Tithe an Oireachtais

An Comhchoiste um Airgeadas & an tSeirbhis Phoibli

An Ceathrú Tuarascáil

Tuarascáil ar Bheartas Micreacnamaíoch agus Rialachas Éifeachtach Fioscach agus Eacnamaíoch

Samhain 2010

Houses of the Oireachtas

Joint Committee on Finance and the Public Service

Fourth Report

Report on Macroeconomic Policy and Effective Fiscal and Economic Governance

November 2010

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Chairman's Preface

I welcome this report of the Joint Committee. Since the breaking of the economic and banking crisis certain structural issues regarding membership of the Euro have come to light. The most important matter is that Ireland no longer has sovereign access to two key monetary policy instruments; exchange rate instruments [the ability to devalue the sovereign currency] and fix interest rates

In the past a Government was able to affect an across the board pay cut by devaluing the sovereign currency; the amount of money a worker took home in their pay-packet stayed the same after devaluation but what did change was the amount of goods and services that could be purchased. In the current economic climate the monetary policy instrument of currency devaluation is no longer an option.

In considering this report it was a salutary exercise to understand that in bad times, when a country is in recession it is necessary to run fiscal policy in a particular way whereas the objective of this report is to chart a path so that in good times we run fiscal policy in a new way.

This report makes a number of recommendations which it is considered should be adopted by Government as soon as possible; two particular areas spring to mind. Firstly, that the way Ireland operates its budgetary process is no longer optimal and secondly, that the macroeconomic data, models and analysis needs to be reviewed and changed.

I would like to extend my appreciations to the members of the Joint Committee Deputies Noel Ahern, Chris Andrews, Joan Burton, Thomas Byrne, Damien English, Frank Fahey, Terence Flanagan, Brian Hayes, Michael McGrath (vice-Chairman) and Michael Noonan together with Senators Dan Boyle, Marc MacSharry, Feargal Quinn and Liam Twomey for their co-operation and work in dealing with this complex issue.

I would like on behalf of the Joint Committee to pay a special thanks to the staff of the Houses of the Oireachtas, the Head of the Oireachtas Library & Research Service, Ms. Madelaine Dennison, Dr. Gráinne Collins, Mr. Niall OCléirigh, Mr. Barry Comerford and the staff of the Economic and Environmental Science Team, The Committee Secretariat Director Mr. Art O'Leary, Deputy Director Mr. Ciaran Smith, the Clerk of the Joint Committee, Mr. Ronan Lenihan the staff, Mr. Eoin Hartnett and Mr. David Edwards, for all their hard work and assistance to the Members in bringing this report to finality. In conclusion, I wish to pay a special word of thanks to Professor Philip Lane, Head of the Economics Department of Trinity College Dublin (TCD) for his very comprehensive report and guidance to the Committee on the complex matter of macroeconomic policy.

Michael Ahern T.D.
Chairman of the Joint Committee on
Finance and the Public Service

10 November 2010

Acknowledgments

The Joint Committee wishes to expresses its gratitude for the work and effort by the staff in the Oireachtas Committee Secretariat, in particular Mr. Ronan Lenihan, Clerk to the Committee, the Library & Research Service in particular Dr. Grainne Collins and Professor Philip Lane for producing his comprehensive report within very tight time-lines.

Summary of Recommendations

1. DATA SETS, MODELS AND ANALYSIS

1.1 In the delivery of a new budgetary process, in terms of recommendation 4 below, a move to EU budget semester model; the Committee recommend the Government publish annually, by way of laying a report before the Houses of the Oireachtas, its macroeconomic data and both short-term and long-term projections. This report forms the basis of the recommended budgetary time-line as set out in Table 1 on page 29.

1.2 The Committee notes that there has not been enough investment in economic modelling and we have only one extensive model of the economy (the Economic & Social Research (ESRI) HERMES model) that is regularly used for macroeconomic policy analysis. There may be other models (for instance in the Department of Finance) but it is unclear how good these other models are, or how good their assumptions are because the Government and the Department of Finance do not explain or justify the data used, the conclusions drawn or the assumptions made. However, the Committee have two concerns; firstly in relation to the lack of information regarding the modelling used by the Department of Finance; and secondly, that Ireland does not have the range of models it needs to support policy making. The Committee notes that the HERMES model used by the ESRI is limited by its dependence on historically-estimated relations across key macroeconomic variables. Therefore, the Committee recommends that there should be a suite of models for the Irish economy maintained by the ESRI, the Department of Finance and the Central Bank. In the case of each model, the dataset, assumptions and analysis should be fully transparent with regular reporting by way of reports laid before the Houses of the Oireachtas and detailed briefing of the Joint Committee on Finance and the Public Service. Further, the Committee notes that while it is the norm for forecasting to put emphasis on the central scenarios; the Committee recommends that greater weight be placed on the distribution of risk with explicit discussion of the impact of negative scenarios.

1.3 The Committee recommends an independent group, including international specialists be established immediately to scope Ireland's macro-modelling requirements and how these models should be developed and maintained by the relevant bodies: the ESRI, the Department of Finance and the Central Bank of Ireland. The results of the scoping exercise and its recommendations should be published and laid before the Houses of the Oireachtas. The Committee further recommends a Dáil debate of the exercise. The Committee recommends that this exercise should not delay other proposals.

2. Fiscal, Budgetary and Taxation Policy

2.1 The Committee recommends that macroeconomic policy must plan for shocks by the creation of 'fiscal space'. Fiscal Space relates to the Sovereign State's ability to react to economic shocks in a sector, such as a spike in unemployment, and borrow at acceptable interest rates because government debt levels are low. If government debt levels are high and an economic shock occurs the sovereign state may be forced, by the bond markets, to borrow at rates that are punitive (as Ireland has experienced since the summer of 2010) or default on debt.

2.2 In terms of future macroeconomic policy the Committee recommends that if a government inherits a public spending level not on the trend level then it must be required to announce the time-scale it will take to get back onto the trend level. The Committee believes that an explicit transition plan builds confidence.

2.3 The Committee recommends, assuming that factors such as asset prices, inflation, the level of private spending and the sectoral composition of output are at their sustainable trend level, then, tax revenues should be set at a level that covers the desired level of public spending and the cost of servicing that level of public debt across the economic cycle.

2.4 The Committee recommends that if a Government inherits a tax level that is not at the sustainable level then it needs to announce a plan to achieve the sustainable level. This provides certainty about future taxes

2.5 The Committee recommends, in periods of deflation, that clauses on downward flexibility in wages may have to be introduced to national pay agreements.

3 THE FISCAL FRAMEWORK

3.1 The Committee notes international trends towards the establishment of formal fiscal frameworks. A fiscal framework is characterised by some combination of the following:

1) reform to the budget process;
2) a medium-term budgetary framework;
3) numerical fiscal rules; and
4) a formal policy role for independent fiscal institutions.

The setting of formal fiscal frameworks forces Government policy to avoid short-termism or 'capture by elites'. The Committee recommends the establishment of formal fiscal frameworks with binding fiscal rules to ensure that the long-term level of public spending is matched with the long-term level of revenues.

4. THE BUDGETARY PROCESS

4.1 The Committee considers that the traditional budgetary process of Votes, Sub-heads and Sub-subheads should be changed. Further, the Annual Output Statement (AOS) does not deliver. The Committee recommends that, with effect from budget 2011, a new budgetary process must be introduced. Further the method for presenting the Departmental Estimates must be changed and the new system must clearly link all expenditure, no matter how disparate, to all projects so that all activity including costs, current, capital, administrative etc. are fully captured and recorded against a project. This will be easier achieved in regard to certain capital expenditures; however, social spending can also be recorded against costs of providing such social spending even where the delivery costs of such social spending is across several programmes.

4.2 The Committee recommends the introduction of multi-year budgets as multi-annual budgets are a better option in allowing Departments and the capital investment programme to be more efficient. However, overruns in one year must be balanced by under-runs in subsequent years.

5 FISCAL RULES

5.1 The Committee considers that, notwithstanding the sovereign right of Government to take decision, for fiscal rules to be effective it would be costly for a Government to flout the rules as market sentiment may change.

5.2 The Committee recommends that the fiscal rules have;

- Have an independent agency monitor compliance with the rules
- Impose on a Government formal sanctions in the event of non-compliance. In this regard the Committee is of the view as set out in recommendation 6.3; that the EU should devise and establish rules for how a Member State economy should act where that economy is running budget surpluses or its economic cycle is contra indicative to the main EU economies. Therefore, in circumstances where the 'fiscal rules' on budget surpluses and windfall revenues are not observed the EU would have rules, on a par with the budget deficit rules, within the Euro Growth and Stability Pact.

To establish the 'fiscal rules', the Committee recommends that an All Party Oireachtas Committee be established and resourced as required; to report back by way of laying a report before the Houses of the Oireachtas, within six months of the Order establishing the All Party Committee.

5.3 The Committee recommends that compliance with the fiscal rules be independently monitored.

5.4 The Committee recommends that a number of independent agencies need to play a role in the fiscal process;

1. An independent agency has to be responsible for the collection of economic statistics. In Ireland, the Central Statistics Office has considerable operational independence, as set out in the Statistics Act but to ensure this independence the Central Statistics Office must be fully resourced so as to maintain the necessary skill base.
2. An independent Court of Auditors to measure the integrity and quality of public spending. In Ireland, this function is performed by the office of the Comptroller and Auditor General, although it is open to question whether the scale and scope of the activities of the C&AG could be

extended to allow for more extensive investigation of the effectiveness and efficiency of individual spending programmes.

3. The National Treasury Management Agency (NTMA) is delegated to independently manage public debt.

5.5. The Committee recommends that a number of other functions should be delegated. A non-exhaustive list includes:

5.5.1 The determination of the macroeconomic forecasts that are employed in making short-term and medium-term budgetary plans;

5.5.2 The determination of the fiscal forecasts that are employed in making short-term and medium-term budgetary plans;

5.5.3 The analysis of alternative fiscal scenarios;

5.5.4 The monitoring of compliance with announced fiscal targets and fiscal rules; and

5.5.5 The evaluation of the quality of the fiscal process and fiscal decisions.

The Committee recommends that these functions must not be collectively delegated to a single agency.

5.6 The Committee recommends the establishment of an independent Economic Advisory Council and a separate independent Budgetary Review Council so that these two bodies are independent. The personnel and functions of these two Councils must, apart from being independent, be kept completely separate. The Committee recommend that the function of the Economic Advisory Council would be 1) a part-time function 2) assess the aims, assumptions and projections in the previous budget and comment as to the effectiveness of both policy and forecasting; where deviations from the 'Steady State' and/or the 'Trend Level' occur, suggest adjustments that should be considered. The function of the Economic Advisory Council is economic advice.

5.7 The Committee recommends that the function of the Budgetary Review Council would be monitoring and analysis of the economy and the development of policy scenarios. The Committee recommends that consideration be given to the expanding the role of the Budgetary Review Council to include analysis of fiscal scenarios proposed by opposition members of the Oireachtas.

5.8 The Committee considers that, in terms of future economic shocks, there exists the possibility of the need to suspend the application of the fiscal rules and in the case of such suspension; the corollary of reinstatement of the fiscal rules. Accordingly, the Committee recommends that there is a need for openness, transparency and independence in regard to any body that would recommend suspension and reintroduction of the 'fiscal rules' and given the need for independent arbitration this specific function should be assigned to the proposed independent Economic Advisory Council or, alternatively, the proposed independent Budgetary Review Council.

5.9 The Committee recommends that the Department of Finance must improve its modelling and surveillance capacity by setting up an intra-departmental, professional, economic analysis unit that would be fully engaged in full-time macroeconomic analysis. Since the Department of Finance is currently set up as a generalist civil service department, the establishment of such a specialist unit type would require careful planning in terms of recruitment and career planning policies.

5.10 The Committee recommends that even if the primary responsibility for macroeconomic projections is delegated to an internal economic analysis unit within the Department of Finance, it is essential that there are independent agencies that can cross-check macroeconomic forecasts.

5.11 The Committee note that the European Commission has called for windfall revenues to be saved. Ireland already has an important fiscal rule in the form of the legal commitment to pay one percent of GNP into the National Pension Reserve Fund (NPRF) to pre-fund future ageing-related expenditures. The NPRF has, in the present crisis, come to play the role of a reserve fund. The Committee considers that it was not the intention of the legislation which established the NPRF that the fund would be used in the manner currently being used. The Committee recommends that the current (unintended) use of the NPRF cannot be allowed to continue and a new reserve fund, a 'rainy day account', needs to be established so that the NPRF can deliver its legislated mandate.

6. Fiscal Monitoring

6.1 The Committee recommends that responsibility for fiscal monitoring be allocated to a Budgetary Review Council.

6.2 The Committee recommends that the mandate for such an independent Budgetary Review Council would be to prepare an annual fiscal monitoring report that evaluates fiscal policy outcomes relative to the announced fiscal policy targets. This would include evaluating whether the fiscal position is sustainable and whether the announced annual and medium-term budgetary targets were on track. Moreover, if a set of numerical fiscal rules were adopted, it could evaluate whether fiscal policy is adhering to these rules. In relation to fiscal rules, an extra role for an independent Budgetary Review Council could be to make the judgement whether, in the event of large shocks, the conditions are met for the normal rules to be temporarily suspended (and, subsequently, to determine when the normal fiscal rules should be restored). Alternatively such a function could be assigned to the Economic Advisory Council. However, it is also important to appreciate that fiscal monitoring is highly valuable even if the government has not yet adopted a set of numerical fiscal rules - it can still be monitored in relation to its announced fiscal plans.

6.3 The Committee recommends that the EU Council of Ministers and the EU Commission need, as a matter of urgency, to devise and implement rules for how a Member State economy should act where that economy is running budget surpluses or its economic cycle is contra indicative to the main EU economic cycle.

Report of the Joint Committee.

1. INTRODUCTION

On 8 July 2010, Dáil and Seanad Éireann ordered

"That Dáil Éireann requests the Joint Committee on Finance and the Public Service, to consider the following reports:

- *'The Irish banking crisis: regulatory and financial stability policy 2003-2008,' by the Governor of the Central Bank, and*
- *'A preliminary report on the sources of Ireland's banking crisis', by Klaus Regling and Max Watson,*

which were laid before Dáil Éireann on 9 June 2010; and taking account of the emerging EU proposals relating to fiscal and economic governance, to conclude its deliberations by 30 October 2010 and to publish and report back to Dáil Éireann its findings and conclusions no later than 4 November 2010 on the following key policy lessons in relation to macroeconomic management set out in the report by Klaus Regling and Max Watson:

- *the role of macroeconomic management and surveillance in securing the long-term sustainability of Ireland's economic performance and also in responding on a timely basis to risks and imbalances that may build-up in both the private and the public sectors of the economy, including external imbalances vis-à-vis other euro area members and the funding of any imbalances that might arise;*
- *the role of fiscal policy in securing an appropriate alignment of the national business cycle with monetary conditions in the economy;*
- *the requirement for the design and conduct of budgetary and taxation policies to take account of the cyclical nature of particular revenues as well as their temporary nature in certain circumstances in order to maintain an appropriate and effective tax base; and*
- *the case for the establishment of new institutional structures to provide an independent validation of economic and fiscal projections as well as for the introduction of domestic medium-term fiscal rules."*

The Joint Committee, following a public procurement procedure, commissioned Professor Philip Lane, Head of the Economics Department of Trinity College Dublin, to prepare a report for the Joint Committee's consideration. This report (Lane, 2010) is published at Appendix 3.

The Joint Committee has proposed a number of recommendations which are in this report to the Dáil and Seanad.

The attainment of economic stability requires that economic imbalances are identified and addressed with a range of economic policy tools. Economic stability means both avoiding recessions and overheating episodes (commonly known as the 'boom-bust' cycle). Economic stability is good and desirable as instability causes a range of costs which are borne, disproportionably, by those least able to afford them. In the boom-bust cycle several factors can reinforce each other causing amplifications of the original boom-bust cycle or elements thereto. One of the dangers is that Government spending can mirror the boom-bust cycle so that Governments spend unsustainably in booms and in times of recessions have to cut back perilously. Furthermore, the boom-bust cycle can lead to uncertainty, which in turn causes individuals and firms to pursue 'safer' options and shy away from taking risk, the driver of any modern economy.

Therefore, to deal with a downturn fiscal space is needed. Fiscal space means the ability to react to economic shocks because debt levels are low. A Government which the markets believe is committed to long-term balanced budgets will, surely, not be punished by high interest rates when it goes to borrow for short-term contingencies, as the markets will believe that the debts will be repaid and are affordable. In addition, high interest rates on Government borrowings imply lower spending, higher taxation or both.

Accordingly, for the reasons above, the most critically important key policy objective for a Government is economic stability so that the sovereign Irish economy is not placed in jeopardy. However, due to Ireland's decision to enter and take part in the single 'Euro' currency, one of the main tools to drive economic stability that the Irish

Government had at its disposal, namely monetary policy[1], has been delegated to the European Central Bank.

In terms of the general world economy, the EU Economy, the economies of EU Member States and the single Euro currency the delegation of monetary policy to the European Central Bank (ECB) is helpful in dealing with global shocks but the consequence of Euro membership is that EU Member State Governments cannot use monetary policy to deal with shocks that affect that Member State alone and in this regard Ireland's home-grown property boom is an example of the difficulties experienced when monetary policy has been removed from the sovereign states arsenal. In the case of Ireland, the world economic downturn and the collapse of Lehman Brothers were compounded and made all the worse by decisions that did not take account of the fact that since Ireland's entry to the Euro Ireland's Government was unable to use monetary policy to deal with shocks that affect Ireland alone.

Accordingly, Ireland has to rely on domestic non-monetary policy instruments. At the very least, as a member of the Euro, this means that the Irish Government must be economically aware that it does not have sovereign access to monetary policy instruments so it must not pursue fiscal policy in a manner that magnifies the economic cycle. Rather the Government must pursue a counter-cyclical fiscal policy. This must mean raising taxes and cutting spending in boom times so as to be able to cut taxes and maintain spending, if not increase targeted social spending, in times of a recession, however deep.

To achieve this end it is critical that the fiscal authorities, that is the Government and the Department of Finance are very clear about the state of the banking system and, therefore, precise, accurate and timely communication is needed between the Central Bank, the Financial Regulator and the Department of Finance. Further, the Government must ensure that the Central Bank and the Financial Regulator prioritises smoothing any fluctuations in bank lending.

[1] Monetary policy relates, in this context, to the sovereign state's ability to raise and lower interest rates and to devalue the sovereign currency.

The Committee concur that it is not desirable to wholly eliminate economic cycles, nor, if it was desirable, would it be possible as economic cycles can have a positive, beneficial, effect on economic organisation. There are many time lags and uncertainties in data trapping, data analysis and policy formulation and operation which means that perfect economic smoothing can never be achieved. Rather the aim must be to eliminate the worst effects of booms and busts.

