

A New Fiscal Strategy for Ireland

Philip R. Lane*

IIIS, Trinity College Dublin and CEPR

January 2009

*Prepared for the UCD-DEW “Responding to the Crisis” workshop on January 12th 2009. This paper is part of an IRCHSS-sponsored research project on *An Analysis of the Impact of European Monetary Union on Irish Macroeconomic Policy*. Agustin Benetrix, Christiane Hellmanzeik and Peter McQuade provided helpful research assistance. Email: plane@tcd.ie. Tel: +353 1 896 2259. Fax: +353 1 896 3939. Postal Address: The Sutherland Centre, Arts Block, Trinity College Dublin, Dublin 2, Ireland.

1 Introduction

Around the world, fiscal policy has now taken centre stage in the debate on responding to the sharp economic slowdown. In large part, this reflects the limited effectiveness of monetary policy, once policy rates are close to zero and the persistent spread between inter-bank and policy rates renders ineffective the traditional monetary transmission mechanism through the bank lending channel. At a global level, the November 2008 summit of the G-20 group signalled the commitment of the world's largest economies to fiscal expansion, with major programmes announced by the United States, China and Japan. At the December 2008 European Council meeting, the member countries of the European Union have also agreed a fiscal expansion plan, amounting to 1.5 percent of EU GDP. However, at both the global and European levels, there is widespread agreement that the appropriate fiscal stance varies across countries, according to the individual circumstances of each economy. Accordingly, the challenge for Ireland is to design and implement an optimal fiscal response that recognises both the general importance of fiscal policy in dealing with a global financial and economic crisis and the set of constraints that may limit the effectiveness of this tool for the Irish economy.

The successful execution of fiscal policy is especially important for members of the euro area, since these countries do not have the option to independently alter interest rates or the nominal exchange rate.¹ The primary focus of the research literature on fiscal policy and EMU has been on the importance of fiscal rules in order to avoid excessive debt accumulation, which are formalised in the Stability and Growth Pact (SGP). However, it is commonly accepted that the acute nature of the current crisis means that the normal

¹Of course, the lack of policy autonomy over interest rates and exchange rates may be a blessing. At a collective level, independent choices over exchange rates have negative spillover effects, through the familiar "beggar-thy-neighbour" channel. In relation to interest rates, it is plausible that weaker members of the euro area would be compelled to raise interest rates during a crisis situation in order to stave off speculative attacks and capital flight.

implementation of the SGP is not appropriate, with temporary deviations from the SGP guidelines to be tolerated. Accordingly, attention has now shifted to the potential effectiveness of fiscal policy in stabilising the euro area economy and the appropriate design of fiscal interventions. However, there is no consensus on the appropriate scale and composition of fiscal expansion programmes, with the German government especially sceptical as to the efficacy of Keynesian-style demand management.

The Irish case is especially interesting for several reasons. On the one side, there are some factors that may make fiscal policy especially effective in current Irish situation. First, the relatively low initial level of public debt at the onset of the crisis means that Ireland is better placed than some other member countries in having room for some degree of fiscal expansion. Second, the severe and prolonged nature of housing-related slowdowns means that there may be a useful role for discretionary fiscal policy in stabilising the Irish economy, since the traditional critique that business cycles are too shallow and temporary to be amenable to fiscal interventions may not apply with full force. Third, two decades of investment in the social partnership process may enable the government to implement radical fiscal interventions that may not be politically feasible in more adversarial socio-political systems.

On the other side, there are important constraints that limit the potential effectiveness of Irish fiscal policy. Most obviously, the high trade openness of the Irish economy means that the impact on domestic demand of a given fiscal intervention is lower in Ireland than in more closed economies. In addition, the Irish economy currently suffers from a major structural imbalance, with export sectors having been squeezed in recent years by the expansion of activity in domestically-orientated sectors (construction, public services, consumption-related services). The long-term health of the Irish economy requires a rebalancing towards sectors that have a greater potential for delivering productivity growth. Accordingly, the appropriate fiscal policy for Ireland needs to incorporate the need for

