

A New Fiscal Framework for Ireland

SSSI

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- Current crisis: pro-cyclical fiscal correction
- Larger surpluses during boom: superior outcome
- Context: Fiscal policy under EMU
- Can a new fiscal framework deliver greater stability?

Relevance of Institutional Innovation

- Long-term fiscal sustainability
- Short-term pay off due to enhanced credibility
- Timing: crises foster structural change
- Complementary to SGP

- Fiscal Rules
 - Restrict choices of fiscal aggregates
 - Procedural rules
- Fiscal Institutions
 - Independent Fiscal Policy Council
 - Other agencies

- Theoretical Debate on Fiscal Cyclicalilty
- Review of Irish Fiscal Policy since 1999
- International evidence on fiscal rules and fiscal institutions
- A New Fiscal Framework for Ireland
- Ancillary reforms
- Conclusions

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- Ideal of counter-cyclicity
 - Auto-stabilisers
 - Discretionary component [large, persistent shocks]
- Cycles versus Trends in Output
 - Uncertain decomposition: smallness, openness
 - Risk management: distribution of fiscal risks
 - Asset markets; sectoral imbalances
- Systemic procyclicality?

- Pro-cyclical access to credit
- Political economy distortions
 - Myopia
 - Common pool problem ('voracity effect')
 - Imperfect information / agency problem
- Solution: "agencies of restraint"
 - Fiscal rules
 - Delegation to independent institution(s)

- Structural change
 - Record growth rates in late 1990s
 - EMU membership
 - Shifts in world economy
 - 2004: labour market and immigration from CEE
- Risk factors
 - Uncertainty → enhanced case for fiscal prudence
 - Housing/Credit booms → skewed distribution of risk

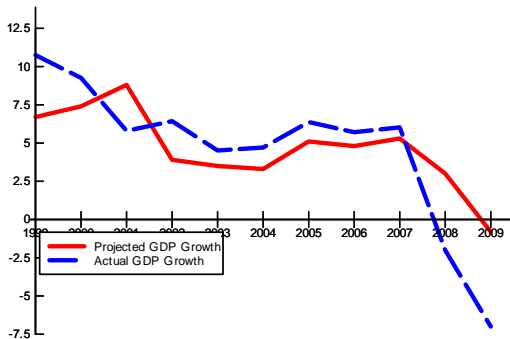
- ESRI method: pro-cyclical fiscal expansions in 1999-2002 and 2003-2008
- Ex-post review
- Ex-ante plans
- Implementation surprises
- European Commission opinions
- Comparative: Ireland versus Finland

- 2001-2007: GDP growth 5.6%; positive output gap 2.1%; GGB surplus 1%; CAB~0%
 - Housing/credit boom [revenue windfalls]
 - Skewed downside risk
- Public investment
- Predictable increases in future ageing-related spending

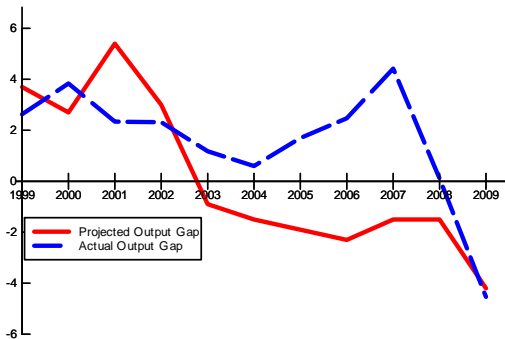
Ex-Ante Plans versus Outcomes

- 2003-2007: output gap projected at -1.6% ; ex-post $+2.1\%$
 - overstated structural balance by 1.5%
- Positive growth surprises each year 1999-2007 (except 2001)
- Negative fiscal surprises in 2002, 2007; weakly positive in 1999
- Positive fiscal surprises in other years: but ex-ante targets too low

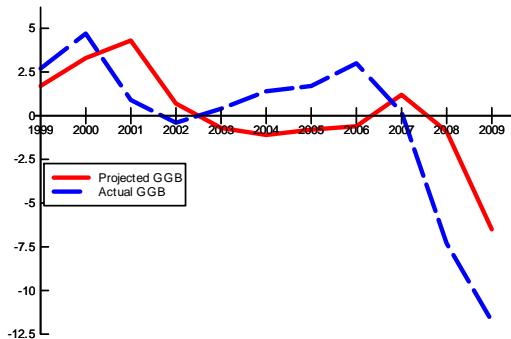
GDP Growth: Projected versus Actual



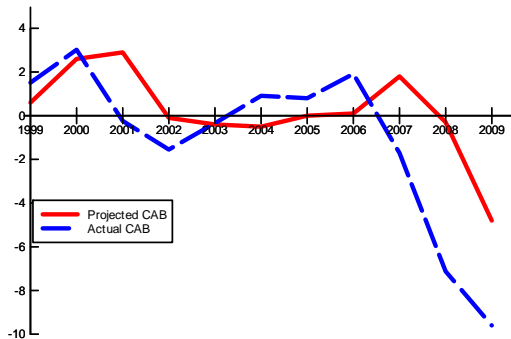
Output Gap: Projected versus Actual



GGB: Projected versus Actual



CAB: Projected versus Actual



Growth Surprises and GGB Surprises 1999 to 2009

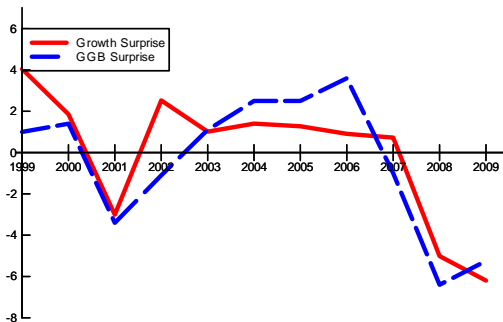


Figure: Growth Surprises and GGB Surprises, 1999 to 2009.