2. MACROECONOMIC SURVEILLANCE

The Committee notes that Ireland did not and does not lack macroeconomic surveillance. What is at question is the quality and timeliness of data, the policy conclusions drawn from the analysis and this is further hampered as, particularly in the case of the Department of Finance, the data and analysis is not open to external scrutiny or the requirement that the Government and the Department of Finance justify the conclusions made.

The Committee notes that there are numerous individuals and bodies engaged in macroeconomic surveillance, as follows;

- the Department of Finance;
- the Central Bank of Ireland;
- the Economic and Social Research Institute (ESRI);
- the private-sector banks,
- the European Commission,
- the Organisation for Economic Co-operation and Development (OECD);
- the International Monetary Fund (IMF);
- Independent commentators
- Academic economists.

The Committee agrees with Professor Lane and notes that there are several levels to economic surveillance:

1 Identification of the trend growth path in order to identify how far from the path the country is.

2 Assess if any gap will quickly close or does it need policy intervention.

3 Assess whether there are underlying risk factors that may trigger a downturn.

Professor Lane gives the following examples

a) Economic activity may be skewed towards sectors that are more at risk of sudden downturns (such as construction),

b) Demand in the economy may be driven by unsustainably-high consumption and investment levels,

c) Demand may be funded by an excessive current account deficit.

The Committee note that with such a number and variety of bodies engaged in surveillance; interdependence occurred leading to an uncritical acceptance of the data and the analysis drawn. This can be said to be particularly true of 'External Agencies' who, it appears, accepted without much question the data supplied. In this regard the Committee notes how in the summer of 2008 international ratings agencies were giving the State and Irish banks, such as Anglo Irish Bank, very good and positive ratings whereas in September of 2010 these same ratings agencies were downgrading both the Sovereign State and the banks.

When examined, the Committee concluded that the data and analysis used was, in the main, generated within Ireland. The Committee notes the points made by Professor Lane that while there may be the existence of checks and balances from external non-Government surveillance bodies it is a reality that the data and analysis in use by the Department of Finance and by default the Government is not open, transparent or subject to the same requirements to justify or defend the conclusions drawn.

The Committee consider this opaqueness of economic modelling a flaw in the macroeconomic management of the Irish Economy and recommend the annual publication, by way of laying a report before the Houses of the Oireachtas, of the Government macroeconomic data and projections. This report must be the subject of Oireachtas scrutiny as this report forms the basis of the recommended budgetary time-line as set out in Table 1 on page 29.

3. ECONOMIC MODELLING

The Committee agrees with Professor Lane that the current economic models do not adequately account for the risks associated with the financial sector, nor do economic models take account of human factors such as panics [what Keynes referred to as animal spirits]. Any projections based on economic models must have a range of values based on different risk scenarios and the importance of these projections (sensitivities) must be internalised by policy makers:

> *"Much of the focus in assessing the outputs from such surveillance analyses is on the "most likely" projection for the economy. However, it is also important to fully internalise the distribution of risks around the central projection. In particular, in view of the high costs of negative macroeconomic and financial shocks, it is essential that policymakers understand the evolution of the downside risks that are highlighted by macroeconomic surveillance exercises. To this end, the design and communication of macroeconomic surveillance reports should explicitly deal with the range of possible scenarios, in addition to reporting the central projections"* (Lane, 2010, p6).

Further, the Committee considers that international economic models should also be improved to take account of the transmission of risks. However, while important there is no substitute for domestic modelling not least because the international surveillance relies on good-quality domestic modelling as Professor Lane notes;

> *"…At a practical level, the international agencies can only allocate limited resources to analysing specific developments in individual small economies. Moreover, the main costs of macroeconomic errors are borne domestically, such that the main responsibility to ensure high-quality macroeconomic surveillance resides with domestic authorities."* (Lane, 2010, p7).

The Committee agrees with Professor Lane that there has not been enough investment in economic modelling and we have only one extensive model of the economy (the ESRI's HERMES model) that is regularly used for macroeconomic policy analysis. There may be other models (for instance in the Department of Finance) but it is unclear how good these other models are, or how good their assumptions are because the

Government and the Department of Finance do not explain or justify the data used, the conclusions drawn or the assumptions made. The Committee agree with Professor Lane when he notes that

> *"... Accordingly, it is desirable that other macroeconomic models also be developed that follow different approaches. It is only by maintaining a suite of macroeconomic models can we be confident that projections are robust to variation in technical modelling assumptions. Macroeconomic models are of limited value if there is an insufficiency of adequate macroeconomic data."* (Lane, 2010, p7).

The Committee have two particular concerns; firstly in relation to the lack of information regarding the modelling used by the Department of Finance; and secondly, that Ireland does not have the range of models it needs to support policy making. In the case of the HERMES model used by the ESRI, which Professor Lane notes that while having many positive features

> *"... This type of model is limited by its dependence on historically-estimated relations across key macroeconomic variables"* (Lane, 2010, p7).

Therefore, the Committee recommends that there should be a suite of models for the Irish economy maintained by the ESRI, the Department of Finance and the Central Bank of Ireland. In the case of each model, the dataset, assumptions and analysis should be fully transparent with regular reporting by way of reports laid before the Houses of the Oireachtas and detailed briefing of the Joint Committee on Finance and the Public Service. Further, the Committee notes that while it is the norm for forecasting to put emphasis on the central scenarios, the Committee recommends that in the future greater weight be placed on the distribution of risk, with explicit discussion of the impact of negative scenarios.

The Committee recommends an independent group, including international specialists be established immediately to scope Ireland's macro-modelling requirements and how these models should be developed and maintained by the relevant bodies: the ESRI, the Department of Finance and the Central Bank of Ireland. The results of the scoping

exercise and its recommendations should be published and laid before the Houses of the Oireachtas. The Committee further recommends a Dáil debate on the outcome of the exercise. The Committee recommends that this exercise should not delay other proposals.

The Committee further recommends that at least every three years there should be a Dáil debate on the economic modelling used and the results revealed so as to ensure the pertinence of the suite of models to the current manifestation of the economic cycle not alone in Ireland but also to the economic cycle in both those countries who are members of the Euro currency and those member states who are not members of the Euro. The Committee recommends that this review must not in any way lead to a delay in the implementation of any other recommendation in this report.

Economic models are only as good as the information used to create them. In this context the Committee agrees with Professor Lane

> *"Macroeconomic models are of limited value if there is an insufficiency of adequate macroeconomic data. While the Central Statistics Office has a very good reputation for high-quality statistics, it is also the case that limited resources and inadequate coordination across State agencies means that there is a scarcity of timely data in relation to a number of key areas. For instance, the earnings data are insufficiently detailed to provide clear guidance on the full distribution of wage dynamics across the economy. The lack of a survey of consumer finances until now means that key financial dynamics at the household level are not adequately tracked. Similarly, the inadequate data on the distribution of transacted housing prices and commercial property prices has restricted analysis of the macroeconomics of the boom-bust cycle in the property sector. Accordingly, improved data coverage is an important requirement for improved macroeconomic surveillance"* (Lane, 2010, p7).

The Committee recommends that the Central Statistics Office produces improved earnings data; that a database of property prices be established and that the Office of the

Revenue Commissioners amalgamate and collate data in their possession to allow analysis in a coherent and timely manner.

3.1 Coherence between surveillance and policy formation

The need for coherence between surveillance and policy is a key requirement. What is apparent is that the domestic fiscal calendar and budgetary process must be changed and cannot continue in its present format.

The Committee agrees with the suggestion of Professor Lane to the effect that the budgetary process be split into three separate stages:

1. An annual Oireachtas debate about the economic situation based on an economic stability report (see below);
2. The government then decides the appropriate budget balance to maintain economic stability;
3. The Minister for Finance then negotiates within the agreed budget with individual Ministers and makes a decision about the tax level.

The Committee considers that the proposed annual Oireachtas debate about the economic situation based on an economic stability report would have two benefits, firstly, that it would align the Irish budgetary process to that of the European semester, where the EU budget is debated at an early stage and secondly, the economic report would also inform the macro-prudential risk assessments conducted by the Central Bank of Ireland and inform public debate.

4. Fiscal, Budgetary and Taxation Policy

As mentioned previously it is prudent to plan for shocks by the creation of fiscal space as fiscal space gives the ability to react to economic shocks because debt levels are low. However, hand-in-hand with debt is revenue; debt can only be repaid when there is certainty to long-term revenue.

4.1 Long-term debt level

The debt level of the sovereign state may reflect either investments in public infrastructure, 'disastrous episodes' or bad decisions. Excessive high public debt is a negative factor because it pushes up interest rates on public debt and may have a knock on effect on private bank interest rates. It also creates fiscal uncertainty as individuals and firms are unclear about how the debt is to be repaid. Finally, the lack of fiscal space means governments cannot react to shocks.

4.2 Long term public spending

The level of public spending is a political decision. However, once the sustainable level has been reached the goal must be to maintain this level through an economic cycle. It should be noted that actual public spending will vary through the economic cycle but the trend level should be stable. In terms of future macroeconomic policy the Committee recommends that if a government inherits a public spending level not on the trend level then it must be required to announce the time-scale it will take to get back onto the trend level. The Committee considered that an explicit transition plan builds confidence.

4.3 Long-term tax revenues

The amount of tax revenues needed depends on many factors such as asset prices, inflation, the level of private spending and the sectoral composition of output. However, two major variables have a primary role – firstly, what is the level of spending the Government are committed to and secondly, what is the level of debt as this determines the interest to be repaid. Assuming that factors such as asset prices, inflation, the level of private spending and the sectoral composition of output are at their sustainable trend level, tax revenues should be set at a level that covers the desired level of public spending and the cost of servicing that level of public debt across the economic cycle. If public spending and debt are high, then the level of revenue raised needs to be high. If a government inherits a tax level that is not at the sustainable level then it needs to announce a plan to achieve the sustainable level. This provides certainty about future taxes (Lane, 2010, p11).

It is vital that the Government shows consistency between the target tax ratio and targets for public spending and public debt (Lane p. 11). The Committee notes that only if the tax base follows these rules can the Government afford to reduce taxes during a recession without triggering a loss of confidence about Irish ability to repay loans.

For a sustainable tax base it is necessary to:

- Understand the difference between cyclical and trend tax revenues (this is not always easy especially in a small open economy such as Ireland);
- The tax base must draw on the less-cyclical tax revenues;
- The tax base must be broad (that there are many sources of taxes and many tax payers);
- Windfall taxes from cyclical sources must be saved.

5. MACROECONOMIC COUNTER-CYCLICAL FISCAL POLICES

To improve economic stability fiscal policy should be counter-cyclical. In booms fiscal surpluses should be higher to allow deficits in downturns. Fiscal spending is naturally counter-cyclical. For instance the number of social welfare claimants rises in downturns. On the other hand revenue tends to be pro-cyclical so in booms revenue rises and in downturns it falls. Taken together revenue and spending should mean than the fiscal balance will automatically move in a counter-cyclical manner. However, the precise outcome will depend on a range of factors: the level of spending, the inflation rate, which prices are increasing and which sectors are contributing to output. The exact combination will dictate the height of the economic peak and the depth of the fall.

It is important to note, when differentiating between permanent and transitory tax revenues, that a small open economy such as Ireland's is susceptible to shocks and these can increase or decrease the trend level of growth. Moreover the effect of shocks – even when they induce a permanent shift in productivity – will cause cyclical fluctuations as markets do not adjust very rapidly. Therefore, there may be temporary shifts in wages, prices and employment levels from efficient levels. These mean that fiscal plans should be "robust to such uncertainty" (Lane`, 2010, p14). However, as

noted above, in regard to economic models, data trapping and analysis; high quality fiscal models are needed which have access to high-quality revenue data and this must be made public so that the conclusions drawn can be judged. But even with the best forecasting, caution is necessary and fiscal strategy should plan over several time horizons not just the annual budget cycle. This prudential approach means governments should be slow to increase spending but quick to reduce it.

5.1 Management of Fiscal balance

Governments can raise taxes in a boom and create subsidies in a downturn to smooth the economic cycle and in particular taxes on employment and property should move in a counter-cyclical manner. Critically, these taxes and subsidies should be temporary. However, the reality is that each and every special interest group will lobby for the opposite.

A reserve fund which goes beyond the NPRF needs to be created. The NPRF, in the present crisis, come to play the role of a reserve fund. The Committee considers that it was not the intention of the legislation which established the NPRF that the fund would be used in the manner in which it has been used. The Committee considers that this 'competency creep' in the use of the NPRF needs to be addressed either by revisiting the legislation that established the NPRF or in new legislation to establish a purpose designed reserve fund. The Committee is very strongly of the opinion that the current drift with no move to formularise the current (unintended) use of the NPRF cannot be allowed to continue – It is not 'best practice' to use legislation and regulation for purposes other than which the Oireachtas intended and not addressing this matter could exacerbate the current economic crisis and, possibly, future economic shocks.

Further, the Committee recommends the Government reviews the possible introduction of inflation-indexed bonds to be used for capital projects. In this regard, the Committee at its meeting of 14 October 2010 received a presentation from the Irish Brokers Association in regard to how pensions could power prosperity. In this context, and not being proscriptive, the Committee note how the Irish Brokers Association indicated to the Committee how pension funds are a key part of a modern global economy and can

drive investment in three ways, 1) incentivising infrastructure; 2) building business by increasing the level of investment in domestic equities and 2) financing Government by investing in Government bonds. The investment in government bonds may also have, in current terms, the effect of reducing the interest cost of servicing government debt.

5.2 Labour market policies

It is in the labour market that the lack of monetary policy instruments is most closely observed by the citizens of Ireland. In past times various Irish Governments devalued the Irish currency, the most recent such incident was in January 1993 when the former Taoiseach, Bertie Ahern as then Minister for Finance devalued the then Irish Punt by 10%. The reality of currency devaluation is that it is an effective wage cut but without the inconvenience or fall-out of actually reducing the pay-packet the worker takes home; rather devaluation hides from the eye the fact that the same pay-packet will now buy less than heretofore - the money in the pay-packet stayed the same. In the current crisis both the private and public sectors have had to take pay cuts, not alone pay-cuts imposed by increased taxes and new levies, but serious and steep cuts in the rate of pay for the work.

Professor Lane argues that real wages have to be adjustable downward in order to avoid unemployment. The Committee note this is not without controversy as Keynesian adherents argue that decreasing real wages just leads to a decrease in demand in the economy. The Committee notes that the Government have negotiated the Croke Park agreement with the public sector unions and renegotiation may be difficult. However, notwithstanding any difficulty the Government may face if it wants a credible macroeconomic policy as a member of the Euro (which has resulted in the transfer of sovereign monetary policy instruments such as devaluation) then clauses on downward flexibility in wages have to be introduced to national pay agreements for periods of deflation.

5.3 The fiscal framework

There is an international trend towards the establishment of formal fiscal frameworks. A fiscal framework is characterised by some combination of the following:

1. reform to the budget process;
2. a medium-term budgetary framework;
3. numerical fiscal rules; and
4. A formal policy role for independent fiscal institutions.

The setting of formal fiscal frameworks forces Government policy to avoid short-termism or capture by political elites. Governments find it difficult to run anti-cyclical policy for the following reasons:

a) Political groups lobby for spending when monies are available;
b) The markets force governments to tighten spending in a recession.

Pro-cyclicality tends to be worse the more macroeconomic volatility there is. However, the political distortions can be mitigated by the existence of independent fiscal institutions and binding fiscal rules. What is important to stress is that the sovereignty of the Government to make political decisions in regard to public spending and taxation is not diminished as long-term fiscal sustainability is consistent with a wide variety of spending levels. Formal fiscal frameworks with binding rules ensure that the long-term level of public spending is matched with the long-term level of revenues.

6. THE BUDGETARY PROCESS

The Committee note that the Budget for 2010 is to take place on the 7th of December and that in the current process of Department of Finance briefings to opposition spokespersons a lacuna has appeared as the revenue data will not be available until the first or second week of November. The revenue data is a major key in economic modelling and facing into a budget speech so soon after the data becomes available is not ideal. The importance of the revenue returns, in terms of modelling the economy, is vital as revenue returns indicate the growth rate. To reverse the economic downturn growth is important as sustainable growth can assist in the 'heavy lifting' - otherwise the corrections will have to be done by expenditure cuts and tax increases.

Centralised control of the overall budget target in terms of balance, level of spending and level of tax revenue is vital. Without centralised control a fragmented fiscal system results and this gives individuals and Departments no incentive to exercise self-control, since they hope that the burden of budgetary adjustment will be borne by others.

However, even in a centralised process a mechanism needs to be established whereby Departmental budgets are not just decided on the basis of the previous year's budget.

"… *this requires centralised oversight and monitoring of the effectiveness of individual spending programmes, increasing the accountability of each department in delivering public services*" (Lane p 19).

The traditional budgetary process of Votes, Sub-heads and Sub-subheads should be changed; further, the Annual Output Statement (AOS) process should be ceased. The Committee recommends that with effect from budget 2011 a new budgetary process should be introduced. Further, the method for presenting the Departmental Estimates must be changed and the new system must clearly link all expenditure, no matter how disparate, to all projects so that all activity including costs, current, capital, administrative etc. are fully captured and recorded against a project. This will be easier achieved in regard to certain capital expenditures; however, social spending can also be recorded against costs of providing such social spending even where the delivery costs of such social spending is across several programmes.

No effective macroeconomic management can be achieved without the full, true costs of the service delivered including the back-office costs of wages (pensions, travel & subsistence etc.), buildings, equipment, maintenance, consumables and all expenditure being assigned and included in the costs of a programme or project. The Estimates process with its tabular format and the Annual Output Statement are incompatible as the information supplied is not expressed in a cohesive common understandable format and does not highlight any deficiencies, lack of oversight or value for money issues; the current system of Estimates and Annual Output Statements is akin to comparing apples with coal.

The Committee recommends that with effect from budget 2011 a new budgetary process must be introduced and the time-scale moved to the EU semester model. The Committee recommends the budgetary cycle and process be changed as set out in the table below

Table 1. Proposed budgetary process and time-scale.

Time-frame	Event, function and outcome
T1*	The Economic Advisory Council comment on where we are and the effectiveness of policies to date in maintaining 'Steady State', 'Trend Level' in relation to both overall objectives of the policy targets and returns in regard to Tax, Debt, GDP and GNP. The Economic Advisory Council report by way of laying a report before the Houses of the Oireachtas.
T2 T1 + 0 days	The Department of Finance and others including the ESRI publish data and projections in regard to the next budget and also forecast the mid-term budget goals
T3 T1 + 60 days	The Budgetary Review Council , having regard to T1 & T2 publish, by way of laying a report in the Houses of the Oireachtas, the various macroeconomic budgetary options available to Government
T4 T1 + 90 days	The Select Oireachtas Committee on Finance and the Public Service to review T1, T2 and T3 and report and publish its considerations , by way of laying a report in the Houses of the Oireachtas,
T5 T1 + 120 days	A Dáil debate in regard to T1, T2, T3, & T4
T6 T1 + 150 days	Budget Day

* The date will be determined by reference to the announced Budget day, the Committee consider that the process and time-lines need to be extended but regard must be taken of the previously expressed view as to the timeliness of data. Accordingly, the Committee view a 150 day or 4 month process as a sustainable position.

