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ABSTRACT

This paper uses the recent controversy between the European Union and the Irish Republic to discuss the more general relation between the European Union, the EMU and the member countries. Despite outstanding economic growth and budget surpluses, Ireland has been criticized by the European Commission because it has reduced taxes in the context of a relatively high rate of inflation. The first part of the paper considers the ways in which the EMU is likely to affect inflation and cyclical unemployment in the member countries over the longer term. The second part deals more specifically with the current Irish situation and the reasons for an EU reprimand of a very small country. That part suggests that an alternative standard, based on the principle of "do no harm" would have lead to a different outcome. Finally, the paper describes a policy of creating investment-based personal retirement accounts that would allow Ireland to share its future budget surpluses with taxpayers in a way that does not contribute to inflationary pressures.

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<u>Economic Problems of Ireland in Europe</u>

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Economic conditions in Ireland have improved dramatically in recent years. When I first visited Ireland in the 1960s, Dublin was a very depressed city. The economic statistics and the facts about emigration from Ireland confirmed these casual impressions. Now all that has changed. The Dublin of today is an attractive, exciting, and clearly affluent city. Emigration has been replaced by net immigration. And the economic statistics confirm rapidly rising incomes and falling unemployment. By these measures, Ireland is now the star performer in Europe. That performance has also benefitted the Irish budget situation, producing substantial budget surpluses and falling national debt.

This outstanding performance reflects a number of things. As a public finance specialist I give a great deal of weight to the tax policies that encouraged both domestic economic activities and the inflow of foreign direct investment. Ireland pursued good policies and they have paid off in excellent economic performance.

Unfortunately, the strong growth that has produced tight labor markets in Ireland and high demand for real estate has led to unacceptably high inflation. And because of the single currency in the Economic and Monetary Union, there can be no offsetting movements of interest rates or the exchange rate to dampen that rise. The rising level of prices is a potentially serious problem for Ireland because it threatens the international competitiveness on which Ireland's exports – and to some extent its ability to attract direct foreign investment – depend.

The European Commission and the Council of Ministers have recently criticized Ireland's current budget as too expansionary for an economy with Ireland's high rate of inflation because some of the projected surplus will be used to lower taxes and to invest in improving the nation's infrastructure. I think this criticism is misplaced. I think it is also indicative of a more general type of problem within the European Union that will become more common in the future.

Moreover, the criticism directed at the current expansionary budget is probably based on something very different. Ireland's ability to attract foreign investment reflects in substantial part the low level of corporate tax on foreign firms. For many years, Ireland taxed foreign corporate

profits at a rate of only ten percent while domestic Irish companies paid a tax of 30 percent. Firms in most other European countries also paid corporate tax rates of 30 percent or more. This strong incentive for firms to locate in Ireland was resented by the rest of Europe. Ireland was declared to be pursuing an illegal policy in giving a differentially low rate of tax to foreign firms. But although others in Europe expected Ireland to respond by raising the tax rate on foreign firms to the pre-existing rate on Irish firms, the Irish government decided to cut the rate on domestic firms to only 12.5 percent and to levy that rate on foreign firms as well. The enormous gap between the corporate tax rate elsewhere in Europe and the 12.5 percent in Ireland has been a continuous thorn in the side of other European nations. Since tax rates are a matter of national sovereignty under the Maastricht treaty, there is no legal basis for complaint. Many observers believe that the complaint against Ireland's current budget policy is an indirect way of expressing the distaste of Ireland's European partners for Ireland's corporate tax policy.

These developments and conditions provide the background for this lecture. I begin by discussing my perspective on the economics and politics of the European Economic and Monetary Union in general. I then turn to the current situation of Ireland and its conflict with the European Commission and the other members of the European Union. Finally, I will offer a suggestion that would allow Ireland to share its future budget surpluses with taxpayers in a way that does not contribute to inflationary pressures.

The Economics and Politics of EMU[1]

I believe the EMU is economically unnecessary and is likely to be harmful to economic performance in the long run. I believe that its motivation – the reason that the EMU exists today – is political rather than economic. And what worries me most is that the development that follows will be a source of political conflict – within Europe and with the United States. I now discuss each of these themes in order.

