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# Some Lessons for Fiscal Policy from the Financial Crisis\*

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## Abstract

The current crisis calls for a re-assessment of the optimal conduct of macroeconomic policies during non-crisis normal times. In particular, the risk and costs of crises can be mitigated by macroeconomic policies that lean against the wind in the face of cyclical, sectoral and external shocks. In this paper, I discuss the challenges involved in deploying fiscal policy in pursuit of a broad definition of macroeconomic stabilisation. The main policy conclusion is that pro-stabilisation fiscal policies are likely to be more effective if fiscal policy is determined under a formal fiscal framework that combines a set of fiscal rules and a substantive role for an independent fiscal policy council.

Keywords: fiscal council, fiscal rules, macroeconomic stabilisation

JEL codes: E62, H60

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## **Introduction**

The global economic and financial crisis that has gripped the world since Summer 2007 has naturally generated much questioning about the conduct of economic policies during the pre-crisis period (and, indeed, the quality of the economic research that is supposed to provide a basis for policymaking). The response to the crisis has involved aggressive orthodox and non-orthodox monetary policies, plus fiscal stimulus packages in many countries. With the passing of the most acute phases of the crisis, attention is now turning to optimal exit strategies for both monetary and fiscal policies, while it is also timely to re-assess the appropriate macroeconomic policies for the resumption of normal times.

In this paper, my focus is on the latter question. In particular, I address the implications of the crisis for the optimal design of fiscal policy. One obvious motivation is that better-run macroeconomic policies during the pre-crisis period may have reduced the likelihood of such a crisis occurring and the possible scale of the crisis. In addition, not all countries were able to pro-actively use fiscal policy to offset the negative demand shock from the global recession. Following the typology of Spilimbergo et al (2008), these countries lacked the fiscal space to respond to the crisis - the lesson to be drawn is that fiscal policy during normal times must be sufficiently sustainable and counter-cyclical to enable aggressive fiscal intervention in the event of a major negative shock.

Although the optimal conduct of monetary policy also requires serious revision, it is important to devote serious research attention to fiscal policy. The heated debate during the

crisis across the different schools of macroeconomics about the conceptual foundations and empirical magnitudes of fiscal multipliers underlines the limited knowledge and understanding in the economics profession in relation to the potential effectiveness of fiscal policy. Moreover, fiscal policy is especially important in environments in which monetary or exchange rate policies cannot be effectively deployed. This applies to members of a monetary union or a pegged exchange rate system in relation to macroeconomic stabilisation at a country level. It also applies more generally in situations in which orthodox monetary policy is redundant, as when interest rate policy hits the zero bound.

It is not possible to cover all dimensions of the fiscal policy research agenda in this paper. Instead, I highlight a small number of key issues. First, I discuss the implications of the crisis for the optimal cyclical conduct of fiscal policy. Second, I argue that the scope of the stabilisation function of fiscal policy ought to be expanded beyond the output cycle, in order to respond to the emergence of excessive sectoral or external imbalances. Third, I propose that the current crisis has re-inforced the case for reform of the institutional frameworks which guide the formation of fiscal policy. These issues are addressed in turn in Sections 2, 3 and 4. Some final concluding comments are offered in Section 5.

### **Fiscal Cyclicity**

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

Such principles are easy to state. However, their application is not so straightforward. First, while the traditional focus has been on GDP cycles, fluctuations in asset markets and the sectoral composition of output are also relevant in determining the optimal stance for fiscal policy. One basic reason is that tax revenues are sensitive to the distribution of output across different sectors. For instance, it is well understood that the United Kingdom was heavily reliant on the high profitability and high labour incomes in the financial services industry as a source of tax revenue. In the Irish case, tax revenues during the 2002-2007 boom period were highly reliant on transactions-based taxes in the property sector and on capital gains taxes that were high during a period of rapid asset price appreciation.

More generally, high asset prices can amplify tax revenues through several channels. At a direct level, capital gains and wealth taxes increase when asset prices improve. Indirectly, high asset prices boost consumption and investment through positive wealth and balance sheet effects. Furthermore, the level of turnover in asset markets is typically increasing in the level of asset prices, such that the revenues from transactions taxes also grow.