6.1 Medium-term budgetary process

The adoption of fiscal rules may promote the introduction of multi-year budgets and Professor Lane argues that Departmental multi-annual budgets are a better option as they give certainty to households and allow Departments and the capital investment programme to be more efficient. However, overruns in one year must be balanced by under-runs in subsequent years.

6.2 Fiscal rules

Fiscal rules can apply to different levels:

- In decentralised fiscal systems, there are often extensive rules limiting the fiscal discretion of sub-national units of government;
- Central or general government often have rules relating to the overall budget balance;
- Expenditure rules are in place in a number of countries;

- Rules may also apply to the financial balance sheet[2].

However, notwithstanding the sovereign right of Government to take decisions, for fiscal rules to be effective, it must be costly for a Government to flout the rules. This can be ensured by:

- Having an independent agency monitor compliance with the rules
- The imposition of some type of formal sanction in the event of non-compliance.

A Government may suffer, with the electorate, a loss of reputation if it doesn't stick to the announced fiscal rules. However, what may inflict more lasting damage will be the loss of Ireland's reputation in the international arena.

6.3 Types of fiscal rules

The best type of debt rule is a ceiling rule since there is consensus that an excessively high level of public debt is damaging.

Such a rule must be complemented by a budget balance rule. A simple type of budget balance rule is to prohibit any type of deficit spending. However, that is clearly destabilising, since a Government would be forced to cut spending and raise taxes during recessions while increasing spending and cutting taxes during booms. Rather, the main focus is on rules that target budget stability over a medium-term horizon.

One option is to require that the projected structural balance in each year is set at a target value. This is transparent and does allow the Government to undertake discretionary fiscal interventions to smooth the cycle. While the operation of the automatic stabilisers may be a sufficient response to shallow and transitory output shocks, these may be inadequate in coping with large, persistent output shocks, as the automatic stabilisers may provide little protection against other types of macroeconomic risks, such as asset price bubbles.

An alternative approach is to specify that the target structural balance is met over the economic cycle. This allows Government to deviate from the structural target, so long as the annual deviations cancel out over the economic cycle. This provides extra fiscal

[2] Rules relating to tax revenues are technically possible

flexibility. Yet there is a risk that this extra flexibility may be abused by a Government as a device to weaken fiscal discipline. Accordingly, such a rule is most effective if it is closely monitored by the recommended independent Economic Advisory Council

However, the above courses or policy actions have a major flaw as commented upon earlier; they rely on excellent data. Yet it is unrealistic to expect that forecasts will be exactly met due to uncertainties in the data. However, what is critical is that any biases in the data are corrected. For instance, a new German rule specifies that the German Government must take corrective action if the cumulative value of such deviations exceeds a threshold floor value. The target balance should be zero but may be positive if the population is aging or if there is a large inherited public deficit. Also a surplus target reduces the probability of a crisis causing a deficit. This latter prudential motive is more critical in volatile economies. The target should also be periodically reassessed to ensure its relevance.

In relation to public spending, a Government may adopt a numerical expenditure rule for several reasons. First, the level of public spending is mostly at the discretion of the Government, such that it is more amenable to control than a budget balance target. In this way, a public spending rule may be an indirect proxy in attaining an underlying target for the fiscal balance. This would also help Government as each request for increased spending must be met with within the overall target. In specifying such an expenditure rule, it is important to allow for the unpredictability of non-discretionary types of public spending, for instance those which are driven by the number of claimants.

The European Commission has called for windfall revenues to be saved. Ireland already has an important fiscal rule in the form of the legal commitment to pay one percent of GNP into the NPRF to pre-fund future ageing-related expenditures. This is helpful in helping to partially pre-fund the projected future growth in ageing-related expenditures on pensions, social services and healthcare. However a more broadly defined ‘rainy day fund’ would be useful. This would avoid the need to go to markets in recessions and deliver a positive in terms of the interest costs on debt.

6.4 Implementation issues

The Committee regards it as essential that compliance with fiscal rules be independently monitored. At the same time 'escape clauses' are needed but the operation of these should be delegated to an independent council.

6.5 The implementation of fiscal rules

The current Irish situation calls for a two-stage strategy. During the current adjustment phase, the priority is on restoring fiscal sustainability over a medium term horizon. However, the effectiveness of current fiscal adjustment is reinforced by a commitment that the post-adjustment fiscal framework will include a commitment to a set of numerical fiscal rules.

6.6 The Role of Independent Institutions in the Fiscal Process

A number of independent agencies need to play a role in the fiscal process.

1. An independent agency has to be responsible for the collection of economic statistics. In Ireland, the Central Statistics Office has considerable operational independence, as set out in the Statistics Act.
2. An independent Court of Auditors to measure the integrity and quality of public spending. In Ireland, this function is performed by the office of the Comptroller and Auditor General (C&AG), although it is open to question whether the scale and scope of the activities of the C&AG could be extended to allow for more extensive investigation of the effectiveness and efficiency of individual spending programmes.
3. The National Treasury Management Agency (NTMA) is delegated to independently manage debt.

However, there are a number of other functions that could be delegated. A non-exhaustive list includes:

- The determination of the macroeconomic forecasts that are employed in making short-term and medium-term budgetary plans;
- The determination of the fiscal forecasts that are employed in making short-term and medium-term budgetary plans;

- The analysis of alternative fiscal scenarios;
- The monitoring of compliance with announced fiscal targets and fiscal rules; and
- The evaluation of the quality of the fiscal process and fiscal decisions.

These functions could be collectively delegated to a single independent Budgetary Review Council or these functions could be split across multiple independent agencies; the Department of Finance, the ESRI, the recommended Economic Advisory Council; the recommended Budgetary Review Council or by the establishment, in the Oireachtas, of a Budget Oversight Office such as the Congressional Budget Office (CBO) in the United States of America or the Netherlands Bureau for Economic Policy Analysis (CPB).

In principle, it is possible to envisage strong and weak forms of delegation to an independent fiscal institution. The strongest form of delegation would make the opinion of the independent fiscal institution a binding constraint on the Government's fiscal decisions. The weakest form would confer purely advisory powers on the independent fiscal institution, with no obligation on the Government to act on its views. An intermediate form might give the Government the power to override the views of the independent fiscal institution but would require the Government to formally explain the reasons for this deviation (for instance, through an Oireachtas debate).

The advantage of stronger forms of delegation is that it increases the credibility of the fiscal process by reducing the risk that political distortions may lead to sub-optimal fiscal decisions. However, stronger forms of delegation dilute the accountability of elected politicians and the civil service for fiscal decisions. At the other end of the scale, if there is no mechanism to force the Government to give due weight to the expert judgement, the limitation of a purely advisory role for independent fiscal institutions is that it may have little ultimate influence on fiscal decisions. Finally, the relative merits of strong versus weak forms of delegation may vary across the different types of functions listed above - the same approach is not necessarily required across all areas.

The Committee recommends that macroeconomic forecasting should be independent. At the same time, the Department of Finance must improve its modelling and surveillance capacity by setting up an intra-departmental economic analysis unit that would be more fully engaged in full-time macroeconomic analysis. Since the Department of Finance is currently set up as a generalist civil service department, the establishment of such a specialist unit type would require careful planning in terms of recruitment and career planning policies.

Even if the primary responsibility for macroeconomic projections is delegated to an internal economic analysis unit within the Department of Finance, it is essential that there are independent agencies that can cross-check macroeconomic forecasts. In Ireland, this role is taken by the ESRI.

An alternative to the above is to establish a separate independent body such as the Office for Budget Responsibility (OBR), in the United Kingdom; the Congressional Budget Office (CBO) in the USA or the Netherlands Bureau for Economic Policy Analysis (CPB).

Table 2 Options for macroeconomic forecasts

Fiscal forecasts	*Advantages*	*Disadvantage*
Department of Finance with ESRI with cross-checking responsibility	Builds up specialist knowledge in the civil service	Open to political influence. Time would be needed to build up expertise.
ESRI as standalone supplemented by independent expert	Already expertise within ESRI	No learning within the civil service
Independent body		Very expensive, no learning within the civil service. Time would be needed to build up expertise.
Body under the Parliament	Builds up specialist knowledge in the civil service. Modellers not open to political influence.	Time would be needed to build up expertise.

6.7 Fiscal projection and fiscal analysis

The Committee notes that fiscal projections and analysis requires sufficiently-detailed tax data and an understanding of the relation between different types of spending and different type of economic activity and tax flows. The Committee recommends the options for consideration:

Table 3 Options for fiscal projection and analysis

	Advantages	*Disadvantage*
Department of Finance retains responsibility but an internal economic analysis unit is created	Builds up specialist knowledge in the civil service	No cross checking, open to political influence. No access to opposition parties
Responsibility delegated to an independent agency	Cross-check Department of Finances projections. Opposition parties would have access to projections and expertise.	Department of Finance would still need to gain expertise in this area.
Provide more resources to ESRI	Opposition parties would have access to projections and expertise.	
Body under the Parliament	Builds up specialist knowledge in the civil service. Modellers not open to political influence. Opposition parties would have access to projections and expertise.	Time would be needed to build up expertise.

The Committee is of the view that an independent source of fiscal analysis provides several benefits. First, it provides a cross-check to the projections generated by the Department of Finance and by passing this ‘double hurdle’ of evaluation, the robustness of fiscal projections is enhanced. Second, it facilitates a broader debate about alternative fiscal scenarios. For instance, the quantitative fiscal models maintained by such an independent fiscal agency could be employed to simulate the alternative fiscal paths that might be proposed by opposition political parties or requested by an Oireachtas committee. More generally, its privileged access to detailed fiscal data would allow it to act as an independent source of fiscal information, thereby enhancing the credibility of fiscal information for both domestic and international audiences.

The Committee recommends the establishment of a Budgetary Review Council to undertake this role and further recommends the establishment of an independent Economic Advisory Council which is to be a separate from the Budget Review Council.

These two bodies must be independent and not subject to pressure. The personnel and functions of these two Councils must, apart from being independent, be kept completely separate.

The Committee recommend that the function of the Economic Advisory Council would be 1) a part-time function 2) assess the aims, assumptions and projections in the previous budget and comment as to the effectiveness of both policy and forecasting; where deviations from the 'Steady State' and/or the 'Trend Level' occur, suggest adjustments that should be considered. When fiscal rules are adopted the Economic Advisory Council would evaluate whether fiscal policy is adhering to these rules. In relation to fiscal rules, an extra role could be to make the judgement whether, in the event of large shocks, the conditions are met for the normal rules to be temporarily suspended (and, subsequently, to determine when the normal fiscal rules should be restored), however, the Committee are not proscriptive as this role could also be assigned to the recommended Budgetary Review Council.

The time-line of the functions of the Economic Advisory Council are as set out in Table 1 on page 29.

6.8 Fiscal Monitoring

The Committee recommends that responsibility for fiscal monitoring could be allocated to a (part-time) Economic Advisory Council. The membership could be drawn from academia, research organisations and former senior policy officials. In relation to each of these categories it would be valuable to draw upon on an international pool of experts in addition to local members so that the membership of the Council is at least 40% comprised of international experts.

A narrow mandate would be to prepare an annual fiscal monitoring report that evaluates fiscal policy outcomes relative to the announced fiscal policy targets. This, which must be after budget day, should include evaluating whether the fiscal position is sustainable and whether the announced annual and medium-term budgetary targets were on track.

Moreover, on adoption of fiscal rules, the Council could evaluate whether fiscal policy is adhering to these rules. Further, in relation to fiscal rules, an extra role assigned to the independent Economic Advisory Council could be to make the judgement whether, in the event of large shocks, the conditions are met for the normal rules to be temporarily suspended (and, subsequently, to determine when the normal fiscal rules should be restored). However, it is also important to appreciate that fiscal monitoring is highly valuable even if the government has not yet adopted a set of numerical fiscal rules - it can still be monitored in relation to its announced fiscal plans.

In addition to evaluating fiscal outcomes, an independent Economic Advisory Council policy council could also report on the quality of the fiscal process. At one level, this could involve the ex-post review of the accuracy of the underlying macroeconomic and fiscal projections. At another level, it could evaluate the quality of the official communication of fiscal policy - that is, whether the Government provides sufficiently persuasive explanations for its fiscal decisions.

A broader role for such an independent Economic Advisory Council would be to also mandate the council to be a source of new ideas concerning fiscal policy. For instance, it could have a research budget to commission exploratory studies that might generate new insights into the optimal conduct of fiscal policy or the effectiveness of fiscal policy in influencing macroeconomic outcomes. There is a general scarcity of independent research on fiscal policy, such that there could be significant returns on such policy-focused research.

Finally, by testifying before the relevant Oireachtas committees and through active engagement with the media, an important goal for both the recommended Economic

Advisory Council and Budget Review Council would be to raise the level of public debate about fiscal policy.

The Committee recommends that responsibility for fiscal monitoring could be allocated to an independent Budget Review Council. This council should be free from political interference but accessible to opposition parties and accountable to the Oireachtas. The membership of such a council should be composed of professional economists and planners. The Fiscal Council would be responsible for:

1. Reporting to the Oireachtas on a regular basis on the state of the economy
2. Developing scenarios for the different policy options
3. Evaluating the fulfilment of government objectives.

7. EUROPEAN DIMENSION

The Committee note that at a European Level the citizens of Europe were not best served. The development of the single currency and the launch of the Euro in 2002 resulted in the transfer of sovereign access to monetary policy to the European Central Bank (ECB). The stability and growth pact and the most recently announced changes have one major flaw in that they appear only to deal with recalcitrant Members States in terms of keeping government debt at/or below determined levels. The rules and pact do not lay down what a Member State must do in a surplus system.

By laying down and prescribing what Euro Member States can or should do in times of budget deficits and making no provisions or rules where a Member State runs a budget surplus is a major oversight. With a Member State's loss of sovereign access to monetary policy implicit on joining the Euro, the Council and Commission should have been alive to how the loss of monetary policy would impact on a Member State when the economic cycle turned in that Member State. The Council and Commission should have taken account of the reality that at the inception of the Euro the various Members States economies were not all convergent and all at the very same point of the economic cycle and devised rules accordingly.

The opinion of the Committee is that the Council and Commission need, as a matter of urgency, to devise and implement rules for how a Member State economy should act where that economy is running budget surpluses. It is the lack of understanding and effective oversight of that, by the EU, which now troubles the Euro.

CONCLUSION

Professor Lane recommends a three-stage fiscal planning process by which there would be an initial debate on the condition of the macroeconomic environment, followed by a decision on the target for the aggregate fiscal balance and then a final stage of deciding the details of individual spending and taxation programmes. In view of the cross-country spill-over issues, it is reasonable to have EU-level input at the first two stages, even if the third stage is primarily reserved for domestic political determination.

Professor Lane also argues that there is a need for three new or improved analyses in the Ireland: macroeconomic predictions, fiscal projections and analysis and fiscal monitoring. The first two could be carried out by one body or separated. They could be carried out by a Department of Finance which is 'beefed up' (this may, in any case, be necessary). However, there are drawbacks to such an approach not least the likelihood of political capture.

The ESRI could have its pre-existing role reinforced and this would have the advantage of providing a cross-check on the Department's calculations and allowing access to opposition parties. Finally a new body, either entirely independent or under the Oireachtas, could provide these functions. These too have the advantage of providing cross-checks on the Department's predictions and providing access to opposition parties. The Oireachtas option also allows the upgrading of economic knowledge in the civil service.

Finally the role of fiscal monitoring should be carried out by an independent body. All of these are an important adjunct to EU level monitoring. Tough sanctions need to be put in place for the violation of rules.

Appendix 1

JOINT COMMITTEE ON FINANCE AND THE PUBLIC SERVICE

List of Members:

Deputies	Michael Ahern (Chairman)
	Noel Ahern,
	Chris Andrews,
	Joan Burton,
	Thomas Byrne,
	Damien English,
	Frank Fahey,
	Terence Flanagan,
	Brian Hayes,
	Michael McGrath (vice-Chairman)
	Michael Noonan
Senators	Dan Boyle,
	Marc MacSharry,
	Feargal Quinn
	Liam Twomey

Appendix 2

Dáil Éireann on 23 October 2007 *ordered*:

"(1) (*a*) That a Select Committee, which shall be called the Select Committee on Finance and the Public Service consisting of 11 members of Dáil Éireann (of whom 4 shall constitute a quorum), be appointed to consider -

(i) such Bills the statute law in respect of which is dealt with by the Department of the Taoiseach and the Department of Finance;

(ii) such Estimates for Public Services within the aegis of the Department of the Taoiseach and the Department of Finance;

(iii) such proposals contained in any motion, including any motion within the meaning of Standing Order 159, concerning the approval by Dáil Éireann of the terms of international agreements involving a charge on public funds; and

(iv) such other matters;

as shall be referred to it by Dáil Éireann from time to time;

(v) Annual Output Statements produced by the Department of the Taoiseach and the Department of Finance; and

(vi) such Value for Money and Policy Reviews conducted and commissioned by the Department of the Taoiseach and the Department of Finance as it may select.

(*b*) For the purpose of its consideration of matters under paragraphs (1)(*a*)(i), (iii), (iv), (v) and (vi), the Select Committee shall have the powers defined in Standing Order 83(1), (2) and (3).

(*c*) For the avoidance of doubt, by virtue of his or her *ex officio* membership of the Select Committee in accordance with Standing Order 92(1), the Taoiseach and the Minister for Finance (or a Minister or Minister of State nominated in his or her stead) shall be entitled to vote.