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[1]This section draws upon and extends several of my earlier articles, including: "The Case Against the EMU," The Economist, June 13, 1992; "EMU and International Conflict," Foreign Affairs, 1997; "The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability," Journal of Economic Perspectives, Fall 1997, and "The Euro Risk," Time, January 25, 1999.

First, the monetary union and the single currency are not necessary for the expansion of trade within Europe. The initial campaign for the EMU – the Delors report entitled, "One Market, One Money," was based on a false premise. Nothing in economic theory or experience implies that countries must have a single currency for trade among them to flourish. The lowering of trade barriers by the creation of a Single Market was important for encouraging trade but the introduction of a single currency was not. The US trade with Canada – our largest trading partner – does not depend on a fixed exchange rate. The same is true of trade between US and Japan – America's second largest trading partner. Japan's large volume of exports has certainly not depended on a fixed exchange rate. And the surge of US - Mexican trade after NAFTA – despite substantial currency volatility in the dollar-peso exchange rate – shows that what matters is trade barriers, tariffs, and quotas, rather than a single currency.

But the single currency is not just irrelevant. It is a potential source of poor economic performance – of higher inflation and higher unemployment – than would happen if each European country kept its own currency. Moreover, the policy dynamics that accompany the EMU are likely to cause tax policy developments that are less favorable to growth in the long run. Let me explain.

I'll start with inflation. Although the inflation situation in Ireland is improving, it remains a serious problem. If the Irish pound were a floating currency, the increasing inflation would automatically cause the rate of interest in Ireland to rise. That automatic process would restrain demand and lower inflation. In addition, the central bank could reinforce this process by more tightening that raises real interest rates further. A country with monetary independence can control its inflation.

Now, because of the single currency, the interest rate in Ireland is set in Frankfurt. In determining the Europe-wide interest rate, the European Central Bank (ECB) looks at Eurozone conditions as a whole. The situation in Ireland, which represents only 1 percent of the GDP of Europe – gets essentially no weight in the decisions of the ECB.

In short, the experience of Ireland is an example of how countries and regions may experience unacceptably high inflation without any reaction from ECB and of course without any spontaneous, automatic rise in the country's interest rate. Ireland's current inflation problem is just the first example of this general problem brought about by the EMU's single currency.

But the problem of inflation within Europe is more than just the problem of differences in inflation rates in different individual countries. I believe that over time the average rate of inflation in Europe as a whole will be higher, possibly substantially higher, because of EMU than it would be otherwise.

Why? There is now a consensus in Europe in favor of low inflation. Low inflation was built into the convergence conditions for joining the EMU. But even in the years before the Maastricht treaty, countries sought to achieve Germany's low inflation rate because a failure to do so would entail the ignominy of a devaluation relative to the German mark.

The strong aversion to inflation in Germany itself – probably the country with the strongest anti-inflation public sentiment in the world – provided a potential anchor for inflation in Europe as whole. As long as the Bundesbank pursued a tough anti-inflation monetary policy, Europe in general would have a low inflation rate.

Now that has all changed. The Bundesbank no longer makes monetary policy for Germany. Monetary policy is made by the European Central Bank. There, all countries are technically equal. In making monetary policy, the rule is: one country equals one vote. Now there is support for a low inflation policy. But how long will it last? If unemployment starts rising throughout Europe because of inadequate demand while inflation is rising, what would the multi-national board of the ECB do? I suspect that 10 years from now – or perhaps sooner – the ECB will be more tolerant of inflation that it is today. Although the German voice at the ECB will be strong, it will be just one voice among many. The result may be a return to the higher inflation rates that characterized many of the European countries back in the 1970s and 1980s.

The independence of the ECB and its ability to make monetary policy decisions without political interference also remains to be tested. In principle, the independence of the ECB is guaranteed by the Maastricht treaty. But the ECB members are politically appointed and may be reluctant to act in ways that would displease their political appointers – especially if they expect to return to their home countries and seek new political appointments after their years at the ECB.

Moreover, there is continuing agitation – by the French in particular – for the Council of Economic and Finance Ministers (ECOFIN) – to have a more powerful role as a counterweight to the ECB. There are those who argue that the independence of the ECB is too great and that its lack

of political accountability is unacceptable in a democracy. Although such independence is well accepted in Germany, it is a much newer and radical departure from the traditions of most other European countries. A period of economic downturn that pits the ECB against the political leaders of Europe may bring about a fundamental change in its independence.