rebalancing.²

Most importantly, the effectiveness of fiscal interventions depends on the sustainability of a country's fiscal position. This is fully recognised in the recent IMF study on the role of fiscal policy in the current crisis (Spilimbergo et al 2008). While this study generally advocates the deployment of fiscal policy, it recognises that it will not be effective in all countries. In particular, the authors state "*However, it is also essential that fiscal stimulus not be seen by markets as seriously calling into question medium-term fiscal sustainability. This is key, not only for the medium run, but also for the short run, as questions about debt sustainability would undercut the near-term effectiveness of policy through adverse effects on financial markets, interest rates, and consumer spending*" (paragraph 27 on page 8). While Ireland had a low initial level of public debt at the onset of the crisis, the sustainability issue is a substantive one due to a number of factors. First, the projected levels of the general government deficits for 2008 and 2009 are sufficiently large at 6.9 percent and 10.2 of GDP respectively (according to the latest ESRI Quarterly Economic Bulletin) that the public debt profile for Ireland has already been transformed. According to the most recent Exchequer Statement, the ratio of gross general government debt to GDP has grown from 27 percent of GDP at the end of 2007 to 41 percent at the end of 2008. This is compounded by the contraction in the value of the National Pension Reserve Fund, which suffered a minus 28 percent return during 2008, such that the net financial position of the Irish government looks much worse now than at the end of 2007.

Second, Irish fiscal policy lacks a sufficiently strong long-term anchor. A period of even high deficits may be quite sustainable, so long as taxpayers and investors believe that the

²The importance of switching the sectoral composition of activity is also a concern for other countries. In general, most other deficit countries (US, UK, Spain, Central and Eastern Europe) are looking to reduce domestic spending and increase exports, while the resolution of global imbalances is best achieved if the major surplus countries (China, Japan, Germany, oil exporters) take steps to raise domestic spending and reduce their reliance on export-driven growth.

fiscal position will recover within a reasonable time frame. Unfortunately, several factors contribute to substantial uncertainty concerning the long-term fiscal prospects for Ireland. These include Ireland's own fiscal history, which showed a capacity to allow the public debt to chronically expand to a very high level before a fiscal correction was eventually accomplished. Next, the current tax shortfall has a major structural component, such that economic recovery on its own will not lead to a restoration of pre-crisis levels of tax revenue, while the level of government spending has been quite unstable relative to GDP. Accordingly, fiscal sustainability requires a reform of medium-term taxation and expenditure plans: however, the nature and timing of the reform that will be delivered by the political system is currently unknown. Finally, the full extent of the required public re-capitalisation of the banking sector remains unknown, with even greater uncertainty attached to the net fiscal cost of the bailout.³

In view of these competing forces, the identification of the optimal fiscal strategy for Ireland is unusually difficult. In the rest of this paper, I analyse in more detail the factors that are relevant in designing the fiscal response. In Section 2, I turn to the potential effectiveness of fiscal policy as a stabilisation tool. Section 3 considers the fiscal sustainability constraint. Based on the foregoing analysis, Section 4 outlines the main features of a credible fiscal plan for Ireland. I then turn to a brief analysis of the newly-released *Addendum to the Stability Programme Update* that outlines the government's proposed adjustment plan. Finally, concluding remarks are offered in Section 6.

2 The Effectiveness of Fiscal Policy

As is reviewed by Spilimbergo et al (2008), there is surprising little solid empirical evidence as to the effectiveness of fiscal policy, with the estimated magnitudes of fiscal multipliers

³The net fiscal cost equals the cost of the bailout minus the value of payments received by the government in return for the capital injections. Both dimensions are subject to considerable uncertainty.

showing considerable variation across across countries and time periods. This should not be too surprising in view of differences in economic structures: textbook analysis suggests that fiscal effectiveness should indeed vary across different environments and across different types of fiscal packages.⁴ An important factor that has been identified 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).

The empirical evidence concerning the effectiveness of fiscal policy for Ireland is scarce. However, Benetrix and Lane (2009) provide some clues. These authors estimate a vector autoregression model of the Irish economy that permits identification of the impact of government spending shocks on the level of output. An important feature of this study is that it allows the impact to vary across different types of government spending (public investment and different components of public consumption). It finds that government investment has a positive fiscal multiplier that is above unity: a given boost to public capital spending raises output by more than the size of the injection. Government purchases of consumption goods and services from the private sector (non-wage government consumption) have a similar effect. In contrast, an increase in the government payroll (wage government consumption) has a negative fiscal multiplier: an expansion in this category is associated with a contraction in output. Moreover, Benetrix and Lane show that the variation in the fiscal multipliers can be linked to the labour market impact of these different policies: an increase in wage government consumption tends to increase the economy-wide level of real wages, whereas the wage effect is not significantly different from zero for the other categories.

These results come with important caveats. First, the model is estimated over the 1970-2006 period, such that the fiscal multipliers are average effects across the range of

⁴The textbook effectiveness of fiscal policy depends on the textbook also, in view of the dispersion of views concerning the appropriate model for business cycle analysis.

economic conditions faced by Ireland over that interval. In particular, the size of the fiscal multiplier surely varies with the level of slack in the labour market and, as indicated above, the perceived sustainability of the fiscal position. However, the main message of the Benetrix-Lane empirical analysis is that the fiscal multiplier varies across expenditure categories, with public investment boosting the level of output whereas an expansion in the public sector payroll is associated with output contraction.