(2) The Select Committee shall be joined with a Select Committee to be appointed by Seanad Éireann to form the Joint Committee on Finance and the Public Service to consider -

(i) such public affairs administered by the Department of the Taoiseach and the Department of Finance as it may select, including, in respect of Government policy, bodies under the aegis of those Departments;

(ii) such matters of policy for which the Taoiseach is officially responsible as it may select;

(iii) such matters of policy, including EU related matters, for which the Minister for Finance is officially responsible as it may select;

(iv) such related policy issues as it may select concerning bodies which are partly or wholly funded by the State or which are established or appointed by Members of the Government or by the Oireachtas;

(v) such Statutory Instruments made by the Taoiseach and the Minister for Finance and laid before both Houses of the Oireachtas as it may select;

(vi) such proposals for EU legislation and related policy issues as may be referred to it from time to time, in accordance with Standing Order 83(4);

(vii) the strategy statement laid before each House of the Oireachtas by the Taoiseach and the Minister for Finance pursuant to section 5(2) of the Public Service Management Act 1997, and for which the Joint Committee is authorised for the purposes of section 10 of that Act;

(viii) such annual reports or annual reports and accounts, required by law and laid before either or both Houses of the Oireachtas, of bodies specified in paragraphs 2(i) and (iv), and the overall operational results, statements of strategy and corporate plans of these bodies, as it may select;

Provided that the Joint Committee shall not, at any time, consider any matter relating to such a body which is, which has been, or which is, at that time, proposed to be considered by the Committee of Public Accounts pursuant to the Orders of Reference of that Committee and/or the Comptroller and Auditor General (Amendment) Act 1993;

Provided further that the Joint Committee shall refrain from inquiring into in public session, or publishing confidential information regarding, any such matter if so requested either by the body concerned or by the Taoiseach or the Minister for Finance; and

(ix) such other matters as may be jointly referred to it from time to time by both Houses of the Oireachtas,

and shall report thereon to both Houses of the Oireachtas.

(3) The Joint Committee shall have the power to require that the Minister for Finance (or a Minister or Minister of State nominated in his or her stead) shall attend before the Joint Committee and provide, in private session if so desired by the Minister or Minister of State, oral briefings in advance of EU Council meetings to enable the Joint Committee to make known its views.

(4) The quorum of the Joint Committee shall be five, of whom at least one shall be a member of Dáil Éireann and one a member of Seanad Éireann.

(5) The Joint Committee shall have the powers defined in Standing Order 83(1) to (9) inclusive.

(6) The Chairman of the Joint Committee, who shall be a member of Dáil Éireann, shall also be Chairman of the Select Committee."

Seanad Éireann on 24 October 2007 *ordered*:

"(1)(a)That a Select Committee consisting of 4 members of Seanad Éireann shall be appointed to be joined with a Select Committee of Dáil Éireann to form the Joint Committee on Finance and the Public Service to consider –

(i) such public affairs administered by the Department of the Taoiseach and the Department of Finance as it may select, including, in respect of Government policy, bodies under the aegis of those Departments;

(ii) such matters of policy for which the Taoiseach is officially responsible as it may select;

(iii) such matters of policy, including EU related matters, for which the Minister for Finance is officially responsible as it may select;

(iv) such related policy issues as it may select concerning bodies which are partly or wholly funded by the State or which are established or appointed by Members of the Government or by the Oireachtas;

(v) such Statutory Instruments made by the Taoiseach and the Minister for Finance and laid before both Houses of the Oireachtas as it may select;

(vi) such proposals for EU legislation and related policy issues as may be referred to it from time to time, in accordance with Standing Order 70(4);

(vii) the strategy statement laid before each House of the Oireachtas by the Taoiseach and the Minister for Finance pursuant to section 5(2) of the Public Service Management Act, 1997, and for which

the Joint Committee is authorised for the purposes of section 10 of that Act;

(viii) such annual reports or annual reports and accounts, required by law and laid before either or both Houses of the Oireachtas, of bodies specified in paragraphs 2(i) and (iv), and the overall operational results, statements of strategy and corporate plans of these bodies, as it may select;

Provided that the Joint Committee shall not, at any time, consider any matter relating to such a body which is, which has been, or which is, at that time, proposed to be considered by the Committee of Public Accounts pursuant to the Orders of Reference of that Committee and/or the Comptroller and Auditor General (Amendment) Act, 1993;

Provided further that the Joint Committee shall refrain from inquiring into in public session, or publishing confidential information regarding, any such matter if so requested either by the body concerned or by the Taoiseach or the Minister for Finance; and

(ix) such other matters as may be jointly referred to it from time to time by both Houses of the Oireachtas,

and shall report thereon to both Houses of the Oireachtas.

(2) The Joint Committee shall have the power to require that the Minister for Finance (or a Minister or Minister of State nominated in his or her stead) shall attend before the Joint Committee and provide, in private session if so desired by the Minister or Minister of State, oral briefings in advance of EU Council meetings to enable the Joint Committee to make known its views.

(3) The quorum of the Joint Committee shall be five, of whom at least one shall be a member of Dáil Éireann and one a member of Seanad Éireann.

(4) The Joint Committee shall have the powers defined in Standing Order 70(1) to (9) inclusive.

(5) The Chairman of the Joint Committee shall be a member of Dáil Éireann."

Report
of
Professor Philip Lane

Report on "Macroeconomic Policy and Effective Fiscal and Economic Governance"

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September 23rd 2010

Abstract

This report provides background analysis of the main types of reforms that can improve macroeconomic stability in Ireland. The main focus is on the conduct of fiscal policy, although other types of policy reforms are also addressed. We highlight some reforms that can improve the quality of macroeconomic and fiscal surveillance. Furthermore, we argue that the adoption of a new fiscal framework can better enable Ireland to achieve long-term fiscal sustainability and implement effective counter-cyclical fiscal policies. The most important elements of a fiscal framework are the adoption of numerical fiscal rules and a substantive role for an independent fiscal council that is charged with the independent monitoring of fiscal policy. While EU-level reforms can contribute to the robustness of a new fiscal framework, the key characteristics of an effective fiscal framework are domestic in nature.

*Preliminary version. In preparation for the Joint Oireachtas Committee on Finance and the Public Service. Email: plane@tcd.ie; Tel.: +353 87 2958 570. I thank a large number of domestic and international colleagues for helpful conversations. This report draws on the lessons of an IRCHSS-funded research project "An Analysis of the Impact of European Monetary Union on Irish Macroeconomic Policy" that I have led over the 2007-2010 period. In the interests of full disclosure, please note that I am also a member of the National Statistics Board and the Council of the ESRI. However, all opinions expressed in this report are mine alone.

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1 Introduction

Around the world, the devastating impact of the global crisis has called into question the established methods of conducting macroeconomic policy. This is especially the case in relation to fiscal policy. For countries with an independent monetary policy, the traditional assignment was that monetary policy could take care of managing business cycle fluctuations, while fiscal policy could be directed towards longer-term objectives. However, it was clear from an early stage of the global crisis that even near-zero interest rates and abundant liquidity provision is insufficient to guarantee stability. Rather, there was a resurgence in fiscal activism, with many governments undertaking stimulus programmes to counteract the global crisis. In so doing, large deficits were incurred and the current concern is whether governments will be able to return to sustainable fiscal paths.

The aim of this report is to provide some background analysis that may help the Committee to formulate its views in responding to the 8 July 2010 request:

"That Dáil Éireann requests the Joint Committee on Finance and the Public Service, to consider the following reports:

- *'The Irish banking crisis: regulatory and financial stability policy 2003-2008,' by the Governor of the Central Bank, and*

- *'A preliminary report on the sources of Ireland's banking crisis', by Klaus Regling and Max Watson,*

which were laid before Dáil Éireann on 9 June 2010; and taking account of the emerging EU proposals relating to fiscal and economic governance, to conclude its deliberations by 30 October 2010 and to publish and report back to Dáil Éireann its findings and conclusions no later than 4 November 2010 on the following key policy lessons in relation to macroeconomic management set out in the report by Klaus Regling and Max Watson:

- *the role of macroeconomic management and surveillance in securing the long-term sustainability of Ireland's economic performance and also in responding on a timely basis to risks and imbalances that may build-up in both the private and the public sectors of the economy, including external imbalances vis-à-vis other euro area members and the funding of any imbalances that might arise;*

- *the role of fiscal policy in securing an appropriate alignment of the national business cycle with monetary conditions in the economy;*

- *the requirement for the design and conduct of budgetary and taxation policies to take account of the cyclical nature of particular revenues as well as their temporary nature in certain circumstances in order to maintain an appropriate and effective tax base; and*

- *the case for the establishment of new institutional structures to provide an independent validation of economic and fiscal projections as well as for the introduction of domestic medium-term fiscal rules."*

Accordingly, this report attempts to present the main lessons from the research literature on this set of issues. In doing so, the report highlights a range of reform options that might improve the quality of macroeconomic policy in Ireland. Throughout, the focus is on the economic analysis of these policy options. An assessment of the broader implications of these reforms for the political system is beyond the scope of this report.

The structure of the report is as follows. Section 2 reviews the role of macroeconomic management in determining the performance of the Irish economy, the quality of macroeconomic surveillance and the coherence between surveillance and policy formation. The

role of fiscal policy in preserving macroeconomic stability is covered in Section 3. Section 4 examines how a formal fiscal framework (including numerical fiscal rules and independent fiscal institutions) might improve the quality of the fiscal process. Next, the report examines emerging EU proposals for economic governance in Section 5. Section 6 pulls together some of the themes covered in the preceding sections in order to provide an overview of the menu of policy options. Finally, Section 7 concludes the report.

2 Macroeconomic Surveillance and Management

The preservation of economic stability requires that the government identify incipient macroeconomic imbalances and address these imbalances with its range of macroeconomic policy tools.

2.1 The Role of Macroeconomic Management

Macroeconomic management is fundamentally important both in providing stability and maximising long-term economic performance.

There is a strong connection between macroeconomic stability and long-term economic performance. Excessive cyclical volatility imposes substantial efficiency and distributional costs. For instance, recessions generate many long-term costs. The lower probability of finding a job during recessions harms the long-term human capital of the unemployed and those newly entering the labour force. Some proportion of those who emigrate during recessions never return, involving a permanent economic and social loss. The increased probability of a firm going out of business during a recession involves destruction of firm-specific (tangible and intangible) capital. Lower profits and tighter access to credit during recessions also means the cancellation or postponement of many investment projects.

In terms of distribution, the employment costs of recessions fall most heavily on those with the weakest attachments to the labour market (the young, part-time workers, immigrants) and those working in cyclically-sensitive sectors (for example, construction and retail). Lower-income cohorts are less likely to have a buffer stock of savings, such that declining incomes more fully pass through to lower consumption levels. Recessions are also especially costly for those in the demographic groups that tend to have the highest net debt burdens.

In addition to recessions, overheating episodes are also costly. In particular, resources are mis-allocated with excessive investment in construction projects and those sectors most sensitive to domestic demand. The upward pressure on economy-wide wage and cost levels leads to a relative shrinkage in the tradables sector. In turn, this imposes long-term costs since losses in market share in international trade are typically hard to reverse and productivity growth in the tradables sector is positively related to activity levels in that sector due to "learning-by-doing" effects.

The boom-bust cycle may be amplified by pro-cyclical credit flows. During boom periods, high asset prices improve the net worth of households, developers and firms and thereby notional collateral available to increase debt levels. In turn, the pro-cyclical expansion in credit leads to over-investment in property and unsustainable levels of consumption, Conversely, the decline in asset values during recessions reduce collateral values

and induce a tightening of credit conditions. This deepens the recession, as investment in the property sector collapses and households cut consumption in order to reduce excessive debt levels. This credit cycle is further amplified if banks fail to maintain an adequate capital buffer, such that the credit crunch during downturns is made more severe due to balance sheet concerns in the banking system.

Furthermore, the boom-bust cycle can also be amplified by pro-cyclical fiscal policies. High tax revenues during boom periods may tempt the political system to increase spending and/or cut tax rates, further adding to the level of domestic demand. Conversely, if fiscal sustainability is threatened and funding conditions tighten during a contractionary period, a government may be compelled to cut spending and raise taxes, leading to a deeper recession.

In addition to the economic efficiency and distributional costs of excessive cyclical fluctuations, economic uncertainty is intrinsically costly. For individuals, uncertainty about income and employment prospects imposes pyschic costs, in addition to making it more difficult to plan for the future. In turn, this may affect occupational choices, with a preference for "safer" sectors, even if this represents a socially-wasteful allocation of resources. Similarly, for entrepreneurs and firms, aggregate volatility may reduce the average level of investment and also mis-direct investment away from high-return but high-risk sectors.

Accordingly, in order to avoid this wide-ranging set of costs, it is critically important that governments target macroeconomic stability as a key policy objective. As a member of the euro area, Ireland has delegated monetary policy to the European Central Bank. A common approach to setting monetary policy is helpful in dealing with European-wide or global macroeconomic shocks. However, it does mean the Irish government cannot use an independent monetary policy or exchange rate policy in order to deal with shocks that affect Ireland differently to other member countries of the euro area.[1] Rather, it must rely on the available domestic policy instruments.

In relation to domestic policies, at the very least, the government should avoid procyclicality in its own fiscal policy. Indeed, as will be discussed later in this report, it may be optimal to adopt an actively counter-cyclical fiscal policy, by which governments selectively raise taxes and cut spending during large-scale booms in order to retain the capacity to cut taxes and increase spending during large-scale recessions.

In addition to a stabilising fiscal policy, it is also essential that government limits procyclicality in credit flows. I do not dwell on this issue, since the responsibility for financial stability is clearly delegated to the central bank and financial regulator. However, I will note that the clear trend at both domestic and international levels is to adopt a more forceful approach to bank regulation. In particular, the "macro-prudential" approach to bank regulation recognises the two-way feedback mechanisms that link macroeconomic stability and financial stability. Accordingly, the implementation of this regulatory approach should contribute to greater macroeconomic stability and fiscal stability by limiting the scale of fluctuations in bank lending. In view of the high macroeconomic and fiscal costs

[1] Whether an independent monetary policy and independent currency is necessarily helpful in achieving macroeconomic stability is open to question. Currency markets are also prone to boom-bust cycles, which can amplify macroeconomic stability. For a small country, international financial flows will tend to be denominated in foreign currency, limiting the effectiveness of currency depreciation in tackling recessions. See Lane (2009) for a more comprehensive analysis of these issues.

of banking instability, it is desirable that there should clearly be very close communication between the central bank and fiscal authorities in order to maintain a strong fiscal overview of developments in the banking system.

A government may also influence macroeconomic stability through its influence on economy-wide wage determination. The government can influence wage dynamics both through its own pay settlements vis-a-vis the public sector but also through national pay agreements. In Ireland, this has been a central component in "social partnership" agreements. In addition, the government also influences the macroeconomic cycle through its other labour market policies (including the level of the minimum wage and the various types of employee protection regulation). I return to labour market policies below.

Finally, it is important to emphasise that it is neither desirable nor possible to fully eliminate macroeconomic cycles. There is a random element in the underlying productivity growth that drives long-term living standards. Some types of economic activity have an intrinsic cyclical pattern, with average efficiency maximised by periods of intense activity followed by more fallow periods. There are periodic shifts in preferences or in environmental conditions that may entail a re-organisation of economic structures, with the transition period characterised by a lower level of measured economic activity.

Most fundamentally, it is not feasible at a technical level for macroeconomic policies to perfectly fine-tune the economy, smoothly eliminating all types of incipient cyclical disturbances. There are considerable information lags and implementation lags which limit the effectiveness of macroeconomic policies. Moreover, policy decisions are taken in a fog of uncertainty, both in relation to the true cyclical state of the economy and in relation to the impact of a given policy intervention. Rather, the main objective for macroeconomic stabilisation policies is to avoid large-scale and persistent cyclical deviations from the long-term sustainable growth path for the economy.

In order to implement stabilising macroeconomic policies, a prerequisite is adequate macroeconomic surveillance in order to identify the current cyclical state of the economy and calculate the distribution of macroeconomic risks. We turn to this topic in the next subsection.

2.2 Macroeconomic Surveillance

Macroeconomic surveillance is conducted by a range of bodies. Within government, the Department of Finance has a primary role but the Central Bank also monitors macroeconomic stability. In addition, the ESRI plays an important role as an independent monitor, with private-sector banks also providing regular analyses of the Irish macroeconomic situation. Independent commentators and academic economists also make contributions on various dimensions of macroeconomic stability, even if full-scale analyses are typically beyond the scope of individual analysts. At an international level, the Irish economy is also monitored by the European Commission, the OECD and the International Monetary Fund, on a semi-annual or annual cycle.

There are several levels to macroeconomic surveillance. In order to identify the cyclical state of the economy, it is necessary to take a view on the sustainable trend growth path for the economy. However, the trend growth rate is itself likely to vary over time, in line with shifts in domestic resources and long-term policies and with shifts in long-term global growth patterns. Accordingly, one basic challenge is to take such shifts into account in

order to provide the best estimate of the current trend path for the economy.

For a given trend, the current level of economic activity may deviate from this long-term sustainable path. A second surveillance task is to assess whether this gap will quickly close or, alternatively, continue to grow in the absence of a policy intervention.

Even if the aggregate level of economic activity is close to the estimated trend path for the economy, a third surveillance task is to assess whether there are underlying risk factors that might trigger a downturn. For instance, the sectoral composition of economic activity may be skewed towards sectors that are more at risk of sudden reversals (such as construction and sectors reliant on domestic demand) and/or the level of aggregate demand may be driven by unsustainably-high consumption and investment levels and/or funded by an excessive current account deficit. Such sectoral or financial imbalances will be reflected in the behaviour of local asset prices (including housing and commercial property prices) and in the growth of credit aggregates. Accordingly, macroeconomic surveillance requires a broad-ranging assessment of the distribution of macroeconomic and financial risks facing the economy. That is, the problem is not simply determining the overall cyclical profile but also the "long-tail" risks embedded in sectoral and financial patterns.

No single approach is sufficient in conducting macroeconomic surveillance. For medium- and longer-term projections of the sustainable growth path for the economy, this requires the design and estimation of quantitative macroeconomic models. Macroeconomic models are also helpful in assessing short-term conditions in the economy but short-term conjunctural analysis also necessarily relies on statistical models of short-term momentum dynamics in the economy and "expert judgement" that synthesises information across a broad range of indicators.

In addition, the current generation of macroeconomic models do not adequately take into account the macroeconomic risks that are generated by the financial sector. In part, this limitation relates to the difficulty of integrating the potential amplification of macroeconomic shocks by the special features of the banking system. In part, this limitation relates to the incompatibility of capturing destabilising mechanisms (such as panics in financial markets) in fundamentally-stabilising macroeconomic model systems. While there are now major global efforts to improve the treatment of the financial sector in macroeconomic models, it is important to supplement model-based macroeconomic analysis with complementary analyses of financial-sector aggregates and risk factors. In this regard, it is important to fully incorporate the output from the financial-stability reviews conducted by the central bank into broader macroeconomic surveillance.

Much of the focus in assessing the outputs from such surveillance analyses is on the "most likely" projection for the economy. However, it is also important to fully internalise the distribution of risks around the central projection. In particular, in view of the high costs of negative macroeconomic and financial shocks, it is essential that policymakers understand the evolution of the downside risks that are highlighted by macroeconomic surveillance exercises. To this end, the design and communication of macroeconomic surveillance reports should explicitly deal with the range of possible scenarios, in addition to reporting the central projections.