All of this makes me worry that the low rate of inflation will not last. The ECB means the end of German standard-setting and therefore eliminates the basic source of price stability that provided an anchor for all of Europe. The shift to a single monetary authority in which all countries are equal is therefore likely to lead to a higher level of inflation in the future.

Higher Cyclical Unemployment

The EMU arrangement is also likely to lead to a higher average level of cyclical unemployment. The basic reason for this is the lack of flexibility of individual country interest rates and exchange rates. To see why, consider what would happen if Ireland experienced the opposite of its current cyclical boom. If the Irish economy were to experience a substantial economic recession, there would be no countervailing effect from Irish interest rates or from the exchange rate to help the economy recovery. In contrast, if Ireland had a floating exchange rate, the level of interest rates in Ireland would fall and the exchange rate would weaken.

This would be the natural and spontaneous response to a weaker economy. The lower interest rate would stimulate interest sensitive spending while the weaker exchange rate would stimulate net exports. Both of these would contribute to a faster recovery. In addition, the Irish central bank could act to depress interest rates further, with a likely concurrent lowering of the exchange rate. With the EMU, none of this can happen, the recovery would be slower and cyclical unemployment higher.

This situation is often summarized by saying that a one-size-fits-all monetary policy is a serious problem. That is a correct conclusion. If the future Irish cyclical downturn occurs at a time when the rest of Europe is experiencing strong demand, the ECB would ignore the conditions in Ireland and tighten monetary policy. The ECB is supposed to make monetary policy on the basis of the economic conditions in the Eurozone as a whole. Since Germany and France have half of the

GDP of the Eurozone, their conditions would be the focus of the ECB policy. The ECB by its own rules would ignore an Irish recession just as it ignores today's Irish inflation.

But the problem is not just the inappropriateness of the one-size-fits-all monetary policy. The single currency also precludes the natural spontaneous response of the interest rates and the exchange rate that would occur even if the Irish central bank kept the money supply constant. The lack of exchange rate flexibility means that the interest rate must be essentially the same in Dublin as it is in Paris or France or Rome. By preventing any spontaneous response of interest rates or exchange rates, the EMU system eliminates a major homeostatic feature of the economy and will lead to higher average cyclical unemployment in the future.

What then could Ireland do to counter a future economic downturn? The obvious answer is a fiscal expansion through tax cuts or higher government spending. Unfortunately, that substitutes a blunt instrument that is hard to change quickly for the more flexible instrument of monetary policy. It also means that an expansion policy saddles the economy with the permanent burden of a larger national debt. Moreover, even if Ireland were willing to accept these disadvantages of using an expansionary fiscal policy, it is not clear whether it would be allowed to do so under the EMU's Growth and Stability Pact that precludes large budget deficits. How would the European Commission and the ECOFIN respond if Ireland, starting with a cyclically enlarged budget deficit, then took steps to deliberately enlarge the deficit by cutting taxes and raising government spending?

U.S. Conditions and a Single Dollar Currency

My pessimism about the effects of a single currency on the long-run average level of cyclical unemployment may seem strange coming from an American. After all, the United States seems to do all right despite having a single currency for an economy that is as large and diverse as that of the Eurozone. Why does a one-size-fits-all monetary policy work better in the United States than I think it will for Europe? And why can the United States have a low unemployment rate without internal regional differences in interest rates and without separate currencies and exchange rates for the different regions of the country?

The basic answer lies in three fundamental differences between the US economy and the economies of Europe: flexible labor markets, internal migration, and fiscal centralization. Let me explain.

A rise in unemployment in a region of the United States – say the Northeast or the Midwest – leads to lower wages in that region. These shifts are large and rapid. Companies respond by raising employment and shifting production to the regions with lower wage costs, offsetting the regional decline of demand. By contrast, wages in Europe are much less responsive to cyclical conditions.

Internal migration within the United States is another important response to regional shifts in demand. An increase in unemployment in the Northeast or Midwest will cause a flow of workers to other parts of the country with lower unemployment rates. A comparable flow of people across national boundaries in Europe is unthinkable because of differences in language. These linguistic barriers are reinforced by cultural and institutional features that make mobility much less.