The composition of government spending also matters for external competitiveness. In the short run, increases in public spending (whether investment or consumption) tend to be associated with real exchange rate appreciation. However, Galstyan and Lane (2008a) find an important long-run difference between government investment and government consumption. An increase in the former is associated with long-run real exchange rate depreciation, while an expansion in the latter is associated with long-run real appreciation. As is shown in the model developed by Galstyan and Lane (2008a, 2008b), this difference can be intuitively explained in a generalised Balassa-Samuelson framework: public investment boosts productivity and thereby drives down the relative price level, whereas government consumption squeezes the export sector by reducing the availability of labour to the private sector.

3 Fiscal Sustainability

A non-sustainable fiscal position is destabilising for the economy. Taxpayers and investors find it difficult to make commitments if there is excessive uncertainty about the future level of taxation; the situation is even worse if a non-trivial probability is assigned to default-type events.⁵

⁵Historically, the returns on sovereign debt could be compromised through the indirect mechanism of inflating away the burden of debt denominated in the domestic currency. This option is not available to a member government of the euro area. There remain two main default risks. First, outright default by a sovereign government can be envisaged as the least bad of all available choices in a truly dire state of

Despite the low initial level of public debt, there are several reasons to be concerned about the sustainability of the Irish public finances. First, as is shown in Figure 1, the rate of deterioration in the general government balance has been dramatic, with a shift between 2006 and 2008 of close to ten percentage points of GDP. In the absence of any corrective action, this is compounded by the current ESRI projection of a general government balance of minus 10.2 percent of GDP for 2009.

The decline in the budgetary position is in part attributable to the collapse in tax revenues, as is illustrated in Figure 3. While a decline in tax revenues can be expected when GDP falls, it is clear that a significant part of the revenue contraction is structural in nature. In particular, the evolution of the tax base over 1997-2006 became increasingly skewed towards asset-related taxes (stamp duties, capital gains tax, capital acquisition tax), which facilitated a decline in the income tax burden. This is sharply illustrated by Figure 4, which shows that the income tax share in core tax revenues declined by 10.1 percentage points between 1997 and 2006 that was offset by a 11 percentage point increase in the share of asset-related taxes. Since the asset-related taxes will not recover for the foreseeable future, this leaves a structural hole in the tax base. Accordingly, the securing of fiscal sustainability necessarily involves clarity on how the tax base will be restored.

However, fiscal uncertainty also relates to the level of public sector spending. Figure 2 shows that the total level of government spending has undergone tremendous oscillations over the 1995-2008 period (for most advanced economies, the ratio of public spending to GDP tends to be much more stable). At one level, this is understandable in view of the unexpected shifts in the GDP growth rate over the period, which has typically led to lagged adjustment in government spending. However, it is not clear what represents the “trend path” for government spending and so it is difficult to make projections about the long-term world. Second, effective default could be accomplished by leaving the euro area and redenominating debt in the new domestic currency at a more depreciated exchange rate. Both default options would carry heavy costs and I take it that these scenarios are not relevant for Ireland.

term tax burden that is required to match the trend level of public spending.⁶ The system of annual budgeting does not help in this regard, to the extent that governments have not sought to target the spending to GDP ratio over a multi-year horizon.

Finally, the banking crisis constitutes a further source of fiscal uncertainty, since the ultimate net fiscal cost to the government is unknown. While some level of uncertainty is inevitable, the gradualist approach to re-capitalisation may also be a contributory factor, since the government's strategy in the event of further deterioration in the health of the banking sector is not fully transparent.

4 Elements of a Fiscal Plan

The analysis in the preceding sections provides some indications as to the optimal design of a fiscal plan for Ireland. First and foremost, it is important to specify a multi-year strategy that ensures the sustainability of the Irish fiscal position. In particular, this should include a clear target range for the trend level of government spending relative to GDP and a tax schedule that can finance this level of spending over the medium term. If such a strategy is adopted and perceived as credible by taxpayers and investors, then a temporary period of high deficits during the transition to the new trend path is more feasible and more likely to help stabilise the economy. The implementation of such a plan will also enable the government to meet the terms of the SGP by demonstrating to the European Commission and the other EU member countries that Ireland will respect the SGP's fiscal rules over the medium term.