At international and domestic levels, a key challenge is to improve the quality of macroeconomic surveillance. In addition to the improved integration of financial factors into macroeconomic models, an important priority for international surveillance is

to improve understanding of the international financial transmission of shocks. Furthermore, an important advantage of international-level surveillance is that it can identify common risk factors that simultaneously emerge across a range of countries. Accordingly, it is important that domestic-level surveillance fully incorporates the risks identified by international organisations.

However, it remains the case that the primary responsibility for domestic macroeconomic surveillance remains with domestic agencies. Moreover, the international agencies heavily rely on domestic surveillance reports as inputs into European-level and global-level surveillance activities. At a practical level, the international agencies can only allocate limited resources to analysing specific developments in individual small economies. Moreover, the main costs of macroeconomic errors are borne domestically, such that the main responsibility to ensure high-quality macroeconomic surveillance resides with domestic authorities.

In relation to domestic surveillance, it is open to question whether there has been sufficient investment in developing quantitative models of the Irish economy. While the ESRI bases its medium-term projections on a full-scale estimated model of the Irish economy (the HERMES model), it is not clear how extensively models are employed in the projections published by the Department of Finance, Central Bank and private-sector entities.[2]

Model-based projections have the advantage that the mechanics of the underlying model can be inspected by outside experts. In this way, if a model fails to take into account structural changes in the economy, external critiques can put pressure on the model builders to undertake suitable revisions. By contrast, it is difficult to evaluate the projections published by the Department of Finance and the Central Bank, since no underlying model-based analysis is published.

Accordingly, improved transparency about the methods employed to generate economic projections can improve macroeconomic surveillance, since the quality of the underlying assumptions and model specifications can be subjected to external review. Through an open debate about model development, potential fragilities can be identified and errors minimised.

In addition, an important priority is the development of new quantitative models of the Irish economy. Although the ESRI HERMES model has many positive features, this type of model is limited by its dependence on historically-estimated relations across key macroeconomic variables. During periods of structural change, such historically-estimated equations may prove to be an inadequate guide to future developments. Accordingly, it is desirable that other macroeconomic models also be developed that follow different approaches. It is only by maintaining a suite of macroeconomic models can we be confident that projections are robust to variation in technical modelling assumptions.

Macroeconomic models are of limited value if there is an insufficiency of adequate macroeconomic data. While the Central Statistics Office has a very good reputation for high-quality statistics, it is also the case that limited resources and inadequate coordination across State agencies means that there is a scarcity of timely data in relation to a number of key areas. For instance, the earnings data are insufficiently detailed to provide

[2]The Central Bank maintains a quantitative model of the Irish economy, which feeds into the European Central Bank's overall analysis of the area-wide economy.

clear guidance on the full distribution of wage dynamics across the economy. The lack of a survey of consumer finances until now means that key financial dynamics at the household level are not adequately tracked. Similarly, the inadequate data on the distribution of transacted housing prices and commercial property prices has restricted analysis of the macroeconomics of the boom-bust cycle in the property sector. Accordingly, improved data coverage is an important requirement for improved macroeconomic surveillance.

2.3 Coherence Between Surveillance and Policy Formation

In addition to improvements in the quality of macroeconomic surveillance, it is also essential that the lessons from macroeconomic surveillance feed into policy formation.

This could be facilitated by a revision in the domestic fiscal calendar, with the budget process split into three stages. First, there would be an annual Oireachtas debate about the macroeconomic situation facing the country. This debate could be informed by the publication of an annual "macroeconomic stability" report that would set out the projected near-term and medium-term macroeconomic projections, together with a full analysis of the distribution of risks around the central projections. Second, following this debate, the government would determine the appropriate budget balance to maintain macroeconomic stability. Third, once the target for the overall budget balance is determined, the Minister for Finance would negotiate with individual ministries regarding spending levels and make decisions about taxation subject to the hard constraint of the previously-determined target for the budget balance.

Improved coherence between surveillance and policy formation could also be supported by a formal fiscal framework that would include a monitoring function that would evaluate the appropriateness of fiscal policy for the prevailing macroeconomic environment. Policy coherence would also be improved by the adoption of some version of the "European semester" proposal by which the macroeconomics of the budget is debated at an EU level at an early stage in the budget cycle.

Furthermore, the annual "macroeconomic stability" report should feed into the macroprudential risk assessments conducted by the central bank. In addition, it should also form the basis for negotations over public sector pay and, more broadly, the determination of national pay agreements. More generally, such a report could also improve public awareness and the quality of the media debate about macroeconomic performance and the optimal fiscal strategy.

3 Fiscal, Budgetary and Taxation Policy

As indicated, fiscal policy is the central policy tool under monetary union to ensure national macroeconomic stability. This section will cover in detail how fiscal policy can be deployed to manage macroeconomic risks. It will explain how fiscal policy can be analytically divided between the a long-term component and a cyclical component. The long-term component is the stuff of fundamental political debate since it determines the level of income redistribution across society and the balance between public and private spending. In contrast, the cyclical component is more technocratic in nature since the variation in the budget over the course of the business cycle does not alter the long-term

trend. As such, to a large extent, the correct cyclical policy is independent of the debate about the appropriate average level and composition of public spending and level and composition of taxation.

As noted above, a prerequisite for effective cyclical fiscal policy is long-term fiscal sustainability. This requires a sustainable tax base that is sufficient to cover the politically-determined trend level of public spending. If fiscal sustainability is secured, then there is scope for the government to minimise excessive fluctuations in income and employment levels by running counter-cyclical policies.

A key target of fiscal policy is the overall budget balance - setting the appropriate level for the general government budget balance at each point in the cycle. This is a substantial issue and will be covered in some detail in terms of an appropriate conceptual framework. This will distinguish between the overall balance, the cyclical balance and the structural balance. It will cover whether the budget balance should be adjusted for the level of public investment and the level of outstanding public debt. It will also cover the relation between the level of inflation and the appropriate budget balance (the level of tax revenue is quite sensitive to the level of inflation or deflation).

However, individual components of fiscal policy are also highly relevant - for instance, cyclical variation in the tax rates on housing, employment, consumption and investment can 'mimic' the role of currency devaluation in macroeconomic adjustment. The appropriate use of the tax code in macroeconomic management will be extensively discussed. Similarly, the pros and cons of cyclical variation in the level and composition of public spending will be covered.

The funding strategy of the government also is influential in preserving macroeconomic stability. In part, this relates to debt management (run by the NTMA in Ireland) in terms of the optimal maturity profile of sovereign debt and the management of rollover risk. However, it also relates to role of asset funds. Historically, the management of foreign-currency reserves was an important component of macroeconomic stabilisation policies. While foreign-currency reserves are not relevant for a member of a monetary union, a rainy-day fund of liquid assets can be helpful in promoting stability. In addition, long-horizon funds (such as the National Pension Reserve Fund) can play an important role in ensuring fiscal sustainability.

3.1 Long-Term Fiscal Sustainability

Long-term fiscal sustainability is a prerequisite for effective cyclical management of the economy, since a high and/or upwardly-trending debt level constrains a government's ability to respond to macroeconomic shocks. This corresponds to the IMF concept of "fiscal space" (Spilimbergo et al 2008, Ostry et al 2010). A government that is credibly committed to long-term fiscal sustainability can run larger deficits in the face of adverse shocks since the markets understand that the fiscal expansion will be unwound once economic recovery takes hold. In contrast, a government lacking such credibility will experience an increase in the debt spread if it attempts fiscal expansion, since markets are unsure as to whether the deficits might remain permanently higher and thereby threaten fiscal sustainability.

The basic principle underlying fiscal sustainability is that there is consistency between the long-term trends for public spending and taxation. In turn, in relation to public

spending, an important factor is the long-term level of public debt which determines the interest servicing burden. All else equal, a high debt servicing burden implies some combination of lower non-interest spending and higher taxation.

If the projection for tax revenues over a long horizon is sufficient to cover interest payments and non-interest public spending and the public debt ratio is projected to stay below a ceiling value, then the fiscal position is sustainable. Otherwise, domestic residents and international markets realise that major adjustments are required if debt default is to be avoided. The fiscal uncertainty and default risk generated by a non-sustainable fiscal position is economically damaging and expensive in terms of higher debt funding costs.

3.1.1 Long-Term Debt Level

In principle, the long-term ratio of public debt to trend GDP should reflect several factors.[3] In one direction, the inherited level of public debt may in part be the result of high historical levels of public investment that provide benefits to the current generation through the economic and social returns on the stock of public capital.

However, the inherited level of public debt may also be the result of prior policy errors or disastrous episodes that pushed the level of public debt to an undesirably high level. Excessively-high public debt is undesirable for several reasons. First, the enhanced default risk associated with excessively-high debt pushes up interest costs on public debt. In addition, it may increase interest costs for domestic banking banks and the domestic private sector, in view of the risk that sovereign default might lead to correlated defaults or other types of disruption in other parts of the domestic system. More generally, an excessively-high debt level increases fiscal uncertainty, since households and enterprises are unsure about how the high level of debt will be eventually paid down (for instance, the mix between tax increases and spending reductions). In addition, an excessively-high debt level constrains a government's ability to respond to negative economic shocks due to the lack of fiscal space.

In the other direction, it may be desirable and inter-generationally equitable to target a reduction in the long-term level of debt if it is anticipated that future incomes will be lower and/or future levels of public expenditure will be higher. In some countries, demographic trends imply that the total population is set to shrink in the coming decades, such that future aggregate incomes will be lower even if per-capita productivity growth is positive. More generally, population ageing in many countries means that it is predictable that age-related public spending will increase in the future, in relation to healthcare, social services and pensions. While population ageing will also require many other policy changes, it is efficient and equitable to partly front-load the cost of higher future spending through reducing the level of public debt and/or accumulating public financial assets.

3.1.2 Long-Term Public Spending

Each government may set a new long-term target for the ratio of discretionary public spending to trend GDP. This ratio will vary according to preferences for public services

[3] In what follows, I foucs on fiscal variables expressed as a ratio to GDP. In view of the large gap between GDP and GNI (gross national income) for Ireland, the target ratios for GDP should take into account that national income is far below the level of national production, mainly due to the importance of foreign-owned capital in domestic production.

relative to private spending, the desired extent of redistribution and the inherited level of public debt. In addition, this ratio is subject to trend factors such shifts in the population's demographic profile.

Once this target spending ratio is attained, the policy objective is to maintain this ratio "through the cycle." Since the target is expressed as a ratio to trend GDP, the ratio of discretionary public spending to actual GDP falls during boom periods but increases during recessions, which is a stabilising pattern. Moreover, non-discretionary types of public spending (most obviously, unemployment benefits) have a natural counter-cyclical pattern, with the numbers of claimants falling during booms and increasing during recessions.

However, if a new government inherits a spending ratio that is deviation from its desired target, it needs to announce a transition plan by which the level of spending converges to its target over a multi-year horizon. By having an explicit transition plan, public and investor expectations about the long-term level of public spending are anchored, reducing uncertainty and improving macroeconomic stability.

3.1.3 Long-Term Tax Revenues

The key to fiscal sustainability is that the target for the ratio of tax revenue to trend GDP is clearly consistent with the target ratios for public spending and public debt.[4] High trend ratios for public spending and/or public debt require a high trend ratio for tax revenues. Conversely, a low trend ratio for tax revenues is only sustainable if it is accompanied by low trend ratios for public spending and/or public debt.

Once a sustainable trend tax ratio is attained, the policy objective is again to maintain this ratio "through the cycle." Since the ratio is expressed as a ratio to trend GDP, the positive elasticity of taxes to economic activity levels means that the ratio of tax revenues to actual GDP will increase during boom periods and decline during recessions, which is a stabilising pattern.

In calculating the long-term ratio of tax revenues to trend GDP, it is important to assume that asset prices, inflation, the level of private spending and the sectoral composition of output are also at trend values, since the level of tax revenues depends on these factors in addition to the level of GDP. If asset prices are temporarily high or inflation is temporarily high or the the level of private spending is temporarily high or the composition of output is temporarily skewed towards tax-rich sectors, tax revenues will rise above trend values. Symmetrically, tax revenues will fall below trend if any of these variables enters a below-trend phase. Accordingly, tax revenues can deviate from trend values for multiple factors but the transitory nature of these deviations must be clearly recognised.

If a new government inherits a tax ratio that is a deviation from its desired target, it needs to announce a transition plan by which tax revenues converge to its target over a multi-year horizon. As is the case for public spending, an explicit transition plan for taxes provides macroeconomic stability by reducing uncertainty about the future course for taxes.

Accordingly, it is essential that the government can clearly demonstrate the consistency between its target tax ratio and the targets for public spending and the public debt. As

[4]For simplicity, I refer to tax revenues throughout this report but this should be broadly interpreted to also include most types of non-tax revenue.

has been made clear by the current crisis, the observed ratio of tax revenues to GDP may provide a misleading guide to the trend ratio during boom periods, especially if the boom is characterised by high asset prices, high private spending and a shift in economic activity towards the tax-rich construction sector.

The stability of the tax base requires detailed modelling of tax revenues in order to clearly identify the relative contributions of cyclical and trend factors in determining revenues in each period. Moreover, a sustainable tax base must draw sufficiently on less-cyclical sources and from a broad tax base in order to guard against excesssive reliance on any one source of revenue. Finally, it is essential that transitory revenue windfalls are "banked" and do not form the basis for permanent increase in public spending. Only if this is the case will the government be able to allow the ratio of tax revenues to GDP to decline during recessions without triggering adverse reactions in funding markets.

3.1.4 Summary on Fiscal Sustainability

As indicated above, long-term fiscal sustainability is important as an independent policy objective. A non-sustainable fiscal trajectory raises economically-damaging uncertainty and increases the risk premium charged on Irish government debt. A systemic approach to announcing target long-term ratios for public spending, tax revenues and public debt and detailing the plans required to achieve these ratios is centrally important in communicating that the fiscal position is sustainable. We return in the next section to the potential role of a formal fiscal framework in underwriting such commitment to fiscal sustainability.

In addition to its independent value, fiscal sustainability is also a necessary condition for counter-cyclical fiscal policy to be effective in providing macroeconomic stability. International markets will tolerate cyclical fluctuations in public spending, tax revenues, the budget balance and the debt level if there is a clear commitment that the long-term target ratios will be attained on a "through the cycle" basis. Moreover, counter-cyclical stimulus packages that temporarily raise spending or reduce taxes are most effective in boosting private spending if it is clearly understood that these packages will be withdrawn once the economy recovers from a cyclical slump. Otherwise, the impact of such packages will be weakened by the adverse impact of anticipated increases in the future tax burden on consumption and investment levels.[5] In related fashion, if a temporary package is not expected to be reversed, funding markets may increase the risk premium on Irish government debt, diminishing the impact of the intended stimulus.

In the discussion below on counter-cyclical fiscal policy, I assume that government has demonstrated commitment to fiscal sustainability. Under this assumption, counter-cyclical fiscal policy has the potential to contribute to macroeconomic stabilisation.

3.2 Counter-Cyclical Policies

There are both macroeconomic and microeconomic dimensions to counter-cyclical fiscal policy. The macroeconomic dimension primarily revolves around determining the appropriate budget balance for the given point in the business cycle. The microeconomic dimension relates to the strategic timing of particular taxes and subsidies to "lean against the wind" in responding to destabilising shocks. In addition to fiscal instruments, this

[5] See Corsetti et al (2009) for a detailed analysis of this point.

section also briefly discusses some other types of policies that may contribute to counter-cyclical stabilisation.

3.2.1 Macroeconomics of Counter-Cyclical Fiscal Policy

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.

If fiscal policy is anchored by a set of long-term targets for spending and taxes, there is a strong automatic momentum for the fiscal balance to move in counter-cyclical fashion. Since discretionary spending is set at its target trend level, the ratio of such spending to GDP naturally falls during boom periods. Moreover, non-discretionary spending is naturally counter-cyclical since the numbers of claimants varies in a counter-cyclical manner.

On the revenue side, tax rates are set to attain the target trend ratio of taxes to GDP. During boom periods, tax revenues rise above the trend ratio but fall below the target during recessions. Accordingly, tax revenues move in a naturally pro-cyclical fashion.

Taken together, counter-cyclical spending and pro-cyclical revenues means that the fiscal balance will automatically move in a counter-cyclical manner. The strength of such "automatic stabilisers" varies across fiscal systems in line with differences in the size of public spending relative to GDP and the elasticity of spending and taxes with respect to cyclical factors.

It is important to appreciate that cyclical variation in tax revenues depends on the specifics of each particular boom-bust episode. In particular, the level of tax revenues depends not only on GDP but also on the level of aggregate spending, the inflation rate, asset price dynamics and the sectoral composition of output. If an output boom is accompanied by a high level of aggregate spending (such that there is an expansion in the current account deficit), high domestic inflation (for instance, due to high demand for locally-produced goods and services), asset price appreciation and a shift in activity towards tax-rich sectors (such as property), then tax revenues will grow very quickly relative to GDP. Equally, however, the subsequent downturn will be characterised by a decline in tax revenues that is far in excess of the decline in GDP.

To the extent that the windfall tax revenues are recognised as transitory and are "banked", such volatility in tax revenues is not in itself too problematic. Rather, the difficulties arise if the windfall revenues are inaccurately interpreted as permanent in nature and/or if there are political economy problems in running the super-large surpluses that would be implied by a strategy of banking all the windfall surpluses.

Although it is easy to state the principle that there should be a clear distinction between permanent and temporary sources of tax revenues, its implementation is not straightforward. In particular, it is not easy to to decompose output between cyclical and trend components. Similarly, it is very challenging to cleanly differentiate between transitory and permanent shifts in spending levels, inflation, asset prices and the sectoral composition of output.

While the trend-cycle decomposition is a difficult challenge for all countries, it is especially difficult for a small and highly open economy such as Ireland. 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.

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.

These considerations mean that 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. Accordingly, it is important to recognise that such estimates are necessarily imprecise and to make fiscal plans that are robust to such uncertainty.

In order to obtain the best possible range of estimates for the cyclical state of the economy, high-quality macroeconomic surveillance is required, as was discussed above. Moreover, understanding the cyclical variation in tax revenues requires parallel fiscal surveillance in view of the multi-factor determinants of the relation between the macroeconomic cycle and the fiscal cycle. Such fiscal surveillance involves the building and maintenance of quantitative public finance models that take into account the different forces driving tax revenues. In addition, it should draw on high-quality revenue data which identifies the relative contributions of different types of activities, different types of spending and different income cohorts in determining the time variation in tax revenues. The goal of such fiscal surveillance is to provide an analytical foundation that can better identify the split between permanent and cyclical components in tax revenues.

Still, even with top-grade surveillance, fiscal policy decisions must be taken in an environment of considerable uncertainty about macroeconomic and fiscal conditions. The existence of such uncertainty calls for a prudential bias in the setting of fiscal policy, in view of the costs of excessive optimism and the importance of providing insurance against downside risks.