The importance of asset prices and wealth shocks for tax revenues has been documented for a panel of countries by Eschenbach and Schuknecht (2004). In the Irish case, Addison-Smyth and McQuinn (2009) calculate a substantial tax windfall from the 2002-2007 housing boom in Ireland that was fuelled by capital inflows. More generally, Morris et al (2009) show that revenue windfalls are more likely when output is growing strongly, such that revenue surprises tend to amplify the normal cyclical variation in revenues.

Accordingly, the optimal fiscal balance is not just a function of the output gap but also needs to take into account the temporary nature of the extra tax revenues that may be generated by unbalanced growth episodes in which asset prices are growing quickly and/or high-income sectors grow disproportionately quickly. Under such conditions, a larger fiscal surplus is appropriate in view of temporary nature of the windfall revenues and risk of sudden stops in activity level in such sectors.

Second, decisions about the appropriate stance for fiscal policy must be taken in a fog of uncertainty. Along one dimension, it is non-trivial to decompose output between cyclical and trend components. Along another dimension, it is vital to consider the distribution of risks around the central forecast, rather than focusing exclusively on the expected path for output.

In relation to the first point, the identification of the trend output path for a small and highly open economy is bound to carry a large standard error band. International mobility of capital and labour 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.

Accordingly, it is extremely challenging to obtain a precise estimate of the relative contributions of cyclical and trend factors in determining macroeconomic outcomes in a given period. Still, the joint analysis of a variety of wage, price and activity indicators may provide a reasonable projection of the cyclical condition of the economy.

Moreover, in relation to policymaking, it is essential to incorporate the distribution of risks around such a central forecast. In particular, a macro-prudential approach to setting fiscal policy would recognise the importance of providing insurance against downside risks.

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

However, beyond the technical difficulties in correctly assessing the cyclical state of the

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

There are two main types of explanation for fiscal procyclicality. First, the capacity to issue 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. While the primary focus has been on the importance of this channel for developing countries, the current financial crisis has underlined that funding costs and funding risks may also increase during recessionary periods even for high-income countries. In principle, this problem has a solution: a far-sighted government would run sufficiently-large surpluses during good times in order to avoid reliance on issuing debt during downturns.

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

benchmark. Lane (2003) presents some suggestive evidence that fragmented political systems generate more fiscal procyclicality. Talvi and Vegh (2005) and Alesina et al (2008) provide complementary explanations.

According to these authors, voters require the government to cut taxes or raise spending on public goods during booms, in order to constrain the political temptation to divert boom-year revenues towards transfers for politically-favoured elites or 'rents' for politicians. In this way, the solution to the agency problem is for voters to call for a procyclical pattern in fiscal policy. While this is suboptimal in terms of the volatility of consumption, it is efficient in terms of limiting the waste of public resources on socially-useless political rents.

A feature of these political economy models is that 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.

Across the research contributions on fiscal procyclicality, a common refrain is that such political distortions can be mitigated by the existence of effective fiscal rules and fiscal institutions. If fiscal policy is determined in an institutional environment that insulates the common interest from the adverse impact of sectoral lobbying or political rent seeking, such

distortions can be neutralised and a fiscal policy with better cyclical properties can be attained. We return to this topic in Section 4.

### **Fiscal Policy, Sectoral Imbalances and Balance Sheet Risks**

It is apparent that the incidence of the global economic crisis has been most severe for those countries that experienced rapid credit growth and ran large current account deficits during the pre-crisis period (Lane and Milesi-Ferretti 2010). In particular, the reversal in capital flows has meant that demand has been compressed in the deficit countries, amplifying the impact of the global recession on living standards. While the increased dispersion in current account imbalances during the pre-crisis period may have been in part justified by a genuine improvement in the level of international financial integration, the vulnerability of deficit countries to sudden stops has re-ignited the debate about whether macroeconomic policy should lean against the wind in order to discourage the emergence of excessive external imbalances.