In relation to the composition of government spending, the evidence suggests that a high level of government investment is both stabilising in the short run and helps to improve external competitiveness over the long run. At the same time, it is important to ensure that

⁶See also Honohan (2008), who suggests that the average level during the pre-boom 1994-1998 period may be taken as a rough-and-ready target for the ratio of public spending to national income.

public investment is focused on high-quality projects that deliver lasting gains: proposals that fail to pass rigorous and transparent benefit-cost tests should not be pursued. It is also case that the downward revision in the growth projections for Ireland means that the optimal public capital stock is not as large was previously projected during the fast-growth period.

High wage government consumption harms external competitiveness in both the short run and the long run and its fiscal multiplier is actually negative. Accordingly, reductions in the government wage bill can help in output stabilisation and in improving the level of external competitiveness. The high level of outside unemployment is no excuse for the postponement of productivity-enhancing reforms in the public sector or the effective redeployment of staff across categories within the public sector. If these reforms (plus the impact of a shrinking economy and outward migration on the demand for public services) result in aggregate over-staffing in the public sector, a decline in public sector employment may be appropriate. However, while part of the adjustment may take the form of skilfully-crafted and targeted redundancy programmes, a major proportion of the adjustment should take the form of a sizeable reduction in public sector pay rates.⁷

The case for a generalised reduction in public sector pay levels is reinforced by several other factors. First, the evidence indicates that there is a considerable premium in public sector pay. Moreover, Kelly et al (2008) show that the premium has grown from 7.7 to 23.5 per cent between 2003 and 2006. A striking feature of this study is that these authors shows that the premium is largest in lower-level grades (a premium in the 24-32 percent range), while the premium at the senior level is around 10 percent. Moreover, these authors argue that it is plausible that the pay differential has expanded since 2006, due to the payment of the two latest installments of the national pay agreements, the awards under the second

⁷The level of public sector pay should be broadly interpreted to include the value of implicit pension contributions. In addition, the same logic applies to sectors in which the government is the primary purchaser of effective labour services through the imposition of lower procurement rates.

benchmarking exercise and those implemented in the wake of the two most recent reports of the Review Body on Higher Remuneration. Finally, the estimated premia in this paper are likely a lower bound, since it takes no account of the superior pension arrangements in the public sector.

Second, the typical arguments against nominal wage reductions do not have much force in the current environment. The most influential recent study on nominal wage rigidity was conducted by Bewley (1999). His main message is that firms avoid nominal wage reductions, due to the adverse impact on morale. However, much of the morale effect 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 workers would be unchanged. Since the public sector pay reductions would take place against a backdrop of tough private-sector labour market conditions, the relative status of public sector workers vis-a-vis private sector counterparts would also not be egregiously affected (beyond the potential elimination of the aforementioned public sector pay premium).

Third, a major difficulty in achieving nominal wage reductions in the private sector relates to the difficulties encountered by workers in assessing the true financial state of their employers (Bruno and Sachs 1985). However, the state of the public finances is common knowledge and the scale of the financing gap is clearly evident to public sector workers.

Fourth, a core strength of the social partnership infrastructure is that it is broader than a pay agreement (O'Donnell 2001, Sweeney 2008). Accordingly, in negotiating with a union movement that cares about the quality and level of public services in addition the pay and conditions of its members, the government should be able to negotiate public sector pay reductions (plus efficiency-enhancing reforms of public sector service provision) in exchange for the preservation of a given level of public service provision. 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, such that pay settlements cannot

be linked to the overall provision of public services.

Fifth, a cut in public sector wages should be helpful in promoting wage adjustment in the private sector, both through the direct competition for labour and via a demonstration effect. Figure 6 shows the rapid increase in the real exchange rate in recent years. While external factors (movements in the euro-dollar and euro-Sterling rates) are important contributors to these dynamics, the appropriate domestic response is to engineer a reduction in domestic costs.⁸

The contribution of public sector pay cuts in fostering a generalised reduction in wage levels is appropriate in view of the need to restore external competitiveness and re-balance the composition of activity in the economy towards the export sector. This effect should again be further reinforced through the social partnership process, especially for those sectors in the private sector in which the national pay agreements influence wage setting. Again, the potential gain from social partnership may be significant, if cuts in public sector pay also promote wage adjustment in the private sector. The evidence suggests that a coordination approach to pay determination enables wage adjustment in response to macroeconomic shocks, since a centralised mechanism helps to clarify the distinction between the appropriate levels of economy-wide and sector-specific wage adjustment.⁹ This is especially important for member countries of the euro area, since the alternative approach to reducing economy-wide real wages (nominal exchange rate devaluation) is not possible.