Finally, the United States has a centralized fiscal system in which most taxes flow to Washington and most transfer payments come from the central government. That means an automatic fiscal stimulus to any region in which demand declines. If GDP falls in my own state of Massachusetts, the result is a smaller flow of tax dollars from Massachusetts residents to Washington, DC and a larger flow of benefits from Washington, DC to Massachusetts residents. Roughly speaking, each $100 decline in Massachusetts' GDP leads to a $40 net flow to Massachusetts – through lower tax payments and higher transfer receipts.

These three natural forces – wage flexibility, internal migration, and automatic fiscal transfers – strengthen the recoveries in individual regions and make separate currencies unnecessary to dampen the unemployment response to regional shocks to demand.

Political Motivation for the EMU

I have been painting a rather bleak picture of the economic implications of the EMU. Why if this is true, did the leaders of Europe adopt a single currency and why have 12 countries joined the EMU system?

The answer is politics. The motivation for the EMU is political not economic. Although there are those who now deny it, the EMU is part of a long-term strategy that goes back to Jean Monnet for the creation of the United States of Europe. The strategy ever since Monnet is to do so through a series of incremental moves rather than in a single large jump.

Creation of a single currency is a major step in that process. When individuals hold Euros in their pockets instead of deutschmarks, francs, or liras, they are bound to feel more like Europeans and less like Germans, Frenchmen, or Italians. I know of no example today or in history of a major country that does not have its own currency. The psychological impact of the shift from national currencies to the single currency euro is likely to be enormous. Moreover, the shift of monetary policy making from national central banks to the ECB represents an enormous and very visible shift of power from national capitals to Frankfurt and Brussels and Strasbourg.

The program to evolve to a United States of Europe has multiple motivations today. Not all of those who support EMU favor such a political development. But it is nevertheless the driving force that has brought Europe to this point in its evolution and that is likely to guide the future economic policies and the future centralization of power.

One of the primary initial motivations was to create a political union that would avoid a repetition of the Franco-German wars that had done so much harm three times in the century before the Treaty of Rome. This is certainly a desirable goal – although I'm not at all certain that forcing Germany and France to abide by common political decisions is a good way to avoid conflict. It could have just the opposite effect. Think, for example, about the civil war in the United States in the 1860s that resulted from the North's desire to restrict slavery in the South. The attempt of the Southern states to assert what they believed were their rights under the US Constitution led to the invasion of the South by Northern troops and a massive and destructive war. So the existence of a single federal government and a written constitution is no guarantee of peace.

In any case, the idea of war among the members of the EMU now seems very remote. While Helmut Kohl would refer to this in defense of the EMU, it always seemed to me be redolent of an earlier age.

A more important reason – especially in the minds of French officials – has been to establish a greater independent identity for Europe and to counter the role of the United States in Europe. This was difficult to do as long as the Soviet Union was a dominant threat and the cold war defined international relations. But with the collapse of the Soviet Union there is more scope for France to pursue this independent role for Europe. We see it today in many forms: the formal creation of a European Security and Defense Program separate from NATO, the opposition of France to US-UK policy on Iraq, the different attitude about genetically modified food, etc.

But the political motivation for EMU was certainly not just about Euro-American relations. For France, the pursuit of EMU and the strengthening of the political union was also seen as a way for France to establish parity with Germany. Before EMU, monetary policy throughout Europe was dominated by the Bundesbank. The Banque de France had no choice but to mirror the interest rate changes in Germany. EMU and the ECB gives France parity with Germany in the making of monetary policy. More generally, after German reunification, it looked in France as if Germany would be the overwhelming economic and political power in Europe. Institutions like the ECB, the ECOFIN and the expanded role of the Commission would (the French hoped) limit German power.

For Germany, the motivations are more complex and less clear. Helmut Kohl emphasized a stronger Europe as a way of containing and controlling Germany power. Others in Germany no doubt see a European Federal State as a way for Germany – the country with the greatest population and largest economy, located in the geographic center of the expanded Europe – to be the dominant player on the continent.

These two views – the French desire to achieve parity in economic policy and leadership in foreign policy, and the German desire to exert its role as the leading country of Europe – are clearly not compatible and are a potential source of future conflict between these two countries.