In one direction, fiscal policy may itself be a source of external imbalances through several mechanisms. The standard intertemporal model of the current account predicts that a temporary increase in government spending will result in a current account deficit, since households opt to smooth private consumption rather than to respond to the surge in government absorption via a decline in private absorption (Sachs 1982, Obstfeld and Rogoff 1995). A similar pattern also holds in the baseline new open economy macroeconomic model. In this type of sticky-price general equilibrium model, a temporary increase in government consumption boosts domestic demand, generating a current account deficit and

real appreciation (Obstfeld and Rogoff 1996, Corsetti and Muller 2006).

In relation to the financing of public spending, an increase in public debt may be associated with an increase in external debt if the conditions required for Ricardian Equivalence do not hold. This is demonstrated in the models developed by Ganelli (2005) and Kumhof and Laxton (2009), in which households have finite horizons, such that a debt-financed tax cut increases the wealth of currently-alive cohorts, boosting consumption and generating a current account deficit. Furthermore, Corsetti and Muller (2006) show that the addition of an investment channel reinforces the pass through from a fiscal deficit to an external deficit in the case of persistent deficits, especially for more open economies.

Kumhof and Laxton (2009) also show qualitatively-similar results apply in relation to a temporary increase in the fiscal deficit even in an infinite-horizon framework if some proportion of households are credit constrained. Under these conditions, a debt-financed tax cut boosts the current consumption of credit-constrained or hand-to-mouth consumers, leading to a current account deficit. These authors also show that a permanent increase in public debt is associated with a permanent decline in the net foreign asset position in the finite-horizon model. This prediction is supported by the empirical work of Lane and Milesi-Ferretti (2002).

In relation to other empirical evidence, Benetrix and Lane (2009a) show that an increase in government spending is associated with an expansion in the relative size of the nontraded sector and a deterioration in the trade balance for a sample of EMU member countries.

Related results for the trade balance are also reported by Lane and Perotti (1998), Corsetti and Muller (2006) and Beetsma et al (2008). Further evidence concerning the impact of fiscal policy on the current account is provided by Feyrer and Shambaugh (2009). These authors identify fiscal shocks in the United States by reference to the narrative approach developed by Romer and Romer (2008). Their estimate is that 50 percent of an unexpected tax cut is passed through to an increase in the US current account deficit.

In the other direction, fiscal policy can facilitate external adjustment, regardless of the original source of the external imbalance. This is especially relevant for countries operating under a currency peg or inside a monetary union, such that the nominal devaluation option is not available. The empirical evidence is that a contraction in public expenditure can generate a decline in the relative price of nontradables and a real depreciation at both short and long horizons (Lane and Perotti 2003, Ricci et al 2008, Beetsma et al 2008, Galstyan and Lane 2009, Benetrix and Lane 2010).

In this regard, it is noteworthy that the empirical evidence indicates a robust relation between government spending and the real exchange rate. At medium- and long-term horizons, the cointegration analysis of Ricci et al (2008) and Galstyan and Lane (2009a, 2009b) shows that a sustained decline in government consumption (relative to trading partners) is associated with real depreciation.<sup>1</sup> A similar result is obtained in annual data by

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<sup>1</sup>Galstyan and Lane (2009a, 2009b) also consider the long-run relation between public investment and the real exchange rate. Since a higher stock of public capital may affect productivity in the traded and nontraded sectors, its impact on the real exchange rate is ambiguous. In the data, there is little robust evidence of a strong link between public investment and the real exchange rate.

Lane and Perotti (2003). In related fashion, the VAR evidence for Europe provided by Benetrix and Lane (2009c) is that a relative decline in government spending is associated with a relative contraction in the size of the nontraded sector and an improvement in the trade balance. Similar results for the trade balance are also reported by Lane and Perotti (1998) and Beetsma et al (2008). In addition, in relation to the financing of the fiscal position, the evidence in the previous section was that, all else being equal, an improvement in the fiscal balance should be associated with a partial improvement in the external balance. Accordingly, a government may also facilitate external adjustment by improving the fiscal balance.