⁸In what follows, I focus on labour costs. However, the effort should also extend to tackling monopoly power in various sheltered sectors in the economy, since high local input costs are also an important factor in determining international competitiveness. See also Lane (2007).

⁹The seminal empirical contribution is Calmfors and Driffill (1988). While the Irish private-sector labour market displays considerable flexibility in some dimensions, the negotiation of nominal wage cuts at a firm level encounters the asymmetric information problem mentioned above in relation to the true state of the employer's finances. Accordingly, the temptation is to delay adjustment until the firm is in dire straits. By setting a lower pay norm, the social partnership agreement could facilitate a smoother form of adjustment in the private sector.

This factor is potentially quite relevant for Ireland, even if recent events show that the Irish private-sector labour market displays considerable flexibility in some dimensions. In particular, the negotiation of nominal wage cuts at a firm level encounters the asymmetric information problem mentioned above in relation to the true state of the employer's finances. Accordingly, the temptation is to delay adjustment until the firm is in dire straits. The empirical evidence of Honohan and Leddin (2006) suggests that the speed of labour market adjustment is quite gradual in Ireland, such that market forces by themselves may not be enough to prevent a sizeable and persistent increase in unemployment. By setting a lower pay norm, the social partnership agreement could facilitate a smoother form of adjustment in the private sector.

Sixth, nominal wage reductions may actually be helpful in boosting aggregate demand in the economy. If pay cuts help to stabilise the public finances, a major deterrent to spending plans is removed in that decision makers can better forecast the future tax burden. In addition, the improvement in external competitiveness will give confidence that economic recovery will be based on a sustainable foundation of expansion in the tradables sector.

Seventh, membership of EMU means that there is no link between domestic wage behaviour and the ability of the European Central Bank to implement an effective monetary policy. In particular, the deflation scenario in its true meaning is a function of aggregate price dynamics at the area-wide level, which are unaffected by domestic wage behaviour. While Irish inflation in the next few years may fall below the area-wide average (and may well be negative for a sustained period), this is a purely temporary phenomenon and is just a byproduct of engineering a depreciation in the real effective exchange rate. Rather, long-term inflation expectations for Ireland will be driven by ECB monetary policy, which is committed to delivering a long-term annual average positive inflation rate of 2 percent.

To this end, it is also important to front load the nominal wage reduction in the design of a new pay deal. In particular, aggregate demand is better supported by a sufficiently large initial cut in wages that can be followed by a rising path for wages in subsequent

periods. Such a positively-sloped wage profile promotes current consumption, in the same way that expected exchange rate appreciation effectively reduces the consumption-based real interest rate. By contrast, Blanchard (2007) shows that slow wage adjustment in Portugal amplified the economic slowdown there, since expectations of further wage cuts in the future acted to increase the effective real interest rate there.¹⁰

The design of the pay deal could also provide some upside potential to workers by specifying the possibility of faster wage growth if economic recovery takes hold more quickly than is currently expected. This can be achieved by agreeing a formula by which wage growth (after the initial cut) is expressed as a function of macroeconomic indicators, such as the rate of (appropriately-measured) productivity growth. Looking to the future, this type of state-contingent wage bargain should be incorporated into future versions of the social partnership agreements. Variants of this idea have been explored in detail by Geary and Honohan (1997) and De Buitleir and Thornhill (2001, 2007) amongst others.

In relation to the restoration of the tax base, the sitting Commission on Taxation may well underpin support for new sources of taxes (carbon tax, property tax) and a widening of the tax base is highly desirable. However, it is probable that a major part of the new tax strategy will involve the rolling back of the income tax reductions that have occurred over the last decade. There may be some limited scope for raising tax rates. In relation to the top marginal tax rate, the prospect of significant hikes in the top marginal rate in both the United Kingdom and the United States means that the mobility deterrent is weaker than in the past. Moreover, the closing of tax breaks for high-income domestic residents is also important in ensuring perceptions of tax equity.

However, a major part of the adjustment will surely include the re-entry of lower-paid workers into the tax net and adapting the tax treatment of cash transfers such as child benefit. The scope for such measures is well illustrated by Figure 7 which shows the sharp decline in the net tax burden (income taxes paid minus cash transfers received) in recent

¹⁰See also Lane (2008a).

years, especially for families with children. Furthermore, Table 1 shows the net tax burden for different types of “typical” households in a sample of advanced economies.¹¹ While the generosity of Ireland to lower-income households with children may deliver important social benefits, it is atypical. Finally, reform of the tax treatment of lower-paid workers must be closely integrated with adjustments to the social welfare system and the promotion of active labour market policies, to avoid the well-known difficulties with high replacement rates.