Outside France and Germany the reasons that drove countries to join EMU are varied and complex. I believe the Italians were eager to join because membership showed that Italy was able to stand alongside France and Germany as a major nation of Europe. Being left out – even though

Italy didn't come close to meeting the Maastricht economic criteria for admission – would have been a major blow to Italy's national prestige since it had been a founding member of the Treaty of Rome.

Spain was eager to join because membership was an important piece of evidence that Spain had outgrown its days as an outcast under General Franco. For many other countries, membership meant not being left behind and having a seat at the table where pan-European decisions would be taken.

To summarize what I have been saying, my basic point is that EMU will have serious long-run adverse effects on inflation and cyclical unemployment in Europe. Its motivation has been political not economic. Bad economic outcomes are a price that member countries have accepted – knowingly or unknowingly - in order to achieve political ends. For France and Germany these political goals are basically incompatible and a source of future friction. For other countries, the shift of political and economic decisions from the national capital to Frankfurt, Brussels and Strasbourg will have adverse economic consequences and may create serious frictions with its neighbors and with the United States.

The Commission, the ECOFIN and the Irish Budget

This brings me to the recent conflict between Ireland and the European Commission and the ECOFIN. To an outside observer, it seems most remarkable that official criticism should be directed at a country with the best economic performance – low inflation and low unemployment, strong economic growth, large budget surpluses and low national debt. Your sin – as you know – is having a low corporate tax rate and, more recently, using some of the budget surpluses to cut taxes and invest in infrastructure.

There is of course nothing about the Irish budget or other Irish policies that conflicts with either the Maastricht Treaty or the subsequent Growth and Stability Pact. Ireland does not have a budget deficit or a high level of national debt.

What then do Irish policies violate? According to the Commission, they violate the guidance the Commission provides to each county as past of its annual recommendations for the broad guidelines on the economic policies of the member states of the European Union – and not just of the EMU. Those guidelines urged Ireland to use its budget surplus to reduce aggregate demands and

therefore to lower inflation. In the eyes of the Commission, Ireland didn't do that and deserves to chastised.

It is significant that this is the first such criticism (based on the annual guidelines) of any country by the Commission and Council . Is Ireland's sin the most serious economic problem in Europe? Should others not be criticized before Ireland for failure to adopt polices to lower unemployment? Should others not be criticized first for failing to adopt policies that lower budget deficits and debt levels that still exceed the Maastricht standard? And should other not be criticized first for industrial subsidies that distort trade? It's hard for me to imagine any legitimate reason why Ireland was singled out for the distinct honor of being the first to be reprimanded.

Just how inflationary is the Irish budget? The Irish government has said that the tax cuts were given as part of a general deal with the trade unions to accept wage restraint in return for lower taxes. I don't know enough about wage setting in Ireland to know whether the net effect of combining an expansionary tax policy and a suppression of wage demands will mean higher or lower inflation. I wonder whether the EC or the ECOFIN knows enough to answer that question.

Wouldn't it be better to leave that decision to Ireland? Certainly Ireland has much more to lose from a rise in Irish inflation than any other European country. And the officials in Ireland understand the leverage on wage setting that tax cuts may be able to achieve far better than the staff of the Commission in Brussels.

The New Saving Scheme

A novel and I think very good feature of the current Irish budget is the New Saving Scheme. As I understand it, individuals may save up to 2400 pounds per year for the next five years and receive a 25 percent supplement to their new special account from the government. Thus an individual who saves 2400 pounds would have a starting balance of 3000 pounds.

Now just what is the effect of this form of tax cut on aggregate demand? First, it is clear that the 25 percent grant does not go directly into consumption, although it may add indirectly to aggregate consumption and demand. The impact on demand and inflation depends on how households respond to this new saving incentive.

As with everything in economics, there are a variety of possible responses. Some individuals may just transfer to the new accounts some of the saving they otherwise would do and receive the 25 percent match as a windfall. For such individuals, the tax cut in this form will not add to demand at all.

Some individuals may treat the 25 percent supplement as a substitute for their own saving and cut their own saving by an equal amount. For such individuals, consumption would rise.

But the most likely response to this strong saving incentive is to induce individuals to save more. Someone who normally saves 1000 pounds a year might respond to the new incentive by saving 1500 pounds a year. For such an individual, total consumption falls by 500 pounds.