For instance, one particular type of downside 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 lead 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. During the expansion phase, the reversal risk may be low for a given planning period but it 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.

Under a prudential approach to fiscal policy, the government should be slow to upwardly revise its estimates of trend output growth and trend tax revenues in order to guard against excessive optimism in setting fiscal policy. However, in view of the asymmetric distribution of risks, it should move more quickly to downwardly revise its trend estimates if there are sufficient indications of a trend decline in output growth or tax

revenues. Furthermore, a prudential approach to fiscal policy may also involve the targeting of a structural surplus and a sufficiently-low long-term public debt level in order to preserve the fiscal space that may be required in the event of an especially severe negative shock.

3.2.2 Microeconomics of Counter-Cyclical Fiscal Policy

In addition to the macroeconomic role of fiscal policy, the government can strategically deploy particular tax and subsidy instruments to contribute to stabilisation.

For instance, private consumption and investment levels may be "smoothed" by tax rates that can be raised during overheating episodes and lowered during slumps.[6] Similarly, taxes on employment (such as employer PRSI) could move in a counter-cyclical fashion. The lower tax rate during recessionary phases relative to expansionary phases provides an incentive to bring forward spending plans, thereby acting as a stimulus to private spending. Similarly, the higher tax rate during the expansionary phase provides an incentive to delay spending plans, thereby cooling down the economy.

For shallow or transitory cyclical shocks, it is probably not worthwhile to invoke shifts in such tax rates in view of the implementation lags. However, cyclical variation in tax rates can be helpful in responding to severe episodes in which the deviation from trend output is projected to be large and persistent or when there is evidence of emerging financial or external imbalances.

In addition to economy-wide taxes, the government may also adjust sector-specific taxes if there is a danger that particular sectors are growing too rapidly. For instance, an increase in property-related taxes can be temporarily raised to cool down an overheating construction sector, with a cut in such taxes stimulating activity during below-trend phases.

The key in employing such microeconomic instruments for stabilisation purposes is the temporary nature of these strategic tax interventions. Accordingly, these can only be effectively deployed if the fiscal process is sufficiently robust that lobbying by special interest groups does not convert temporary tax incentives into quasi-permanent fixtures. Again, the risk of such lobbying pressure means that there are important advantages to a formal fiscal framework that can help a government maintain its focus on the original motivation for such a temporary intervention.

3.2.3 Management of the Fiscal Balance Sheet

Historically, the main focus in relaton to the fiscal balance sheet has been on the gross scale of the public debt. However, it is increasingly appreciated that more active balance sheet management can contribute to both long-term fiscal sustainability and counter-cyclical fiscal stabilisation.

In relation to long-term sustainability, the accumulation of a long-term reserve fund can be a useful device in pre-funding higher future expenditures, such as the costs of an ageing population. In Ireland, this role is taken by the National Pension Reserve Fund. In relation to counter-cyclical fiscal stabilisation, a rainy day fund holding a portfolio of

[6] Positive taxes during booms could even be replaced by negative taxes (i.e. subsidies) during slumps.

liquid assets may provide insurance against the risk that that the government could not obtain affordable financing from international markets during severe downturns.

Finally, in terms of public debt management, there is a case for issuing inflation-indexed 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; 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.

3.2.4 Labour Market Policies

For a variety of reasons, there is deep resistance to downward flexibility in nominal wages (see Lane 2009, 2010 for more detailed discussions). 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.

Despite the loss of the devaluation option, joining the euro area did not prompt any re-design of employment contracts. As a result, the substantial pay reductions in the public sector during the current crisis required special legislation and the risk of such pay cuts was largely unanticipated during the pre-crisis boom period.

There is a strong case for looking at new types of public sector contracts that would explicitly allow for the risk that nominal pay levels may occasionally need to be reduced in response to macroeconomic events. One option is a two-part pay scheme by which part A of a salary would be fully protected against downward adjustments but part B of a salary would be a state-contingent payment. The guaranteed part A component would provide the employee with a level of income insurance for planning purposes. In contrast, the part B component 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.

Clearly, 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.

Even if such "macroeconomic" clauses were not formally added to employment contracts across the economy, there is a strong theoretical case that national pay agreements can provide a mechanism to achieve the coordinated shifts in economy-wide pay levels that are required in the event of large macroeconomic shocks. However, this has not proven effective in Ireland during the current crisis. Whether a new type of national pay agreement could be designed that would promote macroeconomic stability is beyond the scope of this report.

4 The Fiscal Framework

There is a strong international trend towards the establishment of formal fiscal frameworks. A fiscal framework is characterised by some combination of four elements: (a) reform to the budget process; (b) a medium-term budgetary framework; (c) numerical fiscal rules; and (d) a formal policy role for independent fiscal institutions. By setting fiscal policy within the constraints imposed by a formal fiscal framework, the hope is that fiscal decisions will take into account a longer horizon and will be more insulated from the behaviourial traps and political distortions that threaten long-term fiscal sustainability and induce destabilising procyclicality in fiscal policy.

Although the previous Section has demonstrated that there is a very strong economic case for operating fiscal policy in a counter-cyclical pattern, many countries have found it difficult to run fiscal policy in a stabilising manner. Rather, fiscal procyclicality has been evident in many cases (see, amongst others, Lane 2003 and Agnello and Cimadomo 2009). A procyclical fiscal pattern is destabilising, contributing to overheating pressures during good times and aggravating the costs of recessions during bad times.

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 pro-cyclical funding explanation is that a sufficiently far-sighted political system would

maintain a liquid 'rainy day' fund 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. One type of political distortion is typically labelled as the "common pool" problem - individual voters or pressure groups do not take into account the full cost of individual spending proposals. In relation to the business cycle, the outcome is the "voracity effect" mechanism: a positive income shock leads to more intense lobbying by each powerful group (Tornell and Lane 1999).[7] If the level of centralised control over the budget is weak, the collective outcome is that spending patterns are procyclical. In contrast, a centrally-controlled fiscal system does not exhibit such a procyclical pattern and spending is less volatile than income under this first-best benchmark.

A common feature of these political economy explanations is that 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 independent fiscal institutions and binding fiscal rules. 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. As a result, many countries have taken purposeful steps to adopt fiscal frameworks that are designed to improve long-term sustainability and the cyclical behaviour of fiscal policy.

I also note that the "self-restraint" characteristic of a formal fiscal framework is also helpful in combating the types of cognitive biases and self-control problems that have been highlighted in the increasingly-popular behaviourial economics literature. In the context of fiscal policy, there are powerful tendencies to be excessively optimistic about future growth prospects, which encourages a more lax attitude towards fiscal control. By imposing extra discipline on the formation of fiscal policy, a formal fiscal framework can help counter such tendencies.

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, long-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 accomodated by the specification of a transition plan that specifies how long-term revenues will be adjusted to match the new desired long-term level of government expenditure.

[7] See also Talvi and Vegh (2005) and Alesina et al (2008).

In what follows, I cover the reform agenda across the four constituent elements of a formal fiscal framework. Moreover, I relate this general agenda to the specific features of the Irish fiscal process.

4.1 The Budgetary Process

The design of the budgetary process may influence fiscal outcomes. One basic principle is that there is centralised control of the overall budget target - the budget balance, the overall level of spending and the overall level of tax revenue. Otherwise, in a fragmented fiscal system, no individual power bloc has the incentive to exercise self-control, since each may hope that the burden of budgetary adjustment is borne by other groups.

Such problems are especially contentious in federal political systems and in systems in which budgetary power is split between the executive and the parliament. However, even under the Irish political system, the design of the budgetary process still matters.

To ensure centralised control, one approach is to delegate final authority to the finance minister or a “star chamber” consisting of a small number of ministers. Especially for coalition governments, another approach is to reach a high-level cross-party agreement on the overall budget parameters and the allocation of spending across departments.

In negotiating with individual departments, the asymmetry of detailed information about spending programmes between departmental officials and finance officials means that it is difficult to achieve spending control if the starting point for bargaining is determined by the level of spending required to maintain the existing level of services. Rather, performance-based budgeting or zero-based budgeting techniques represent some alternative approaches by which it may be more feasible to avoid drift in expenditure levels. To implement such approaches, this requires centralised oversight and monitoring of the effectiveness of individual spending programmes, increasing the accountability of each department in delivering public services.

4.2 Medium-Term Budgetary Framework

A medium-term budgetary framework serves a number of purposes. First, in relation to the overall budget balance, the commitment to a multi-year plan reduces uncertainty about future fiscal developments. This is reassuring not only to financial markets but also to households and enterprises that must make multi-year economic plans.

Second, in relation to a multi-year framework for public spending, a multi-year budget for each department improves efficiency by allowing each department to make longer-term spending plans rather than focusing on an annual horizon. Similarly, a multi-year framework for the capital programme enables public investment to be planned in a more stable environment.

For a medium-term budgetary framework to be effective, it must be the case that controllable overruns in one year are offset by under-spending in subsequent years. Otherwise, the multi-year framework is purely notional and provides little discipline relative to a purely annual budget cycle.

Since it is difficult for governments to enforce such multi-year discipline, the implementation of a medium-term budgetary framework may be facilitated by the adoption of a set of fiscal rules. This is the subject of the next subsection.

4.3 Fiscal Rules

As was discussed above, long-term fiscal sustainability is the sine qua non for an effective fiscal role in macroeconomic policy management. The adoption of numerical fiscal rules is increasingly popular as a commitment device to help governments achieve and maintain sustainable fiscal positions.

There are different types of numerical fiscal rules. In decentralised fiscal systems, there are often extensive rules limiting the fiscal discretion of sub-national units of government in order to avoid common pool problems. In relation to the central government or general government, an important class of rules relates to the overall budget balance. However, expenditure rules are in place in a number of countries, while it is also possible to envisage rules relating to tax revenues. Finally, numerical rules may also be specified in relation to the management of the government's financial balance sheet.

As noted, the main objective of numerical fiscal rules is to ensure the maintenance of a sustainable fiscal position. For rules to be effective, a desirable property is that governments find it costly to flout the rules. This can be achieved by giving legislative (or even constitutional) backing to the rules. It also can be achieved by having an independent agency monitor compliance with the rules - this is further discussed below. An additional mechanism is to impose some type of formal sanction in the event of non-compliance. Finally, even if there is no formal legislative basis for a rule, a government will still suffer a reputational loss if it fails to adhere to its own self-announced rules.

In what follows, I focus on national-level fiscal rules. In addition, Ireland is subject to the rules of the EU-level Stability and Growth Pact (SGP). However, the SGP rules are relatively weak, in that the main focus of the SGP is on avoiding excessive deficits and excessive debt levels. In particular, the SGP is not very helpful in providing numerical guidelines for the operation of fiscal policy during periods in which a government is far from the deficit and debt ceilings. I return to EU-level rules in the next section.

4.3.1 Types of Fiscal Rules

Since the budget balance and the level of public debt are the main proxies for long-term fiscal sustainability, many fiscal rules relate to the behaviour of these variables.[8]

In terms of debt-related rules, imposing a target for the level of public debt may have value but requires ancillary rules on the budget balance in order to ensure convergence towards the target debt ratio. In addition, as was discussed in the previous section, the optimal level of public debt is not uniquely determined, since it depends on a host of factors and preferences across current versus future generations. Accordingly, the most common type of debt rule is a ceiling rule, since there is more consensus that an excessively-high level of public debt is damaging. The logic of a ceiling rule is that it should specify constraints on the budget balance that will ensure public debt stays below the ceiling or, in the case of violation, guides public debt back below the ceiling. However, if the current level of public debt is far below the ceiling, such constraints are very weak.

For such reasons, it is important to complement a debt rule with a budget balance rule.[9]

[8] International Monetary Fund (2009) provides a comprehensive guide to the fiscal rules literature.

[9] In what follows, I focus on the general government balance, which is the measure that is most widely monitored by international agencies and is the concept relevant for the SGP.

A simple type of budget balance rule is to prohibit any type of deficit spending. However, that is clearly destabilising, since a government would be forced to cut spending and raise taxes during recessions while increasing spending and cutting taxes during booms.[10] Rather, the main focus is on rules that target budget stability over a medium-term horizon.

In terms of an operational rule that seeks to deliver medium-term budget stability, one option is to require that the projected structural balance in each year is set at a target value.[11] This has the merit of transparency. While a structural balance rule allows the automatic stabilisers to operate over the cycle (such that the overall budget balance moves over the cycle in a stabilising manner), it does not permit the government to undertake discretionary fiscal interventions to smooth the cycle. While the operation of the automatic stabilisers may be a sufficient response to shallow and transitory output shocks, these may be inadequate in coping with large, persistent output shocks. Moreover, the automatic stabilisers may provide little protection against other types of macroeconomic risks, such as asset price bubbles, distortions in the sectoral composition of output or excessive net capital flows.

Accordingly, an alternative approach is to specify that the target structural balance is met "over the cycle". This allows the government to deviate from the structural target, so long as the sum of the deviations cancel out over the cycle. This provides extra fiscal flexibility. While such flexibility may be deployed to improve macroeconomic stability, the risk is that it can be abused by a government as a device to weaken fiscal discipline. Accordingly, such a rule is most effective if it is closely monitored by an independent fiscal policy council, as is described in the next section.

Since such rules are typically specified in terms of projected fiscal balances, this requires that the quality of macroeconomic and fiscal projections be of the highest quality, as was discussed in the previous section. In view of the innate uncertainty in making projections, it is inevitable that fiscal outcomes will not match the planned targets. The key is to ensure that there are no biases - that is, fiscal outcomes should be as likely to exceed the planned target as to fall short. Moreover, this also requires that there are mechanisms to address sustained deviations of realised fiscal balances from the projected fiscal balances. For instance, the new German rule specifies that the government must take corrective action if the cumulative value of such deviations exceeds a threshold floor value.

In setting the target for the structural balance, a zero balance is a natural baseline. However, the optimal target will vary with the inherited level of public debt, the scale of projected future expenditure growth, the state of the public capital stock, the volatility of the economy and the degree of uncertainty about fiscal projections. An excessively-high level of public debt may indicate that the government should run a structural surplus in order more quickly reduce the debt-GDP ratio. If ageing-related expenditures are projected to grow quickly in the future, a structural surplus target can help limit the scale of future tax increases. In the other direction, if the public capital stock is below its target value, a temporary phase of structural deficits may be justified.

[10]Consider the hypothetical scenario by which the Irish government tried to balance the budget during the current crisis.

[11]For simplicity, I will treat the cyclically-adjusted balance and the structural balance as equivalent concepts. In practice, the cyclically-adjusted balance also includes one-off items.

For prudential reasons, a structural surplus target may be valuable, since this reduces the probability of the fiscal balance turning very negative in the event of a crisis and triggering elevated funding risk. This prudential motivation is stronger for more volatile economies and where fiscal projections are more uncertain.

Accordingly, it may make sense to re-calibrate the the target structural balance on a periodic basis to take into account medium-terms shifts in the level of public debt, the relative balance of current versus future spending and the scale of economic and fiscal volatility. However, the re-setting of the target should not be too frequent, in order to maintain the medium-term nature and stability of the target.

In relation to public spending, a government may adopt a numerical expenditure rule for several reasons. First, the level of public spending is mostly at the discretion of the government, such that it is more controllable than a budget balance target. In this way, a public spending rule may be an indirect proxy in attaining an underlying target for the fiscal balance.

Second, an expenditure rule may be an effective way to ensure that the government sticks to its long-term target for the ratio of public spending to trend GDP. For instance, if public spending is initially at its target value, a government might commit that annual public expenditure growth follows this trend path. In turn, this would provide overall discipline in contending with the spending requests from each ministry, since each individual request must be addressed in the context of the target rule for aggregate expenditure growth.

In specifying such an expenditure rule, it is important to allow for the unpredictability of non-discretionary types of public spending which are driven by the number of claimants. It is also important to specify the remedy for non-compliance. For instance, over-runs in one period might invoke a subsequent period of below-trend expenditure growth in order to ensure convergence to the trend path.

The cyclical volatility of tax revenues means that revenue-based rules are not common. However, European Commission (2009) has advocated the greater use of revenue windfall rules, since the historical tendency has been for transitory windfalls to be dissipated in increased spending or unsustainable tax cuts. Such a windfall rule might specify that a revenue flow in excess of the projected level should be used to pay down debt or parked in a rainy day fund. Over time, if the projected trend path for tax revenues is revised upwards (for instance, if there is an upward revision to the trend output growth for the economy), this revenue overshoot can be reimbursed to taxpayers or used to opportunistically reduce public debt on a permanent basis.

In relation to the government's financial balance sheet, Ireland already has an important fiscal rule in the form of the legal commitment to pay in one percent of GNP into the National Pension Reserve Fund to pre-fund future ageing-related expenditures. This is helpful in helping to partially pre-fund the projected future growth in ageing-related expenditures on pensions, social services and healthcare.

However, it would also be helpful to have a rule that specifies the growth and maintenance of a rainy day fund that would hold a stock of liquid assets. The motivation for a rainy day fund is that a downturn in the public finances may occasionally coincide with adverse conditions in international financial markets. Under such circumstances, the liquidity provided by a rainy day fund can enable the government to avoid borrowing from the markets and/or provide the collateral to secure a lower cost of funding.

A rainy day fund is not a new concept. Under an independent exchange rate, countries always hold a liquid stock of foreign-currency assets for precautionary reasons. Under a currency union, there is not the same need to hold foreign-currency liquid assets but there is value in holding euro-denominated liquid assets. Indeed, Lane (1998) advocated the establishment of a rainy day fund as part of Ireland's preparations to join EMU.

During the current crisis, the NPRF has acted as a de-facto substitute rainy day fund through its role in recapitalising the Irish banks. However, this has disrupted its long-term investment strategy and forced it to adjust its equity-dominated portfolio. A dedicated rainy day fund would be more suited to smoothing short-term fluctuations in debt market access.

4.3.2 Implementation Issues

In relation to all types of numerical fiscal rules, it is essential that compliance with such rules be independently monitored. In particular, a government may be tempted to resort to creative accounting in order to formally satisfy a rule while financing extra expenditure or tax cuts through off balance sheet tricks.[12] Accoridingly, there is a natural complementarity between the adoption of formal fiscal rule and the establishment of an independent fiscal policy council, as is covered in the next Section.

Finally, there may be extreme situations (such as the current crisis) in which the normal fiscal rules may need to be suspended. Accordingly, such rules need to include "escape clauses." To avoid over-use of such escape clauses, as is further discussed below, the trigger decision to permit deviation from the normal rule could be delegated to an independent fiscal policy council.