IREFIN

Fiscal Balances in Ireland and Finland

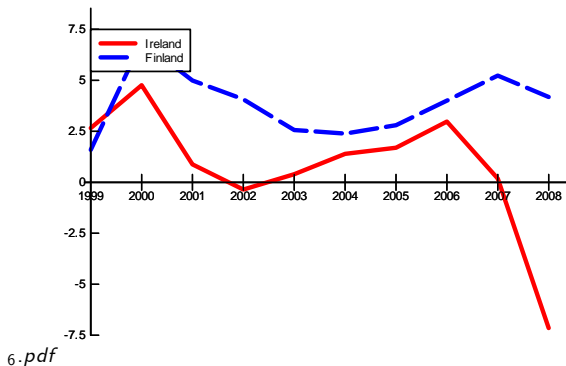


Figure: Fiscal Balances in Ireland and Finland

- ECFIN Fiscal Database
- Many types of rules [fiscal balance; expenditure growth;...] with different levels of legal standing and enforcement
- Ireland: NPRF; multi-annual capital envelopes
- ECFIN Fiscal Rules Index
 - statutory basis
 - clarity of the target
 - independent monitoring?
 - independent enforcement?
 - clarity and severity of sanctions
 - media profile

- ECFIN (2009): structural balance positively related to FRI
- Fabrizio and Mody (2006): stronger budget institutions deliver more positive primary balance
- Beetsma et al (2009): stronger rules associated with higher planned balances and better implementation
- Debrun and Kumar (2009): rules work better in more volatile economies and if fiscal authority centralised
- ECFIN (2009): many rules weak; few rules regarding revenue windfalls
- Brittle nature of many rules: escape clauses required

The Chilean Success Story

- New fiscal framework in 2001 (codified in Fiscal Responsibility Law in 2006)
- Target: structural fiscal surplus
- Cyclical stance determined by an expert committee
- 2004-2008: cumulative surplus of 28.5% of GDP
- 2009: 14.5% real growth in public spending, despite 28.5% fall in fiscal revenue (fiscal deficit 4%)

- Complementary to effective fiscal rules
- Delegation to independent agency insulates fiscal stance from political pressures
- Wide variety of independent fiscal institutions
 - “Soft” variety prevalent

Fiscal Policy Councils - unlovable or just unloved?

- (Wyplosz 2008)
- Resistance from lobby groups
- New concept
- Popularity set to grow

- Established in Summer 2007
- Eight members; small secretariat
- Broad mandate
 - Long-run sustainability
 - Budget surplus target
 - Ceiling on central government spending
 - Fiscal policy cyclically appropriate
 - Review of economic forecasts and models
 - Stimulate public debate on fiscal policy
- Issues annual report
 - used by parliament to evaluate policy
- Complementary to other economic institutions
- Conducts research on fiscal policy issues

- Set of fiscal rules
- Independent fiscal policy council

- Primary rule: Target positive structural fiscal balance
 - Future ageing needs
 - Post-crisis pay down high public debt
 - Skewed fiscal risks: need structural surplus to enable active counter-cyclical response during large downturns (escape clause)
- Ancillary rule: Rainy-day fund
 - Clear cyclical role
 - Source of liquidity in event of international credit market problems
 - Home for revenue windfalls
 - Analogy to FX reserves
- Procedural rules?

- Swedish model a good guide
- Assess cyclical position and fiscal risk distribution
- Recommend appropriate cyclical policies
- Monitor compliance with fiscal rules
- Annual evaluation of fiscal policy
- Evaluate debt management strategy
- Monitor transparency of fiscal data
- Research on Irish fiscal policy

- Consistent with any structural level of public spending
 - Long-term spending matched by long-term revenues
 - Transition plans
- Modest scale
- Accountability
 - Review by Oireachtas committees
 - Periodic external technical reviews

- Institutional reforms insufficient for coherence with EMU
- Public Sector Pay
- Index-Linked Government Debt

- Shift to two-part pay
 - Part A: guaranteed never to fall in nominal terms
 - Part B: paid in normal times, partially/fully suspended if macro situation negative
- Trade off: stability against flexibility
- Larger part A: lower average pay levels required
- Private sector pay contracts?

- Inflation uncertainty under EMU (shifts in RER)
- Bonds linked to local price level would improve risk management options for savers and borrowers
- Liquidity issues?
- (Precedent: France)

- New Fiscal Framework: improve macroeconomic stability
 - Fiscal rules
 - Independent fiscal policy council
- This paper: broad outline of the issues
- Next steps:
 - detailed proposals
 - “buy in” from political system and department of finance
- Pay off: long term; short term