In an environment in which a real devaluation is required in order to boost net exports but a nominal devaluation is not possible, a cut in the level of public-sector wages may be especially helpful in accelerating the required adjustment. A cut in public sector wages promotes wage adjustment in the private sector, both through the direct competition for workers across sectors but also through a demonstration effect.

While there is considerable resistance to the notion of nominal wage reductions, some of the main frictions do not apply to coordinated wage reductions across the public sector. For instance, the negative morale effect identified by Bewley (1999) relates to the relative status of workers: if there is a general wage reduction across the public sector, the relative positions of different groups of public-sector workers would be unchanged. Similarly, the holdup problem analysed by MacLeod and Malcomon (1993) and Holden (1999) refers to the localised bilateral bargaining problem between an employer and workers – wages may be

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rigid in the face of sector-specific issues but flexible in response to macroeconomic factors.

Moreover, such wage flexibility is more feasible under a social partnership infrastructure under which unions factor in macroeconomic conditions in wage negotiations. Such an encompassing deal would be less feasible in a non-coordinated setting in which the government must deal with individual public sector unions in a decentralised fashion.

Finally, there is a stated fear in some quarters that nominal wage reductions may induce a deflationary spiral that will only serve to deepen the current recession. However, deflation is self-correcting for an individual member of a pegged exchange rate system or monetary union, since the cumulative real depreciation ultimately boosts economic activity levels and associated inflationary pressures.

In Ireland, there has been a considerable reduction in public sector pay over the last two years, with the scale of the pay cuts increasing in the level of wages. While this adjustment may have been desirable, it necessitated the introduction of new legislation, since the existing wage contracts did not allow for such downward revisions. It would have been better to re-design pay contracts upon entry into EMU in 1999, in order to provide explicit recognition that negative macroeconomic conditions may occasionally require nominal pay reductions.

In particular, a two-part pay scheme may be preferable. Under such a system, part A of a salary would be fully protected against downward adjustments - this component would provide the employee with a level of income insurance for planning purposes. In contrast, part B of a salary would be a state-contingent payment. Under an adverse shock, the part B payment could be reduced or eliminated in response to a set of defined trigger events, such

as a contraction in GDP or tax revenues beyond given threshold levels.

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

If such a state-contingent 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.

So far, this discussion has focused on the role of fiscal flows (spending, taxes, the deficit). In

addition, fiscal policy may be deployed to address balance sheet problems in the banking, corporate and household sectors with the net acquisition of financial assets by the government periodically deployed to bailout distressed private-sector entities or to take these into public ownership. Such private-sector financial problems are more likely to occur if external or sectoral imbalances have accumulated. For instance, rapid credit growth and significant external debt levels characterise those economies that have suffered the most severe financial distress during the current crisis. More generally, prior lending booms are a significant predictor of subsequent banking and currency crises (Reinhart and Rogoff 2009).

Through such bailout operations, the public balance sheet may be transformed with the level of gross public debt or contingent liabilities jumping in a discrete fashion. In turn, such rescue packages may increase funding costs for the government and also constrain public spending and taxation decisions.

While such interventions may be conditionally optimal given the circumstances (rescuing a banking sector from imminent collapse), a forward-looking fiscal strategy should incorporate the risk of such events in determining the optimal level of net public debt during normal times. In addition, it may be useful to accumulate a liquid rainy day fund to fund such interventions. Along these lines, Lane (1998a) advocated the establishment of a rainy-day fund upon Ireland's entry into EMU in order to provide some pre-funding in the event of a subsequent banking crisis.

In the Irish case, no such rainy-day fund was established. However, the National Pensions Reserve Fund (NPRF) was established in 2001 in order to accumulate assets with the goal of

pre-funding the long-term increase in ageing-related public spending after 2025.<sup>2</sup> Although its mandate was to invest commercially on a global basis, a substantial proportion of its net value was recently re-directed towards the re-capitalisation of the two main Irish banks. In this way, the NPRF was re-deployed as a rainy-day fund, despite its stated long-term mission.