In short, if the saving incentive succeeds in raising saving, aggregate consumption and demand will fall. This part of the overall tax and budget package would therefore be contractionary.

Since we don't know how large the response will be to this saving incentive, it's impossible to know on balance how the overall tax cut would affect demand and inflation. It's too bad that the EC does not seem to have thought about this.

A Rule for All Countries

The more basic issue is the criterion by which the Commission can decide to reprimand a country for its behavior. A large budget deficit (or a large rise in an existing budget deficit) is a reason that is specifically provided for by the Growth and Stability Pact on the grounds that large deficits increase the risk of default by a member government. It's not clear how necessary such collective action is since the financial markets are very sensitive to default risk and would impose a risk premium on countries with large deficits. Nevertheless, it is something that the governments agreed to in the Growth and Stability Pact.

But why should the potential for a reprimand extend to general fiscal policy of a government with a budget surplus and low national debt? And if the Commission extends itself to this, where will it stop?

Pedro Solbes, The EU Commissioner responsible for economics and finance, answered this question in a recent letter to the Economist newspaper (February 24, 2001). According to Commissioner Solbes, the Economist's earlier criticism of the Commission for its censure of Ireland

"fails to take into account the fundamentals of the EMU model. The notion of national but coordinated economic powers is not only embedded in the Maastricht Treaty but is also necessary to ensure an appropriate policy mix against a background of a single monetary policy. The coherence, consistency and predictability of the euro-area's economic policy management is important for the credibility of our currency over the medium-term. Big or small does not make any difference here."

It is hard for me to understand the logic of this statement or to see <u>any</u> form of national economic policy that Brussels could not consider to be subject to review by the Commission.

What does "national but coordinated economic policies" mean? Either Ireland is free to set its tax rates – subject to the budget deficit rules to which it agreed in the Growth and Stability Pact – or it is not. Could Ireland have "coordinated" its budget policy in a way that allowed it to do what it has chosen to do? If not, in what sense would this be a national policy?

It's interesting also that Mr. Solbes did not refer to "budget policies" but wrote instead of "economic policies." Does that mean that every kind of economic policy must be "coordinated" through Brussels in order to be consistent with a single monetary policy? Did Ireland understand that, in agreeing to a single currency, it would have to make its future economic policies subservient to that end and to the judgment of Brussels?

Mr. Solbes and the Commission base their reprimand on the principle that "big or small does not make any difference" when it comes to "the importance of the coherence, consistency and predictability of the euro-area economic policy .... for the credibility of our currency over the medium term". But how can the increase in demand in Ireland with just about 1% of the GDP of the Eurozone as a whole – have any effect on the euro? Clearly it cannot.

If there is a justification for the Commission's expression of concern about Ireland's policy it must be the idea that any policy of the Commission and of the Community must be a <u>general</u> rule that can be applied to <u>all</u> countries, small as well as big. But how should that general rule be stated? There is <u>no reason</u> to make the <u>general</u> policy one that precludes a domestic policy in one country if that policy does <u>no harm</u> in the others countries.

Do No Harm

A sensible rule that could be applied to all countries might therefore be something like this: the fiscal policy of each member country should do no direct harm to other countries or to the community as a whole. That "do no harm" standard could be applied equally to all countries – to a relatively small country like Ireland as well as to larger countries like Germany and Italy.

As a practical matter, of course, the "do no harm standard" would have some minimum threshold. This standard would mean that a very small excess stimulus in a large country like Germany or Italy that is experiencing rising inflation might not be a cause for comment while a very large excess stimulus in a small country like Ireland under similar conditions could be a cause for comment. The test in each case would be: does this action do more than the threshold amount of direct harm to other countries? On that basis, I find it hard to believe that the size and structure of the current Irish budget are an appropriate reason for a Commission reprimand.

Personal Retirement Accounts to Share Budget Surpluses with the Taxpayers of Ireland

There is however a policy that I think Ireland might consider as a method of sharing its current and future budget surpluses with the taxpayers of Ireland in a way that does not contribute to inflationary pressures.