In terms of timing, it makes sense to adopt a tax strategy that defers part of the increase in the tax burden into the future, since a positive gap between future and current tax rates helps to stimulate the current level of economic activity.¹² However, the scale of required fiscal adjustment is such that significant tax increases will be required from Budget 2010 onwards: not all the tax adjustment can be deferred into the indefinite future. Moreover, initial tax increases should enhance the credibility of the fiscal plan by demonstrating a commitment to the new tax model. While this holds true for the aggregate level of taxation, this is not to rule out selective temporary reductions in some types of taxes. For instance, Calmfors (2003) highlights that counter-cyclical shifts in employer payroll taxes can help to stimulate labour demand during downturns and this option may warrant some consideration in the current environment.

Finally, the ideal fiscal plan should also include a range of measures to ensure that the current fiscal situation does not recur in the future. One core element should be to develop mechanisms that permit the accumulation of much greater fiscal reserves during boom periods. While the National Pension Reserve Fund has acted as a *de facto* rainy day fund during the current banking crisis, it was not established with that intention. Rather, as was proposed by Lane (1998) as part of Ireland’s preparations for the constraints of

¹¹See also Lane (2007, 2008b).

¹²In this spirit, the UK government recently announced a future increase in the top rate of tax to 45 percent.

EMU membership, the fiscal framework should make explicit provision for a liquid reserve fund that may be deployed in the event of severe shocks and financial-sector problems. In addition, the new fiscal framework should attach greater weight to independent analytical work on the sustainability of the public finances, such as might be conducted by the type of independent fiscal council that is advocated by Calmfors (2003) amongst others.

5 The Government's New Plan

The general framework of the government's new plan is described in the *The Addendum to the Irish Stability Programme Update* document that was published on January 9th 2009. It is not my intention to use this occasion to review this document in detail. Rather, the main aim at this stage is to highlight some key features of the plan and raise some queries about the assumptions that lie behind the projections.

The government proposes a five-year adjustment period, expressing the concern that “*Taking action over a shorter period of time, given the scale of the emerging position, would impose substantial economic and social costs and would not be sensible or appropriate*” (p1, my italics). It would be helpful for analytical purposes if the government provided a more detailed explanation of this decision, since the optimal duration of the adjustment phase presumably in part depends on the composition of the adjustment programme.¹³ In similar vein, the dynamics of output and unemployment over the next five years will be influenced by the precise design of the fiscal adjustment: it would be illuminating to learn more about the fiscal multipliers assumed by the government in making these projections. Put differently, a key element in evaluating the proposal is to compare the paths for the key macroeconomic variables under alternative sets of assumptions concerning the design

¹³A good model is provided by the Obama transition team which has provided a detailed analysis of the impact of its proposed fiscal recovery programme. See http://otrans.3cdn.net/45593e8ecbd339d074_l3m6bt1te.pdf

of the fiscal package.

In terms of the fiscal balance, the government recognises the imperative for fiscal sustainability in planning an improvement in the structural (that is, non-cyclical) component of the budget balance from a deficit of 6.7 percent of GDP in 2009 to a surplus of 0.9 percent in 2013. A turnaround of 7.6 percent of GDP in the structural balance is very large and will require a radical transformation of long-term spending and taxation programmes. A noteworthy feature is that the overall budget adjustment is less than the structural adjustment: it is projected that the cyclical component of the deficit will widen from 2.8 percent of GDP in 2009 to 3.5 percent of GDP in 2013 (the economy is projected to remain far below potential output in 2013).

As is shown in Figure 9, the projected composition of the fiscal adjustment is striking. Tax revenue (scaled by GDP) is projected to increase only slightly over 2009 to 2013, from 22.2 percent of GDP to 22.9 percent of GDP. On the spending side, government investment is projected to maintain a smooth profile, averaging 4.4 percent of GDP over 2009-2013. Government consumption will take a significant hit: falling from 17.5 percent of GDP in 2009 to 15.9 percent of GDP in 2013. However, the single biggest decline will be in the category “social transfers other than in kind” that is set to fall from 13.1 percent of GDP in 2009 to just 8.2 percent of GDP in 2013 (far below its 2007 ratio of 9.8 percent). In part, the projected decline in transfer payments may be linked to the projected rapid adjustment in the labour market: unemployment is modelled as declining from a peak of 10.5 percent of GDP in 2010 to 7.9 percent in 2013. Labour market performance is central to the fiscal projections, such that it is critical to understand the assumptions about real wage adjustment that lie behind this recovery in employment.