While the existence of a rainy-day fund does carry moral hazard risks, it is also the case that the capacity of a government to fund a rescue package through new debt issuance may not be available when it is needed --- the same types of shocks that generate private-sector financial distress may also be associated with tough funding conditions in the sovereign debt market. Recent proposals to tax bank profits in order to accumulate an insurance fund are similar in terms of objectives.

We note also that rainy day funds can also support other counter-cyclical policies. As is discussed in Calmfors (2003), Finland set up a rainy day fund upon entry to EMU that accumulates extra social security contributions from employers during upswings in order to enable a lower contribution rate during downturns. This smoothing policy supports the stabilization of employment over the cycle.

In relation to risk of banking-sector distress, the other lesson is that it is fiscally costly to permit the emergence of excessive external and sectoral imbalances that add to the fragility

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<sup>2</sup>In addition to initial funding from the proceeds of the privatisation of the national telecoms operator, the government allocates one percent of GNP each year to the NPRF.

of private-sector balance sheets. This provides a motivation to engage in preventive operations to limit the scale of such imbalances.

Such interventions can be justified by a variety of distortions that limit the capacity of the private sector to self-correct excessive imbalances. In general, individual decisions by debtors and creditors on the accumulation of debt liabilities cannot fully take into account the systemic risks that a function of the economy-wide aggregate balance sheet and the correlations in investment decisions across all types of entities.

In relation to the external account, Summers (1988) and Blanchard (2007a) have argued that financial constraints mean that a contraction in tradables output during a period of high domestic expenditure may not be easily reversed once the economy needs to make the transition towards greater net exports. In addition, high net inflows may increase the risk of a sudden stop and the attendant risk of financial distress. For these reasons, economic policy should lean against the wind, in order to limit the scale of external imbalances.

A wide range of preventive policies can contribute to a more stable and balanced pattern of economic growth. Most obviously, macro-prudential financial regulation can limit banking-sector instability and excessive pro-cyclicality in lending practices (see also Geanakoplos 2009). However, this is an incomplete approach to the extent that non-bank financial firms, non-financial corporates and households can directly obtain credit from external funders.

For countries with independent monetary policies, interest rate policy can in principle also contribute to the stabilisation of asset markets. However, it is open to question whether

interest rate policy can be effectively deployed to this end and whether the cost would be too high in terms of deviating from the core objective of targeting inflation (Assenmacher-Wesche and Gerlach 2010).

Accordingly, part of the responsibility for preventive stabilisation may fall to the fiscal authority. In relation to the real estate sector, fiscal intervention may take the form of counter-cyclical taxes on property transactions as recommended by Fitzgerald (2001). In relation to the external account, Blanchard (2007a) shows how the timing of government spending on nontradables and tradables may be optimally manipulated to limit the distortions induced by current account imbalances. In addition, the government can target the current account balance via a number of instruments. First, a government that wishes to narrow a current account deficit could run a more positive fiscal balance. Second, even at an unchanged fiscal balance, a reduction in government absorption can improve the external balance.

Third, tilting the schedule for particular types of taxes can alter the timing of consumption and investment decisions and thereby improve the current external balance. For instance, a reduction in employment taxes contributes to real depreciation by lowering the cost of domestic labour (Calmfors 2003). A further type of microeconomic intervention is to alter the timing of consumption decisions through subsidies to saving schemes, which mimics the impact of a shift in the interest rate.<sup>3</sup>

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<sup>3</sup>While Ireland introduced the Special Savings Incentive Account (SSIA) scheme in 2001 to cool down the booming economy, the design of these scheme was not targeted at cyclical stabilisation. Most important, its fixed five-year horizon meant that the withdrawal of the subsidy in 2006/2007 was independent of the cyclical state of the economy. In contrast, a

The current crisis has underlined the high costs of a “do nothing” attitude towards the management of imbalances. Accordingly, a major challenge for future research is to assist in the design of optimal intervention strategies for sectoral stabilisation.

Of course, the implementation problems are quite substantial in terms of correctly identifying the emergence of excessive imbalances and working out the optimal timing and scale of policy interventions. In part, one type of reform is to modify and strengthen automatic stabilisers in order to deliver greater stability in a passive manner. However, automatic stabilisers will not be sufficient to deal with all types of shocks, such that the design and implementation of optimal discretionary fiscal interventions is also an important element of the policy toolkit.