4.3.3 The Implementation of Fiscal Rules

The main focus in the fiscal rules literature has been on the maintenance of a sustainable fiscal position. If fiscal sustainability is not yet secured, the flexibility required to ensure that sufficient fiscal adjustment is quickly achieved may call for the delayed implementation of a fiscal rules regime. However, even in that case, there is considerable value to pre-announcing the future introduction of a set of fiscal rules. Since the future fiscal rule regime will help to pin down the future behaviour of fiscal policy, it acts to stabilise current expectations about future sustainability among domestic residents and international markets that the payoff from current fiscal adjustment efforts will not be subsequently abandoned.

Accordingly, the current Irish situation calls for a two-stage strategy. During the current adjustment phase, the priority is on restoring fiscal sustainability over a medium-term horizon. However, the effectiveness of current fiscal adjustment is reinforced by a commitment that the post-adjustment fiscal framework will include a commitment to a set of numerical fiscal rules.

[12] Milesi-Ferretti (2003) provides a striking investigation of creative fiscal accounting.

4.4 The Role of Independent Institutions in the Fiscal Process

As noted above, the key to insulating the fiscal process from procyclicality pressures is to find institutional devices that assist governments in maintaining the cyclically-appropriate fiscal stance.

To this end, it is standard that multiple independent agencies play a role in the fiscal process. At one level, it is important that an independent agency be responsible for the collection of economic statistics, in view of the importance of data quality for the credibility of fiscal policy. In Ireland, the Central Statistics Office has considerable operational independence, as protected by the Statistics Act.

In similar vein, it is increasingly widespread to have an independent Court of Auditors to measure the integrity and quality of public spending. In Ireland, this function is performed by the office of the Comptroller and Auditor General, although it is open to question whether the scale and scope of the activities of the CAG could be extended to allow for more extensive investigation of the effectiveness and efficiency of individual spending programmes.

Ireland has also been a leader in the delegation of debt management to an independent agency, with the NTMA among the first such offices around the world. Over time, the remit of the NTMA has been extended to deal with the implementation of a range of other financial policies through the establishment of a host of affiliated agencies (National Pension Reserve Fund, National Development Finance Agency, State Claims Agency, National Asset Management Agency).

However, there are a number of other functions that may be delegated to independent institutions. A non-exhaustive list includes: (i) the determination of the macroeconomic forecasts that are employed in making short-term and medium-term budgetary plans; (ii) the determination of the fiscal forecasts that are employed in making short-term and medium-term budgetary plans; (iii) the analysis of alternative fiscal scenarios; (iv) the monitoring of compliance with announced fiscal targets and fiscal rules; and (v) the evaluation of the quality of the fiscal process and fiscal decisions.

In relation to each of these functions, there is a range of options concerning the potential role for independent institutions. Moreover, these functions could be collectively delegated to a single independent fiscal council or, alternatively, these functions could be split across multiple independent agencies.

In principle, it is possible to envisage strong and weak forms of delegation to an independent fiscal institution. The strongest form of delegation would make the opinion of the independent fiscal institution a binding constraint on the government's fiscal decisions. The weakest form would confer purely advisory powers on the independent fiscal institution, with no obligation on the government to act on its views. An intermediate form might give the government the power to override the views of the independent fiscal institution but would require the government to formally explain the reasons for this deviation (for instance, through an Oireachtas statement or a letter to the relevant Oireachtas Committee).

The advantage to stronger forms of delegation is that it increases the credibility of the fiscal process by reducing the risk that political distortions may lead to sub-optimal fiscal decisions. However, stronger forms of delegation dilute the accountability of elected politicians and the civil service for fiscal decisions. At the other end of the scale, the

limitation of a purely advisory role for independent fiscal institutions is that it may have litle ultimate influence on fiscal decisions, if there is no mechanism to force the government to give due weight to the expert judgement of the independent fiscal institution. Finally, the relative merits of strong versus weak forms of delegation may vary across the different types of functions listed above - the same approach is not necessarily required across all areas.

4.4.1 Macroeconomic Projections

In relation to macroeconomic forecasts, this role has been delegated to independent institutions in a number of countries. The case in favour of delegation is that the Department of Finance might be placed under pressure to make biased forecasts in order to suit political objectives. For instance, this has been a primary motivation for the delegation of macroeconomic forecasting to the new Office of Budget Responsibility (OBR) in the United Kingdom, since it was widely perceived that the Labour government's commitment to a balanced budget "over the cycle" led to pressure on the Treasury to recalculate the timing of the UK business cycle in order to ensure that the government could claim that this commitment was honoured.

As was argued in the previous section, it is certainly the case the quality of macroeconomic projections can be improved in Ireland through increased investment in macroeconomic model development and a greater allocation of resources towards macroeconomic surveillance. However, this does not necessarily mean that responsibility for official macroeconomic forecasts should be removed from the Department of Finance. Rather, the Department of Finance could improve its modelling and surveillance capacity by setting up an intra-departmental economic analysis unit that would be more fully engaged in full-time macroeconomic analysis. Since the Department of Finance is currently set up as a generalist civil service department, the establishment of such a specialist unit type would require careful planning in terms of recruitment and career planning policies.

In turn, this economic analysis unit could draw upon external expertise through several channels. In relation to its macroeconomic forecasts, it might appoint a panel of part-time external experts that would advise on the quality of the underlying analysis and offer alternative insights on the state of the economy. In addition, the research focus of such a unit makes it natural that its work be supported through exchange programmes and visiting programmes for external scholars.

The advantage of this approach is that responsibility for macroeconomic projections clearly remains with the Department of Finance and the enhancement of internal analytical capacity may have positive spillover effects for its other duties, such as the formulation of budgetary policy advice for the government.

However, if this route is followed, it is important to complementary actions be taken to support the quality of external macroeconomic surveillance and macroeconomic forecasting by external agencies. In relation to macroeconomic forecasting, there are myriad private-sector financial institutions providing their own short-term projections. In addition, the European Commission provides its own forecasts, relying on its common modelling approach across all countries for its medium-term projections of trend growth. Similarly, the IMF and OECD also provide external short-term forecasts. However, none of the private-sector firms or the international organisations maintain the types of quanti-

tative model tailored to the Irish economy than can provide the most effective cross-check to the internal projections of the Department of Finance. Moreover, the rotation policies inside international organisations means that these agencies do not retain "institutional memory" concerning the specifics of the Irish economy.

Accordingly, even if the primary responsibility for macroeconomic projections is delegated to an internal economic analysis unit within the Department of Finance, it is essential that there is an independent agency that can provide an alternative set of macroeconomic forecasts. In Ireland, this role is taken by the ESRI. However, it is important that sufficient resources are allocated to the ESRI to enable it to deepen its capacity to undertake macroeconomic analysis.

However, if it is deemed infeasible to establish such a unit within the Department of Finance, an alternative approach would be transfer responsibility for macroeconomic forecasting to an external agency. This could take the form of a new institution (such as the OBR in the United Kingdom), which would require large-scale resources to establish and maintain a new set of macroeconomic models of the Irish economy.

However, a simple alternative approach would be to delegate responsibility for macroeconomic forecasts to the ESRI. Again, it would be important that sufficient resources are allocated to the ESRI to enable it to deepen its capacity to undertake macroeconomic analysis. Furthermore, the analytical input into ESRI projections could be boosted by the appointment of a panel of part-time external experts that would participate in the design of short-term and medium-term macroeconomic projections.

4.4.2 Fiscal Projections and Fiscal Analysis

Macroeconomic projections are only one input into budgetary planning. In addition, high-quality fiscal analysis is necessary in order to make the best possible projections concerning short-term and medium-term tax revenues. This requires sufficiently-detailed tax data and an understanding of the relation between different types of spending and different type of economic activity and tax flows.

The set of issues here is mainly similar to the discussion in relation to macroeconomic projections. One option is that the Department of Finance retain responsibility for fiscal projections but that is analytical capacity is improved by the creation of internal economic analysis unit, as described above. An alternative approach is to delegate responsibility for fiscal projections to an independent agency, as is the case with the new OBR in the United Kingdom.

However, even if the official fiscal projections were outsourced to an independent agency, it remains the case that the fiscal analytical capacity of the Department of Finance would still require support, in view of its role in providing fiscal policy advice to the government. Equally, if the Department of Finance retains responsibility for fiscal projections, there is a pressing need to improve external analytical capacity in order to provide a cross-check on the departmental projections.

Indeed, the need to support independent fiscal analysis is even more important than the need to support independent macroeconomic analysis, in view of wider base of private-sector support for macroeconomic analysis and the general public availability of macroeconomic data. In contrast, effective fiscal analysis requires access to the detailed revenue data, in addition to the aggregate revenue flows. Accordingly, it is important that there

is public support (both financial and in relation to data access) for independent fiscal analysis.

Again, there are two main options. One is to establish a new independent institution that would conduct fiscal analysis. The other is to provide more resources to the ESRI, such that it could undertake more a more extensive fiscal research programme.

An independent source of fiscal analysis provides several benefits. First, it provides a cross-check to the projections generated by the Department of Finance. By passing this "double hurdle" of evaluation, the robustness of fiscal projections is enhanced.

Second, it facilitates a broader debate about alternative fiscal scenarios. For instance, the quantitative fiscal models maintained by such an independent fiscal agency could be employed to simulate the alternative fiscal paths that might be proposed by Opposition political parties or requested by an Oireachtas committee. More generally, its privileged access to detailed fiscal data would allow it to act as an independent source of fiscal information, thereby enhancing the credibility of fiscal information for both domestic and international audiences.

4.4.3 Fiscal Monitoring

An additional possible role for an independent fiscal institution is to conduct fiscal monitoring. This is the case, regardless of whether the formal responsibility for macroeconomic projections and fiscal projections is retained by the Department of Finance or delegated to an independent fiscal institution. It is also the case that the type of independent institution that might be made responsible for macroeconomic or fiscal projections need not be the type of independent institution that is charged with fiscal monitoring.

In particular, the making of macroeconomic or fiscal projections requires a substantial full-time staff. In contrast, responsibility for fiscal monitoring could be allocated to a part-time fiscal review council. The membership of such a review council could be drawn from academia, research organisations and former senior policy officials. In relation to each of these categories, it would be valuable to draw upon on an international pool of experts, in addition to local members.

A narrow mandate for such an independent fiscal policy council would be to prepare an annual fiscal monitoring report that evaluates fiscal policy outcomes relative to the announced fiscal policy targets. This would include evaluating whether the fiscal position is sustainable and whether the announced annual and medium-term budgetary targets were on track.

Moreover, if a set of numerical fiscal rules were adopted, it could evaluate whether fiscal policy is adhering to these rules. In relation to fiscal rules, an extra role for an independent review council could be to make the judgement whether, in the event of large shocks, the conditions are met for the normal rules to be temporarily suspended (and, subsequently, to determine when the normal fiscal rules should be restored). However, it is also important to appreciate that fiscal monitoring is highly valuable even if the government has not yet adopted a set of numerical fiscal rules - it can still be monitored in relation to its announced fiscal plans.

In addition to evaluating fiscal outcomes, an independent fiscal policy council could also report on the quality of the fiscal process. At one level, this could involve the ex-post review of the accuracy of the underlying macroeconomic and fiscal projections. At

another level, it could evaluate the quality of the official communication of fiscal policy - that is, whether the government provides sufficiently persuasive explanations for its fiscal decisions.

A broader role for such an independent fiscal policy council would be to also mandate the council to be a source of new ideas concerning fiscal policy. For instance, it could have a research budget to commission exploratory studies that might generate new insights into the optimal conduct of fiscal policy or the effectiveness of fiscal policy in influencing macroeconomic outcomes. There is a general scarcity of independent research on fiscal policy, such that there could be significant returns on such policy-focused research.

Finally, by testifying before the relevant Oireachtas committees and through active engagement with the media, an important goal for such an independent fiscal policy council would be to raise the level of public debate about fiscal policy.

4.4.4 International Examples of Fiscal Councils

The foregoing description of how an independent fiscal policy council might take on a fiscal monitoring role closely resembles the design of the Swedish Fiscal Policy Council.[13] The Swedish Fiscal Policy Council was established in August 2007 and consists of eight members, which is assisted by a small secretariat. Its membership consists of six academics (including two from Denmark) and two former policy officials.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. 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. In fact, the Council has an even broader mandate, since it also covers non-fiscal issues such as whether the development of the economy is in line with healthy long-run growth and sustainable high employment. 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.[14] 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. These include: the National Institute for Economic Research (Konjunkturinsitutet), which publishes macroeconomic forecasts, analyses the cyclical development, and regularly comments on the Government's fiscal policies; the National Financial Management Authority (Ekonomistyrningsverket) 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),

[13] Details about the Council are available at www.finanspolitiskaradet.se.

[14] 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.

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.

In contrast, the intended mandate for the new OBR in the United Kingdom is relatively narrow. It is responsible for providing macroeconomic forecasts for the UK fiscal process and assessing whether the government's fiscal plans are likely to meet its announced fiscal targets. In view of the innate uncertainty in making forecasts, it must report a range of projections around the central forecastIn addition, the OBR will also have a role in making an independent assessment of the public sector balance sheet, including analysing the costs of ageing, public service pensions and Private Finance Initiative contracts.

Accordingly, it must build considerable analytical capacity to produce credible macroeconomic and fiscal projections. A three-person Budget Responsibility Committee leads the work of the OBR, with the intention that these full-time positions are supported by a sizeable professional staff.

In passing, an important lesson from the rushed establishment of the interim OBR in the wake of the election of the new UK government is that tremendous care must be taken in demonstrating the independence of such a new institution. For instance, the interim OBR was heavily criticised for relying too much on staff temporarily seconded from the Treasury and for occupying office space at the Treasury, which failed to sufficiently signal its operational independence.

In relation to longer-established fiscal institutions, these vary in design and mandate.[15] [16] In the United States, the mandate of the Congressional Budget Office is to provide objective and impartial analysis of budgetary and economic issues. In order to maintain its non-partisan position, it does not offer policy recommendations but instead provides analytical inputs. For instance, it maintains quantitative fiscal models that allows it to produce alternative fiscal scenarios in responst to requests from Congress. In addition, it provides an independent assessment of the plausibility of the macroeconomic and fiscal projections employed in the President's proposed budget. It also produces regular reports on the long-term fiscal consequences of an ageing population. Its 250 staff produce also produce a large volume of research reports on a wide range of economic policy issues that are of interest to Congress.

Established in 2006, the Parliamentary Budget Office (PBO) in Canada is a small-scale version of the CBO. Its fourteen-member staff provides independent analysis to Parliament concerning the fiscal plans of the government, the state of the public finances and general economic trends. In addition, upon request from a committee or individual member of parliament, it will estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

The Netherlands Bureau for Economic Policy Analysis (CPB) combines many of the individual functions of an independent fiscal institution outlined above.[17] It makes short-, medium and long-term forecasts. In addition, it estimates the economic effects of different

[15]The European Commission maintains a database of independent fiscal institutions in member countries: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/independent_institutions/index_en.htm.

[16]Professor Simon Wren-Lewis of Oxford University has established a helpful website that provides links to independent fiscal councils around the world: http://www.economics.ox.ac.uk/members/simon.wren-lewis/fc/Fiscal_Councils.htm.

[17]The Federal Planning Bureau in Belgium has a broadly similar design to the CPB.

policy porposals, including analyses of the electoral manifestos of each political party. It also conducts policy-relevant research across a broad range of economic topics.

The CPB conducts its research on its own initiative, as well as upon request by a limited group. This group includes the Cabinet, government ministries, the Parliament, individual members or factions of Parliament, and political parties (parties in office, as well as opposition parties). In addition, employers' and employees' organisations, the Social Economic Council and several other institutes and organisations in the field of social economic policy and research are also able to request research from the CPB. To preserve its independence, there is no charge for these research services.

The Danish Economic Council is another long-standing independent fiscal institution. This council is a multi-layered organisation. Assisted by a twenty-person secretariat, the four-person chairmanship (typically consisting of university professors) produces two economic reports a year. These reports contain economic analyses of fiscal issues and broader economic policy topics. The report also contains a forecast of the Danish economy for the coming 2 to 3 years. The reports are discussed by a 26 member council which includes representatives from the unions, employers, the Central Bank, the Danish Government and independent economic experts.[18] [19]

The newly-established Fiscal Council of the Republic of Hungary has been entrusted with the task of promoting the transparency and sustainability of Hungary's public finances. Through fiscal analysis and forecasting, it monitors the consistency of fiscal decisions with the fiscal rules prescribed by the 2008 Fiscal Responsibility Law. Through its public communications, it has the objective of establishing a culture of fiscal responsibility in Hungary, thereby improving policy credibility in the eyes of the domestic electorate and international markets.

Slovenia has also legislated for the establishment of a Fiscal Council. Its responsibilities include the ex-post assessment of fiscal decisions, in terms of sustainability and cyclical stability. In addition, amongst other tasks, it will make medium-term and long-term fiscal projections and assess the quality of public finance data and the quality of the government's macroeconomic forecasts. It is also charged with evaluating the efficiency of public expenditure programmes and financial balance sheet management.

Finally, Germany has also established a Stability Council to monitor compliance with the new fiscal rules that were added to the German constitution in 2009 and that take full effect from 2016 onwards. Furthermore, it is important to note that the German fiscal rule requires that the structural balance be calculated on the basis of the European Commission's estimate of potential output - there is no role for domestic input into this crucial calculation.

[18]In this way, the membership of the Danish Economic Council resembles the National Economic and Social Council in Ireland. However, a crucial difference is that the Danish reports are the responsibility of the expert chairmanship group, whereas NESC reports are the responsibility of the Council itself.

[19]Since 2007, this apparatus has been extended to include a Danish Environmental Economic Council. The chairmanship group produces an annual economic report on various environmental policy issues. The environmental council has a different membership structure to the economic council - for instance, it includes representatives from the NGO sector.

4.4.5 Summary on Independent Fiscal Institutions

As indicated by the Swedish example, the fiscal process can be improved by the involvement of an array of independent fiscal institutions. In relation to macroeconomic and fiscal projections, it is important to improve analytical capacity both within the Department of Finance and in external institutions. In the Irish case, the main current independent institution that can take on such tasks is the ESRI.

Whether official responsibility for macroeconomic and fiscal projections should be retained by the Department of Finance or delegated to an independent institution is open for debate. If responsibility is to be retained by the Department of Finance, its internal analytical capacity should be upgraded through the creation of an economic analysis unit that is fully engaged in macroeconomic and fiscal modelling and surveillance. To provide a cross-check on the work of such a unit, it is important that external analytical capacity is beefed up in order to ensure that projections are robust to alternative modelling specifications and assumptions.

If responsibility is transferred to an independent institution, one natural solution is to delegate these tasks to the ESRI. In turn, this solution requires a considerable increase in resources for the ESRI in order to improve its macroeconomic and fiscal surveillance and modelling capabilities.