Finally, as is recognised in the document, macroeconomic projections for the next five years are subject to greater than usual uncertainty. While the point estimates in this document provide a useful framework for discussion, the fiscal strategy that is actually adopted must be sufficiently flexible to adapt to changing circumstances. Moreover, prudent

risk management indicates that greater weight be attached to downside risks, since the current crisis teaches us that it is easier to correct excessively-pessimistic budgets than to row back from excessively-optimistic ones.

6 Conclusions

Getting fiscal policy right is especially important for Ireland, since it is the main macro-economic policy instrument available to national governments within the euro area. In view of the extremely adverse economic and fiscal environment, the rapid adoption of a sustainable fiscal strategy must be a high priority for early 2009. While the government has now published the broad framework for its fiscal adjustment efforts, many details have not been specified and its implementation faces severe challenges.

The political economy challenges in securing fiscal sustainability are significant. In contrast to the 1980s episode, the short-term external pressure to undertake reform is relatively weak. While the euro area sovereign debt market provides a degree of market discipline to the extent that spreads are systematically related to perceptions of fiscal sustainability, the sensitivity of interest rates to the level of public debt is much weaker than under an independent currency regime. Accordingly, a “delayed reform” scenario may be envisaged, under which the Irish socio-political system defers radical adjustment at the price of economic stagnation and the rapid accumulation of external debt. While this approach may be viable for several years, the deferred costs could be very high in terms of economic stagnation and would be further compounded if international economic recovery triggered a substantial increase in international interest rates (such the debt interest burden became substantial) and increased pressure at the European Union level to enforce the SGP in a more rigorous fashion. Rather, national welfare would be much enhanced by a front-loaded approach to fiscal reform, on the basis that remedial action now is much preferable to crisis-induced adjustment further down the road.

References

- [1] Beetsma, Roel, Massimo Giuliadori and Franc Klaassen (2008), “The Effects of Public Spending Shocks on Trade Balances and Budget Deficits in the European Union,” *Journal of the European Economic Association*, .
- [2] Benetrix, Agustin and Philip R. Lane (2009), “The Impact of Government Spending Shocks on the Irish Economy,” *work in progress*, IIIS-TCD.
- [3] Bewley, Truman (1999), *Why Wages Don't Fall During a Recession*, Harvard University Press.
- [4] Blanchard, Olivier (2007), “Adjustment Within the Euro. The Difficult case of Portugal,” *Portuguese Economic Journal* 6(1), 1-21.
- [5] Bruno, Michael and Jeffrey Sachs (1985), *The Economics of Worldwide Stagflation*, Harvard University Press.
- [6] Calmfors, Lars (2003), “Fiscal policy to stabilise the domestic economy in the EMU: What can we learn from monetary policy?,” *CESifo Economic Studies* 49 (3), 3-19.
- [7] Calmfors, Lars and John Driffill (1988), “Bargaining Structure, Corporatism and Macroeconomic Performance,” *Economic Policy* 6, .
- [8] Corsetti, Giancarlo and Gernot Mueller (2008), “Twin Deficits, Openness and the Business Cycle,” *Journal of European Economic Association* 2008 .
- [9] De Buitleir, Donal and Don Thornhill (2001), “A Mechanism for Sharing the Fruits of Growth,” *ESRI Quarterly Economic Commentary*, March.
- [10] Favero, Carlo and Francesco Giavazzi (2007), “Debt and the Effects of Fiscal Policy,” *mimeo*, Bocconi University.

- [11] Galstyan, Vahagn and Philip R. Lane (2008), “Fiscal Policy and International Competitiveness: Evidence from Ireland,” *IIIS Discussion Paper No. 274*.
- [12] Galstyan, Vahagn and Philip R. Lane (2008), “The Composition of Government Spending and the Real Exchange Rate,” *IIIS Discussion Paper No. 257*.
- [13] Geary, Patrick T. and Patrick Honohan (1997), “Can Better Contracts Help Solve Ireland’s Sterling Dilemma?,” *Irish Banking Review*, Summer, 30-41.
- [14] Honohan, Patrick (2008), “Not a Re-Run of the 1980s,” paper presented at the ESRI’s Budget Perspectives 2009 Conference.
- [15] Honohan, Patrick and Anthony J. Leddin (2006), “Ireland in EMU: More Shocks, Less Insulation?,” *Economic and Social Review* 37(2), 263-294.
- [16] Lane, Philip R. (1998), “Irish Fiscal Policy under EMU,” *Irish Banking Review*, Winter, 2-10.
- [17] Lane, Philip R. (2007), “Fiscal Policy for a Slowing Economy,” in *Budget Perspectives 2008*, ESRI.
- [18] Lane, Philip R. (2008a), “EMU and Financial Integration,” *IIIS Discussion Paper No. 272*.
- [19] Lane, Philip R. (2008b), “Setting a Course for Irish Fiscal Policy,” paper presented at the ESRI’s Budget Perspectives 2009 Conference.
- [20] Lane, Philip R. and Roberto Perotti (2003), “The Importance of Composition of Fiscal Policy: Evidence from Different Exchange Rate Regimes,” *Journal of Public Economics* 87, 2253–2279.