### **Reforming the Fiscal Framework**

The preceding analysis has highlighted that the conduct of fiscal policy has been revealed by the global crisis to have been far from optimal during the pre-crisis period. In part, the quality of public finances was insufficiently robust to enable an unfettered fiscal response to the crisis at least in some countries due to the failure to run the required fiscal surpluses during the good years. In part, fiscal policy was passive in the face of the accumulation of sectoral and external imbalances in a number of countries. The net result was that the

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cyclically-focused scheme would have specified a subsidy schedule that was conditioned on cyclical indicators.

severity of the crisis was exacerbated by the deficiencies of fiscal policy during the pre-crisis years.

These problems suggest that the fiscal process requires reform. In particular, it is possible that a re-designed fiscal framework that combines fiscal rules and an independent fiscal council could deliver superior macroeconomic stabilisation. The formalisation of the fiscal process helps to mitigate the political distortions that can de-rail the setting of public spending and taxation; moreover, the conduct of fiscal policy in pursuit of macroeconomic stabilisation is technically demanding, which requires considerable input from independent fiscal specialists.

There is some evidence that stronger fiscal rules are correlated with superior fiscal performance. European Commission (2009) estimates that those countries that adopt stronger fiscal rules are more successful in improving the structural fiscal balance. A similar result is also obtained by Fabrizio and Mody (2006) for a different panel of countries and a different index for the quality of budgetary institutions. Related evidence is provided by Beetsma et al (2009), who show fiscal balances are more positive in countries with stronger fiscal rules. However, it is also important to appreciate the limitations to the empirical work in this area. In particular, Debrun and Kumar (2007) highlight the difficulties in obtaining identification, since the adoption of a rules-based system may be more likely in countries that would attain good fiscal outcomes even under a discretionary system.

Moreover, the analysis of the European Commission (2009) also emphasises common problems in the design of fiscal rules. Ex-post independent monitoring of compliance with fiscal rules is not widespread and there is little by way of sanctions in the event of non-compliance. In relation to central governments, many of the rules focus on expenditure growth, whereas the main cyclical problem in most economies is how to handle unexpected revenue windfalls.

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

In terms of further evidence concerning the efficacy of fiscal rules, Chile provides an especially relevant case study (see, amongst others, Ffrench-Davis 2010). It adopted a new fiscal framework in 2001, which was subsequently codified in the 2006 Fiscal Responsibility Law. Under this framework, the Chilean government must run a structural fiscal surplus. Moreover, the state of the business cycle is evaluated by an expert committee such that the government must operate under this independently-determined constraint. During 2004-2008, Chile ran a cumulative fiscal surplus of 28.5 percent of GDP, with the Treasury becoming a significant net creditor (fiscal liabilities were small, while the assets accumulated were substantial). By building up a war chest during the boom years, Chile was able to meet the 2009 recession with a vigorous counter-cyclical policy: there was a 14.5 percent real

growth in public spending in 2009, despite a 28.5 percent fall in fiscal revenue. (The projected 2009 overall fiscal balance was a 4 percent deficit.)

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

However, as has been highlighted by Wyplosz (2008), there are so far relatively few examples of effective Fiscal Policy Councils.<sup>4</sup> One interpretation is that the concept is relatively new and that such councils will become increasingly prevalent in the coming years, with the rate of adoption stimulated by the current fiscal crises in many countries. Another is that there may be resistance among lobby groups to the establishment of a Fiscal Policy Council, since a shift towards a more long-sighted fiscal process would limit the access of such groups to debt-financed tax breaks or spending programmes.

The current crisis presents a window of opportunity to make such institutional reforms, since it has revealed in dramatic fashion the costliness of the discretionary approach to fiscal policy that was practised in many countries during the pre-crisis years.

