achieved by unions accepting low pre-tax wage increases in exchange for significant reductions in the income tax burden. On this basis, some recommend a policy of continuing tax reductions, even in the face of overheating pressures in the economy, in order to ensure the survival of the social partnership framework. However, it is clear that a strategy of continually reducing income taxes has limited long-term viability: eventually, income tax rates would be driven to zero. Given the absurdity of this scenario, the basic pay strategy underpinning the social partnership framework must soon be fundamentally reassessed. Of course, income tax reductions are more feasible, if public spending is tightly controlled or other revenue sources, such as a comprehensive property tax, are developed. It must be recognised that, at a time when infrastructural spending needs are rising and EU transfers are in decline, the scope for expenditure reductions is strictly limited.

This is not to argue in favour of the status quo with respect to the taxation system. Reforms that enhance efficiency or equity are clearly to be welcomed. However, a basic principle is that such reforms should be budget-neutral in the long-run. It is imprudent to believe that tax cuts are self-financing --- although tax revenues may continue to rise under boom conditions, what matters is the impact on revenues when the economy eventually returns to "normal" conditions. It follows that those arguing in favour of income tax cuts, say, should recognise that other tax rates must ultimately be increased or some categories of public spending must permanently decline as a fraction of GDP.

The current boom conditions constitute an excellent environment for implementing reform. Good times provide an opportunity to take otherwise painful measures. In addition to adjustments to the tax code, including revisiting the question of a comprehensive property tax, reforms such as refinancing the noncontributory state pension scheme as a fully-funded system should be on the current agenda.

Public Debt Management

EMU poses fresh challenges for management of the public debt. In recent years, this task has been delegated to an independent agency, the National Treasury Management Authority (NTMA). Their mandate has been to minimize financing costs relative to a benchmark portfolio. However, this is an incomplete strategy from a macroeconomic perspective. Rather, optimal debt management should attempt to hedge macroeconomic risk, even at the price of higher average debt servicing costs. Hedging is all the more important under EMU, since the loss of monetary autonomy means that macroeconomic risk is enhanced.

Along these lines, the government financial portfolio should include assets that offer returns that are negatively correlated with the domestic cycle and, conversely, liabilities with procyclical returns. A portfolio designed in this fashion would serve to insulate the government budget and domestic

[3] Indeed, a fiscal stimulus will be more effective under EMU than under a more flexible exchange rate regime, since no offsetting exchange rate movements will be induced inside a currency union.

incomes from volatility in domestic production. A good illustration is provided by Sterling-denominated debt. If Sterling depreciates, this has an adverse impact on Irish producers and, by extension, tax revenues. However, the government gains, via the composition of its debt portfolio, since the euro-value of Sterling liabilities declines and debt servicing costs are reduced. In this way, the adverse impact of a Sterling decline is at least partially offset.

Following similar reasoning, the NTMA should also ensure that the public debt portfolio is not too exposed to ECB interest rate policy. The flipside of the current asymmetry between Ireland and the rest of euroland is that a future slowdown in Irish economic performance may occur at a time when other EMU member countries are growing more quickly. This may induce the ECB to raise interest rates, thereby increasing debt servicing costs at a time when other components of the domestic government budget are declining due to the growth slowdown.[4] The NTMA can mitigate this problem by taking steps to hedge the vulnerability of the public debt portfolio to ECB interest rate fluctuations.

Of course, firms and individuals should also be encouraged to take steps to insulate their income streams from domestic production risk. This may involve the accumulation of a buffer stock of savings that could be drawn upon in bad times. In addition, the composition of private savings should again be biased towards assets that provide a hedge against local economic risk. In this regard, the tax treatment of savings should be altered so that investment in the risky local property market is not favoured over foreign assets that have more attractive return properties from a diversification perspective. An increase in the national savings rate would also be facilitated by a government switch to a fully-funded basis for the non-contributory pension scheme.

Finally, the integration and consolidation of euro capital markets has further implications for debt management. In particular, liquidity concerns mean that larger bond offerings will be more attractive to investors. This raises the possibility that funding costs could be reduced were the NTMA to periodically "overfund" the government debt by issuing bonds in large tranches and investing the surplus in marketable assets.

A Fiscal "Reserve Fund"

Banking and financial crises have plagued numerous countries in recent years, including the 1980s S&L crisis in the US, Scandinavia in the early 1990s, Mexico in 1995 and Japan and South-East Asia at the present time. Such crises can have significant adverse output costs, as collateral values fall and investment plans must be curtailed. Property-backed lending is a frequent source of problems, since shocks to the domestic economy have a magnified impact on local property values.

A characteristic of modern financial systems is that "unnecessary" crises can occur. For whatever reason, creditors may become pessimistic about prospects for the economy and seek to withdraw funds from local banks. Since banks maintain reserves that are only a small fraction of liabilities, not all creditors can be simultaneously repaid. Banks must call in loans, inducing debtors to inefficiently liquidate long-term projects and pushing many into default.

[4] See also the discussion in Woodford (1998).

A central bank that is not bound by a fixed exchange rate commitment can forestall such unnecessary crises by acting as a "lender of last resort" to the banking system, providing the funds that allow banks to meet the demands of its creditors without having to call in illiquid loans. Indeed, the very existence of an institution that has the capacity to act as a lender of last resort may be sufficient to forestall panic-induced attacks, since creditors need not fear being squeezed out in a scramble for the limited reserves of the banking system.