In addition to the importance of independent institutions in ensuring that macroeconomic and fiscal projections are robust, this section has also highlighted the value of an independent fiscal policy council in acting as a fiscal monitor. Such an independent fiscal council could monitor compliance with announced targets and the specified fiscal rules and make recommendations concerning the appropriate adjustment path in the event of non-compliance. Furthermore, it can contribute to the quality of the fiscal policy through ex-post evaluation of the conduct of fiscal policy over the preceding year, acting as an independent monitor of the quality and availablity of the fiscal data, sponsoring research on fiscal topics and promoting the level of public debate about fiscal policy through engagement with Oireachtas committees, media and the organisation of policy workshops.

5 Emerging EU Proposals

In view of the cross-country spillovers from domestic policies and domestic imbalances and the commitment to mutual assistance during crisis periods, the EU system of fiscal surveillance requires much greater development. In any event, a more effective system of EU-level surveillance is highly desirable as part of an overall fiscal framework.

The key principle in interpreting EU-level reform proposals is that EU-level surveillance is a useful supplement but is not a substitute for a robust domestic macroeconomic policy framework.[20] Indeed, the European Commission ultimately relies on domestic agencies for most of the input into its analysis - a transparent domestic fiscal framework and high-quality independent domestic fiscal monitoring are the foundations for an effective EU-level monitoring. The main thrust of any EU-level surveillance system will

[20]This also mostly holds true in relation to EU-level surveillance of financial stability, which is intended as a supplement to domestic-level financial regulation. The main difference is that EU-level financial stability also requires coordinated regulation of large cross-border banks, whereas fiscal systems remain nearly-exclusively national in character.

be at ensuring "quality control" in the design of domestic fiscal frameworks and analysis of domestic economic and fiscal trends. Indeed, a primary focus of the reform proposals described in European Commission (2010) is to ensure that member countries develop adequate domestic fiscal frameworks, including roles for numerical fiscal rules and independent fiscal institutions.

However, it is also valuable to have EU-level analysis of domestic economic and fiscal trends. A common EU surveillance system promotes "best practices" across the EU and allows policy coordination. It is also useful to have a "second pair of eyes" in interpreting domestic macroeconomic and fiscal developments, especially given the risk that the views of domestic analysts might be distorted by cognitive biases or domestic political pressures. In line with the principle that independent institutions have a valuable role in surveillance and fiscal analysis, the input of Commission staff could by supplemented by an independent European fiscal council or by a college drawn from the national fiscal councils of each member state.

An EU-level perspective is especially helpful in dealing with financial and external imbalances, given that intra-regional cross-country capital flows are jointly influenced by the policies in both "sending" and "receiving" countries. European Commission (2010) envisages a scorecard approach to flag the emergence of incipient imbalances. While this type of approach may be a useful EU-level early warning system, the interpretation of the indicators may differ across countries. In particular, there will typically be country-specific factors that influence the development of unit labour costs, net exports and capital flows. Accordingly, in order to provide an accurate analysis of such country-specific factors, the quality of domestic macroeconomic surveillance is of paramount importance. Moreover, for such domestic analyses to be accepted by the other member countries, it is important that an independent fiscal monitor is able to verify such proposed explanations for such danger signals.

In relation to the proposal for a "European semester" by which fiscal plans will be initially screened at an EU level, this is well aligned with the adoption of a revised budgetary process in Ireland. In particular, Section 3 recommended a three-stage fiscal planning process by which there would be an initial debate on the condition of the macroeconomic environment, followed by a decision on the target for the aggregate fiscal balance and then a final stage of deciding the details of individual spending and taxation programmes. In view of the cross-country spillover issues, it is reasonable to have EU-level input at the first two stages, even if the third stage is primarily reserved for domestic political determination.

The reform proposals contained in European Commission (2010) and European Central Bank (2010) also provide a range of options in relation to possible sanctions for non-compliance with EU-level fiscal guidance. As is explained in European Commission (2010), many of these sanctions are consistent with the current European Treaty. However, more intrusive types of sanctions that go even further will require Treaty amendments. In any event, it remains the case that sanctions are only envisaged for extreme and persistent forms of non-compliance; the main focus remains on promoting self-directed fiscal adjustments by member countries.

In relation to crisis management, the new European Financial Stability Fund (EFSF) has been established in response to the current financial crisis. However, it has only a temporary lifespan and a more extensive crisis management system is required. As is

pointed out by European Central Bank (2010), an important principle is that the funds released under a crisis-management fund should not be used to bail out private creditors. For instance, the ECB advocates that resources should be used to repurchase bonds at market prices rather than at their face value.

Greater clarity on the details of EU-level reforms will soon be available. As indicated in his 16th September speech to the European Parliament, the von Rompuy Task Force will report by late October. In addition, the European Commission intends to present legislative proposals by the end of September, in line with the principles outlined in European Commission (2010).

In addition to the reform of the current set of EU-level procedures, it is possible to envisage other types of reforms. At a technical level, there is considerable merit in the idea of joint bond issuance by the members of the euro area, which would improve the operation of euro bond market. Of course, the design of such a joint bond programme would have to take into account the differences in the fiscal positions of each member country - but there are viable mechanisms to ensure that joint issuance of some types of bonds does not affect the individual responsibility of each member country for its own sovereign debts (see, for example, Delpla and von Weizsäcker 2010).

At a more extensive level, it is possible to argue that an area-wide federal fiscal system would increase the stability of the euro area by providing an automatic mechanism for transferring fiscal resources from faster-growing member countries to slower-growing member countries (see, for example, Strauss-Kahn 2010). However, this would require a much deeper level of political integration than currently looks feasible at the European level.

6 The Menu of Reforms: An Overview

As a device to pull together some of the main themes covered by this report, Tables 1 and 2 summarise some of the main options in reforming the fiscal process in Ireland.

Table 1 considers the relative pros and cons of allocating various tasks between the Department of Finance and independent institutions. Table 1 emphasises that an upgrading of the internal analytical capacity of the Department of Finance is essential if it is to retain responsibility for macroeconomic surveillance, macroeconomic forecasting and fiscal forecasting. However, even if these duties are retained by the Department, the robustness of these processes is improved by allocating sufficient resources to independent institutions to provide alternative surveillance and modelling capacity. Table 1 also emphasises that a key task - fiscal monitoring - can only be credibly performed by an independent institution. It is also important to emphasise that independent capacity in fiscal analysis would also be very helpful in enabling a more informed debate about fiscal policy, by proving analytical resources that can be called upon by Oireachtas Committees and opposition parties.

Table 2 compares the relative merits of national-level versus international (EU-level or otherwise) independent fiscal institutions. The value from having national-level indepedent fiscal institutions is that it facilitates a tailored, detailed analysis of the Irish economic and fiscal situation. In contrast, the typical approach at an international level is to use a common methodology across all countries. While international-level institu-

	Dept. Finance	Independent
Surveillance	Improve internal analytical capacity.	Independent capacity improves robustness.
Macro Forecasting	Improve internal analytical capacity.	More objective. But requires substantial resources.
Fiscal Forecasting	Improve internal analytical capacity.	More objective. But requires substantial resources.
Fiscal Analysis	Improve internal analytical capacity.	Independent capacity improves robustness.
Fiscal Monitoring	Self-monitoring of limited value.	Independence critical for credible monitoring.

Table 1: Allocation of Tasks: Department of Finance and Independent Fiscal Institutions

tions are more likely to be insulated from local cognitive biases and domestic political pressures, an exclusive reliance on international-level institutions is risky to the extent that detailed knowledge of the local situation is required to conduct a full macroeconomic and fiscal risk assessment. Since the costs of fiscal errors are primarily borne by domestic residents, it makes sense to have a domestic layer of independent institutions, in addition to contribution from international independent fiscal institutions.

	National	EU
Surveillance	Specialist knowledge but less objective.	Cross-country perspective but limited resources.
Forecasting	Tailored local models more accurate.	More objective but uniform approach less accurate.
Fiscal Rules	Optimal rules vary with country conditions.	Uniform rules help cross-country monitoring.
Fiscal Analysis	Tailored local analysis more accurate.	Cross-country perspective but limited resources.
Fiscal Monitoring	Specialist knowledge but less objective.	More objective but less local information.

Table 2: Fiscal Frameworks: National-Level and EU-Level

Next, Figure 1 provides a simple graphical representation of the contribution of alternative fiscal reforms to policy credibility. While this representation is subjective to some extent, it highlights that the most effective types of reforms are to adopt a set of numerical fiscal rules and, even more importantly, to ensure there is a robust mechanism for independent fiscal monitoring. It is also important to emphasise that there likely complementarities between the adoption of fiscal rules and independent fiscal monitoring, such that the impact of adopting both reforms is plausibly greater than the sum of the invididual contributions.

Figure 2 provides a graphical representation of the different points in the fiscal process at which an independent fiscal institution may make a contribution. It divides the fiscal process into three phases. The first phase is the fiscal planning phase during which the government considers its policy options.[21] The second phase begins when the fiscal proposal is made by the government to the Oireachtas. Finally, the third phase begins once the final fiscal decision is made.

During the fiscal planning phase, an independent institution may participate through the making of macroeconomic and fiscal projections. It may also provide fiscal analysis - for instance, by making macroeconomic and fiscal assessments of various policy options. Finally, it may also take on a normative role by advising on which policy proposals should be adopted.

[21] As was discussed in Section 2, the fiscal planning phase itself could be helpfully split intro three stages where the macroeconomic environment, the aggregate fiscal stance and micro-level spending and taxation allocations are sequentially determined. In turn, each of these stages could be made the focus of separate Oireachtas formal decisions. I have collapsed all of these stages into a single phase for simplicity.

Figure 1: Types of Delegation and Policy Credibility

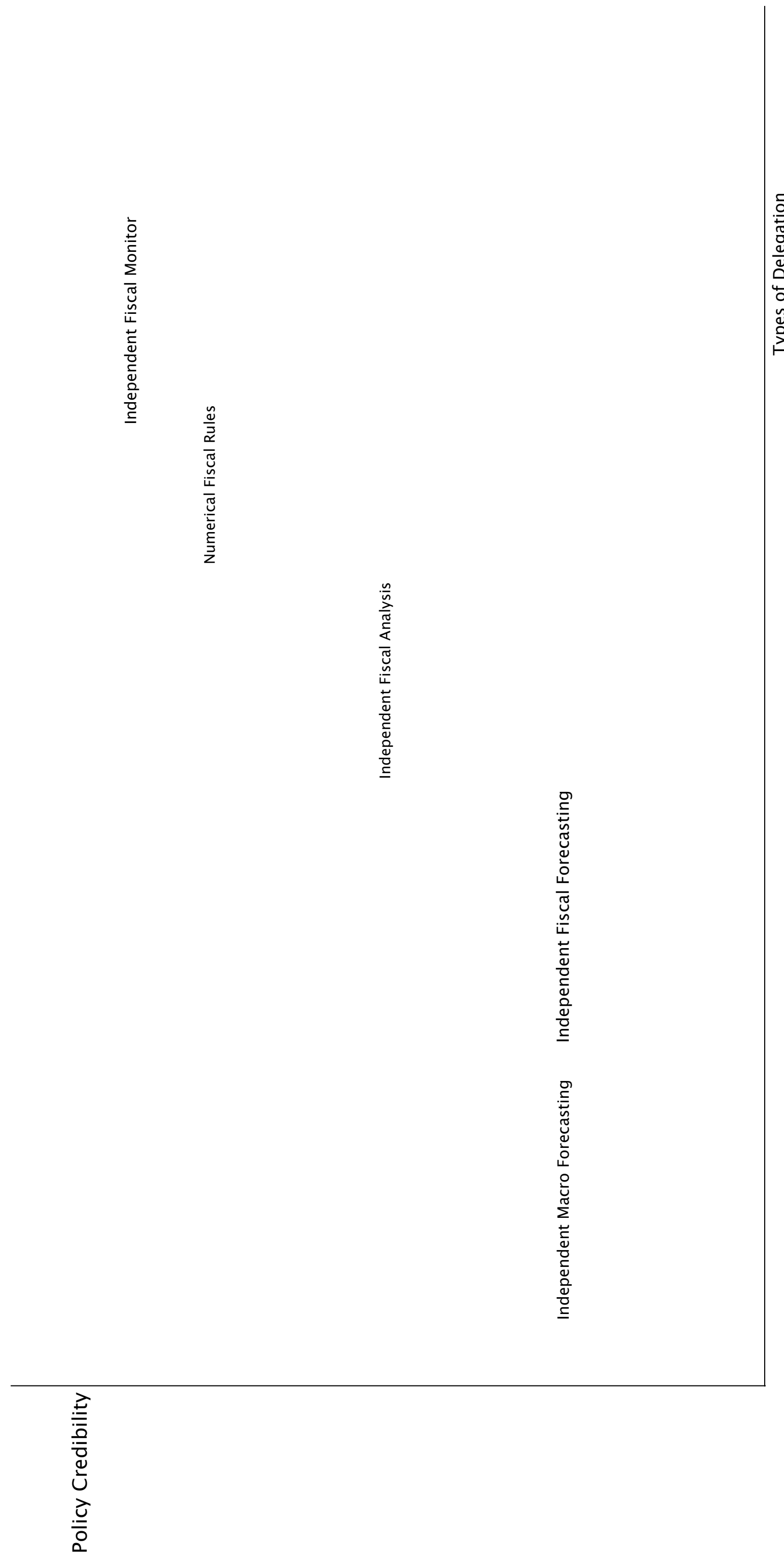
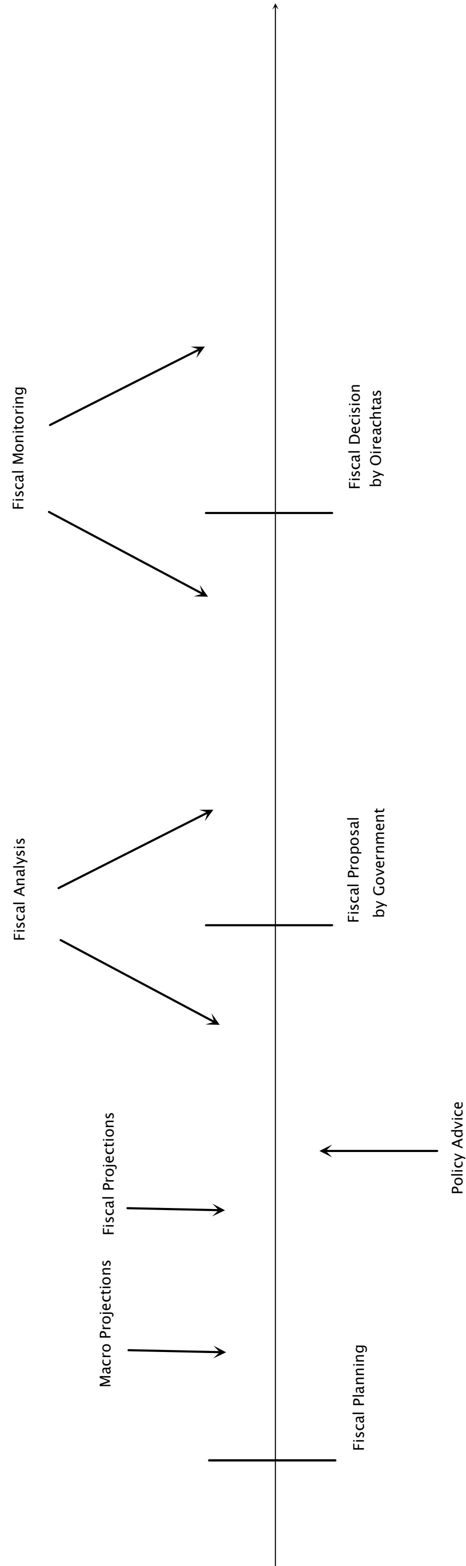


Figure 2: The Fiscal Timeline



An independent institution may also prove helpful during the interval between the announcement of the government's fiscal proposal and the final vote by the Oireachtas. At one level, at the request of the Oireachtas, it may provide independent fiscal analysis of the government's proposal. At a second level, an an independent fiscal monitor may offer an evaluation of whether the government's proposal is reasonable and plausible.

Finally, once the fiscal decision is finalised, an independent fiscal monitor can play a role by analysing the consequences of the fiscal decision. Such ex-post monitoring can provide a helpful input into the next round of the fiscal process.

As is clear from this timeline, it would be extremely challenging for an independent fiscal institution to take on all of these roles. In addition to the large-scale resources that would be required, there are significant conflicts of interest across some of these roles. For instance, an independent fiscal monitor cannot at the same time be directly involved in the fiscal planning phase. Equally, an independent fiscal institution that is tasked with conducting independent fiscal analysis for both the government and the Oireachtas cannot take on advisory functions in which it must express an opinion on the relative merits of alternative policy proposals.

Accordingly, the full set of functions might be better distributed across different types of independent institutions. While this might be cumbersome, it would have the virtue of providing clarity as to the mandate for each institution.

7 Conclusions

This purpose of this report has been to provide background analysis that might help in the formulation of policy reforms that may improve macroeconomic stability in Ireland. As indicated throughout the report, there are many elements in a comprehensive reform programme to improving macroeconomic. While there is some degree of substitutability across some of these reforms, it is mostly the case that there are complementarities across the different types of reforms and that a lack of reform in one area might threaten the effectiveness of reforms in other areas. I provide below a brief summary of the some of the main points in this report:

- Improve the quality of macroeconomic surveillance. Requires extra analytical capacity both in the Department of Finance and in external institutions. Also requires a "big push" to expand the range of quantitative macroeconomic models of the Irish economy.

- Long-term fiscal sustainability is both important in itself but also a prerequisite for effective counter-cyclical fiscal policies.

- Counter-cyclical fiscal policies must respond to financial and external imbalances in addition to the GDP cycle. Micro-level interventions can be a useful supplement to the macroeconomic dimension of fiscal policy. Fiscal balance sheet management and the government's approach to pay determination can also add to cyclical stabilisation.

- The adoption of a formal fiscal framework may be very helpful in securing long-term fiscal sustainability and effective counter-cyclical stabilisation. In addition to

reforms to the budget process and a more extensive use of a medium-term budgetary framework, key steps include a commitment to follow a set of numerical fiscal rules and greater use of independent institutions in the fiscal process.

- Full adoption of a set of fiscal rules should wait until long-term fiscal sustainability has been secured. However, a fixed commitment to future adoption of a set of fiscal rules can assist in the fiscal adjustment process that is currently required.
- Independent fiscal institutions have many potential roles in the fiscal process. The allocation of responsibilities should be clearly defined in order to provide a clear mandate to such institutions.
- A more extensive role for EU-level institutions in monitoring domestic fiscal choices is required in view of the enhanced level of fiscal interdependence that has revealed by the current crisis. In any event, EU-level economic governance reforms should be viewed as largely complementary to domestic-level reforms and will provide an extra layer of insulation against strategic fiscal errors.

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