The appropriate fiscal framework involves both fiscal rules and a central role for an independent fiscal council. In relation to the specification of fiscal rules, a priority is to set a target for the structural balance, even if the precise target may vary across countries with

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<sup>4</sup> See also the discussion in Calmfors (2008) and Calmfors (2010) in relation to the lessons from the Swedish Fiscal Policy Council.

different initial conditions and different long-term fundamentals.

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

Moreover, a rules-based approach should enhance of counter-cyclical fiscal interventions.

It should also be recognized that estimating the structural balance in real time is subject to considerable uncertainty, in view of the non-observability of the level of potential output. Accordingly, it is important to incorporate this uncertainty about the level of the structural balance into short-term decisions over fiscal policy, with the structural balance more appropriately considered a useful medium-term indicator of the fiscal stance. In the short-term, fiscal uncertainty can manifest itself by revenue outcomes that deviate from projected levels. A key principle of fiscal prudence is that windfall revenue gains are saved rather than mapped into un-planned increases in the level of public spending.

An important consideration is that the short-term effectiveness of fiscal policy critically depends on long-term fiscal sustainability: if an increase in spending today signals a long-term increase in the tax burden, its positive demand effects will be negated (Favero and Giavazzi 2006, Corsetti et al 2008). Accordingly, a credible rules-based framework that

ensures that temporary fiscal injections will be subsequently unwound will enhance the effectiveness of the fiscal boost by removing doubt about the long-term sustainability of the fiscal position.

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

In relation to the appropriate role for an independent fiscal council, a partial list of tasks may include estimation of the cyclical state of the economy and the distribution of macroeconomic risk factors. In particular, an independent fiscal council may advise or issue a determination on an ex-ante basis concerning the appropriate cyclical fiscal balance.

Alternatively, it may hold the government to account on an ex-post basis for the choices it has made concerning the cyclical operation of fiscal policy.

In view of the difficult analytical challenges in determining the appropriate fiscal responses

to the incipient emergence of sectoral or external imbalances, an important additional task may be to determine the conditions under which such imbalances require fiscal intervention. Moreover, an independent fiscal council could specify the types of fiscal interventions that may be required to correct excessive imbalances. In turn, this may require a considerable research effort to design the appropriate fiscal instruments and calibrate the required adjustments to public spending and taxation.

In terms of setup, it is important that the fiscal policy council is an independent institution, for the same types of reasons that justify the independence of central banks.

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

Finally, it is desirable to match the Swedish practice by including some non-nationals in the membership of the council, since this expands the range of potential members and provides a mechanism to learn from the fiscal experience in other countries.

## **Conclusions**

The goal of this paper has been to highlight how the global crisis should lead to a re-

assessment of the optimal conduct of fiscal policy during normal non-crisis times. First, the severe costs of the crisis signal that it is vital to run a prudent fiscal policy that not only operates in a counter-cyclical manner but also has a structural balance and level of fiscal debt that can permit a country to engage in aggressive fiscal interventions in the event of a severe negative shock. In addition, the cyclical conduct of fiscal policy must incorporate the distribution of macroeconomic risks, in addition to the central projection of the current cyclical state of the economy.

Second, the stabilisation role for fiscal policy not only relates to the output cycle but should also respond to excessive sectoral and external imbalances, in view of the risks to macroeconomic and fiscal stability embedded in such imbalances. In tandem with macro-prudential financial regulation, a wide range of fiscal interventions can help to tackle such imbalances, especially in environments in which monetary policy is rendered ineffective.

Third, pro-stabilisation fiscal policies are more likely to be successful if the fiscal policy is conducted within a formal fiscal framework that combines a set of fiscal rules with a substantive role for an independent fiscal policy council. While such ideas have been in circulation for quite some time, the current crisis provides an opportunity to consider them more seriously and broaden the scope of such fiscal frameworks, even in countries which have already partially implemented such fiscal reforms.

Finally, it is important to acknowledge that the current crisis has also revealed the poor state of our knowledge about the empirical evidence concerning the effectiveness of fiscal interventions. In addition to research on the normative issues that have been the main focus

of this paper, it is a high priority to improve our empirical understanding of how fiscal policy affects macroeconomic outcomes.

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