I visited Dublin last in September 1999, and met at that time with Governor O'Connell at the central bank. We spoke about the then current situation in Ireland and his concern about the high and rising rate of inflation. He described the expected budget surpluses and the general expectation that it would be used to reduce taxes as part of an overall agreement with the trade unions.

My immediate reaction was to suggest an alternative to a tax cut that would take the form of government deposits in personal saving accounts to start an investment-based social security pension program. Now I'll confess that I'm generally very much in favor of such investment-based social security pension accounts for all countries, regardless of their current budget situation or macroeconomic condition. I favor such universal investment-based individual accounts as a supplement to the traditional pay-as-you-go pension systems that exist in the United States and in most other OECD countries. I believe that such a mixed system, with a significant investment-based component, is the best way to deal with the problem of an ageing population that affects all countries

around the world. I will say more about the appeal of such accounts in general but let me first say why they may be particularly appropriate for Ireland at the present time, as a modification or in addition to the new National Pension Reserve Fund.

Government contributions to individual Personal Retirement Accounts made in proportion to wages would, in a sense, be equivalent to an across-the-board proportional wage increase. A flat rate contribution to each account would be equivalent to an equal pay increase for each individual. Each individual would see his or her personal wealth rise by that amount. And yet the extra compensation would not be directly available to spend but would be added to national saving in much the same way as it would if the government simply used the funds to buy back national debt or to contribute to the National Pension Reserve Fund. Of course, some individuals might respond to the extra funds in their accounts by decreasing other savings. But the overall effect of the deposits to PRAs would undoubtedly be a substantial increase in saving rather than in consumption.

The idea of using government deposits to personal retirement accounts as part of a plan to reduce wage increases is one that I borrowed from the Australians. Back in the 1980s, Australia faced substantial pressure for wage increases. The government at that time was a Labor government with strong ties to the Australian trade unions. It negotiated an agreement in which the unions would forego wage increases if the employers would make contributions to a system of personal retirement accounts. Although the employer contributions added to the cost of employment, the personal retirement account deposits did not add to consumption spending in the way that ordinary wage increase would have done.[2]

Ireland could achieve this same advantage of negotiating away some of the inflationary pressures for wage increases and, because of the projected budget surpluses, could do so without adding to employers' costs of production. It is a unique opportunity to achieve a desirable macroeconomic goal, give back extra tax reserves to the taxpayers as a whole, and start an important

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[2]For more information on the Australian experience, see Malcolm Edey and John Simon, "Australia's Retirement Income System," in M. Feldstein, editor, Privatizing Social Security (Chicago: Chicago University Press, 1998)

social policy that will help to deal with the ageing of the population and the resulting rise in the relative number of retirees.[3]

The special saving scheme in this year's budget has some of the same character – giving back funds in the form of a saving deposit rather than as spendable cash. But contributions to personal retirement accounts would be better in being universal – i.e., going to everyone – and being related to each individual's pay.

A system of personal retirement accounts could, as I noted a moment ago, be an alternative or a supplement to the National Pension Reserve Fund. It would have the same advantages of prefunding future public pension costs as the National Pension Reserve Fund and would avoid some of the problems of the Pension Reserve Fund, particularly the potential politicization of the Fund's investment decisions. The experience with state level pension funds in the United States shows that there is often substantial pressure to invest these funds in local firms and to apply "social" rather than commercial criteria to the investments. Shifting the funds to individual accounts would significantly reduce the risk of politicization because the individuals would protect the value of their own assets.

Professor Phillip Lane has made an ingenious suggestion of an alternative way of preventing the politicization of the National Pension Reserve Fund by requiring that it invest only in non-Irish assets. That however entails a significant national cost in the form of foregone investment in the Irish economy. Since one percent of GDP is to be deposited in the NPRF each year, the immediate impact would be to divert savings equal to one percent of GDP from domestic investment in Ireland to investment in other economies. Over time, the cumulative effect is quite large – reaching 42% of GDP in less than 25 years according to Professor Lane.