Under EMU, national central banks will not have the monetary autonomy to act as local lenders of last resort.[5] Moreover, the ECB is unlikely to intervene in the case of a purely regional financial crisis that does not pose a systemic risk to the overall euroland financial system. One solution to a regional crisis would a fire-sale of local financial institutions to deep-pocketed international banks. If the government rather wished to maintain locally-owned banks, an alternative may be to establish a fiscal "reserve fund" that could fulfill, at least partially, a lender of last resort function. Such a fund would have to be kept distinct from the general government budget, since its resources would have to be available for immediate disbursal in the event of a crisis. Moreover, to make such a rapid response feasible, the fund should hold mostly highly liquid assets. Of course, to minimize moral hazard problems, resources should be released only when there is a serious systemic risk to the local financial system and with significant penalties imposed on recipient institutions.

In addition to the provision of liquidity, a fiscal reserve fund may also be helpful in financing a reorganisation, were the banking sector to fall into chronic difficulties. As has occurred in such circumstances elsewhere, it may be efficient for the government to restart normal lending activity by buying out the nonperforming loans of the banking sector.[6] The international experience is that such bailouts may entail upfront costs in excess of 10% of GDP and, in the absence of a reserve fund, this could severely damage the government's fiscal position and have especially adverse implications in the context of the limits imposed by the Stability and Growth pact.

Upon reflection, the idea of a fiscal reserve fund is quite analogous to the central bank's holding of external reserves. Even when Ireland had very large gross external debt, serviced at high interest rates, substantial foreign currency assets were held to guard against currency crises. Similarly, a fiscal reserve fund can act as a bulwark against local financial crises. Indeed, that part of the central bank's reserves that will not be handed over to the ECB may be an appropriate source of initial capital for such a fiscal reserve fund.

The Politics of Fiscal Policy

The making of fiscal policy is inherently a political process. This stands in contrast to monetary policy, which has been depoliticised in many countries in recent years. The political dimension poses obvious challenges

---

[5] See also Prati and Schinasi (1997).

[6] These delinquent loans could then be administered by a so-called "bad" bank in the hope of eventual, partial repayment. In the rescue of the AIB-owned Insurance Corporation of Ireland, such an entity was established and is still in operation today (Icarom). See Honohan and Kelly (1997) for more details on the ICI case.

to the optimal conduct of fiscal policy from a macroeconomic perspective. In particular, there is pressure from interest groups to run an inefficiently procyclical fiscal policy. Tax revenues naturally rise during upswings and an economist-run government would bank the surplus in order to cushion the blow of future slumps. Individual interest groups rather try to convert revenue windfalls into increased spending on their preferred sectors, be it public sector pay or subsidies for various private sector activities, since overall macroeconomic management is not their responsibility. The result is that public spending rises excessively during boom periods. This pattern is clearly evident in the Irish case and government expenditure has grown rapidly during the current boom.[7] Moreover, it should be recognised that a collapse of the social partnership system can only serve to exacerbate this problem, since pressure groups will be yet more tempted to discount the common good in favour of aggressively pursuing their individual spending agendas.

One option in moderating pressures on fiscal policy would be to introduce a budgetary procedure by which the overall fiscal stance is determined prior to any bargaining over taxation/spending innovations. In this way, since the overall position could not be altered, a concession in one area would have to be financed by savings elsewhere in the budget. This process would have to be formalised in order to ensure that the government could not be swayed to relax the overall fiscal position as a means of satisfying all interest groups. The effect would be to strengthen the hand of the finance minister in dealing with the various fiscal pressure groups. Again, the current good times provide an ideal opportunity to implement such institutional reforms.

Conclusions

Fiscal policy will be the sole instrument of national macroeconomic policy under EMU. This article has discussed some basic issues concerning the optimal design of fiscal policy. In particular, it is recommended that fiscal policy be more strongly countercyclical, the public debt portfolio be redesigned to hedge macroeconomic risk and the establishment of a fiscal reserve fund should be considered. The political pressures to deviate from optimal fiscal policy were also discussed and the question of reform of the fiscal process was raised, in order to better enable the finance minister to implement the optimal fiscal policy. Having outlined these issues, there remains a pressing need for an educated, general debate about the appropriate design and conduct of fiscal policy in the years ahead.

References

Honohan, Patrick and Jane Kelly (1997), "The Insurance Corporation Collapse: Resolving Ireland's Worst Financial Crash," Administration.

International Monetary Fund, World Economic Outlook, October 1998.

Lane, Philip R. (1997), "EMU: Macroeconomic Risks," Irish Banking Review, Spring, 25-33.

Lane, Philip R. (1998a), "Profits and Wages in Ireland, 1987-96," Journal of the Statistical and Social Inquiry Society of Ireland, forthcoming.

[7] See Lane (1998b).

Lane, Philip R. (1998b), "On the Cyclicality of Irish Fiscal Policy," Economic and Social Review, 1-16.

Obstfeld, Maurice (1998), "EMU: Ready or Not?, Princeton Essays in International Finance, No. 209, July.

Prati, Alessandro and Gary Schinasi (1997), "EMU and International Capital Markets: Structural Implications and Risks," in (P. Masson, T. Krueger and B. Turtelboom, eds.) EMU and the International Monetary System, Washington, DC: International Monetary Fund.

Woodford, Michael (1998), "A Fiscal Theory of the Price Level," mimeo, Princeton University.