When funds are invested abroad, Ireland receives the interest and dividends on those assets but foregoes the taxes collected on the resulting corporate profits by the foreign government. For example, an investment of $100 in United States equity would indirectly add $100 to the US capital stock, producing additional national income in the United States of about $10 a year. The US tax authorities at the federal, state and local levels would capture about 40% of this – i.e., about $4 – in

[3] This idea is developed by my Harvard colleague John McHale in "Adding an Instrument to Social Partnership: A Proposal for Deferred Compensation," forthcoming in the bulletin of the Economic and Social Research Institute of Ireland.

taxes. The remaining $6 would then come to Ireland in the form of the dividends and the capital gains that reflect retained earnings. In contrast, if those $100 were invested in Ireland, the return to the Irish nation – including the taxes collected – would equal the full productivity of the investment.

In a perfectly and completely integrated global capital market the outflow of funds from Ireland would be offset by an equal inflow from the rest of the world because individual investors would shift funds around the world to the places with the highest returns.

But experience, combined with statistical research,[4] shows that the global capital market is far more segmented than this. Saving tends to remain in the country of origin. Countries with higher saving rates have higher investment rates. If the Irish government decides to export some of its national saving by a rule requiring that the Pension Reserve Fund invest only abroad, it cannot count on an offsetting inflow of fund from abroad.[5]

There are other advantages of a system of individual accounts. Individuals would have a stronger sense of security about their retirement incomes, knowing that their accounts are personal property that cannot be taken away. These accounts would permit individuals to tailor the risk-reward ratio and their behavior toward investments in industries like alcohol and tobacco to their personal preferences. And the individual accounts would provide a framework that would encourage individuals to accumulate additional funds on a voluntary basis.

Although the National Pension Reserve Fund is intended to run down after the year 2055 and eventually to be eliminated, there is no economic reason to return in this way to a pure pay-as-you-go

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[4]See M. Feldstein and C. Horioka, "Domestic Savings and International Capital Flows," Economic Journal, June 1980 and M. Feldstein, "Tax Policy and International Capital Flows," Weltwirtshaftsliches Archiv, 1994.

[5]More specifically, I interpret the Feldstein-Horioka finding as saying that over relatively long periods of time private savers tend to keep their saving in the country in which it originates. We have too little experience with sustained budget surpluses to know how they affect international capital flows. The Feldstein-Horioka logic suggests that if the surpluses are used to finance the repurchase of domestically held government debt, the funds will also remain at home. The key question for Ireland now is what happens if the government taxes people and then sends the money abroad. I believe that it will lead to an increase in foreign investment with little or no reflow back to Ireland. Foreign savers will continue to keep their savings at home while Irish taxpayers will not borrow funds from the rest of the world to offset the government outflow.

financing of public pensions. Personal retirement accounts could instead be a permanent part of financing future pension benefits.

The great advantage of including personal retirement accounts in the system of financing social security pensions is the higher rate of return on such investment-based accounts than in the traditional pay-as-you-go accounts.

In the United States, President Bush has proposed such accounts and announced that he will appoint a commission to work out the details. Calculations by the U.S. government's actuaries show that, with the existing pay-as-you-go system, the aging of the population will raise the cost of providing the existing ratio of benefits to past earnings from the current 12 percent of earnings to 19 percent of earnings. By shifting to a mixed system, the same level of benefits can be provided without any increase in the 12 percent pay-as-you-go tax if it is supplemented by personal retirement account deposit equal to 2% of earnings.[6] That is, the 6 percentage point rise in the pay-as-you-go tax can be replaced by a 2% investment-based saving. By increasing the personal retirement account deposit to 3% of earnings, the long-term pay-as-you-go tax rate can be reduced from today's 12% to only 9%, leaving the combination of the pay-as-you-go tax and the 3% PRA deposits at today's total of 12% despite the 50% rise in the relative number of retirees.

A similar 3 to 1 advantage in likely to be available in Ireland, with perhaps some difference to reflect differences in demographic conditions and economic growth rates between Ireland and United States.

There are many possible alternatives in the design of a universal individual account investment based portion of the national retirement system. Each country must tailor the arrangements to its own conditions and traditions. But it is an idea that is gaining acceptance around the world in countries as different as Australia and China, as Sweden and Mexico. I think it is an idea that deserves careful consideration here in Ireland as well.

Cambridge, Massachusetts
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[6]See M. Feldstein and A. Samwick, "Potential Effects of Two Percent Retirement Accounts," Tax Notes, May 4, 1998 as updated in "New Estimates of Two Percent Personal Retirement Accounts," available at www.nber.org.