- [21] Monacelli, Tomasso and Roberto Perotti (2006), “Fiscal Policy, the Trade Balance and the Real Exchange Rate: Implications for International Risk Sharing,” *mimeo*, University of Bocconi.
- [22] Monacelli, Tomasso and Roberto Perotti (2008), “Openness and the Sectoral Effects of Fiscal Policy,” *Journal of the European Economic Association* 6, 395-403.
- [23] O’Donnell, Rory (2001), “The Role of Social Partnership,” *Studies* 90, Spring.
- [24] Spilimbergo, Antonio, Steven Symansky, Olivier Blanchard and Carlo Cottarelli (2008), “Fiscal Policy for the Crisis,” *IMF Staff Position Note No. 08/01*.
- [25] Sweeney, Paul (2008), *Ireland’s Economic Success: Reasons and Lessons*, New Island.

General Government Balance

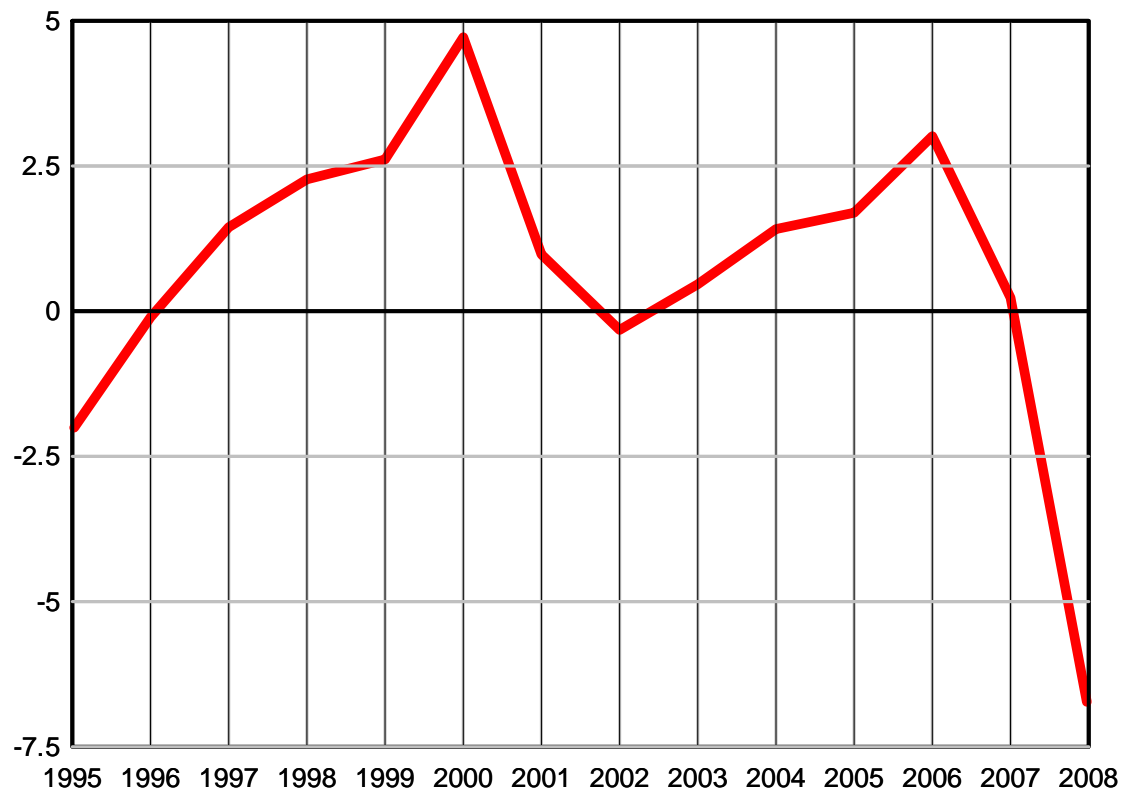


Figure 1: General Government Balance. Source: OECD Economic Outlook, plus ESRI estimates.

Total Outlays

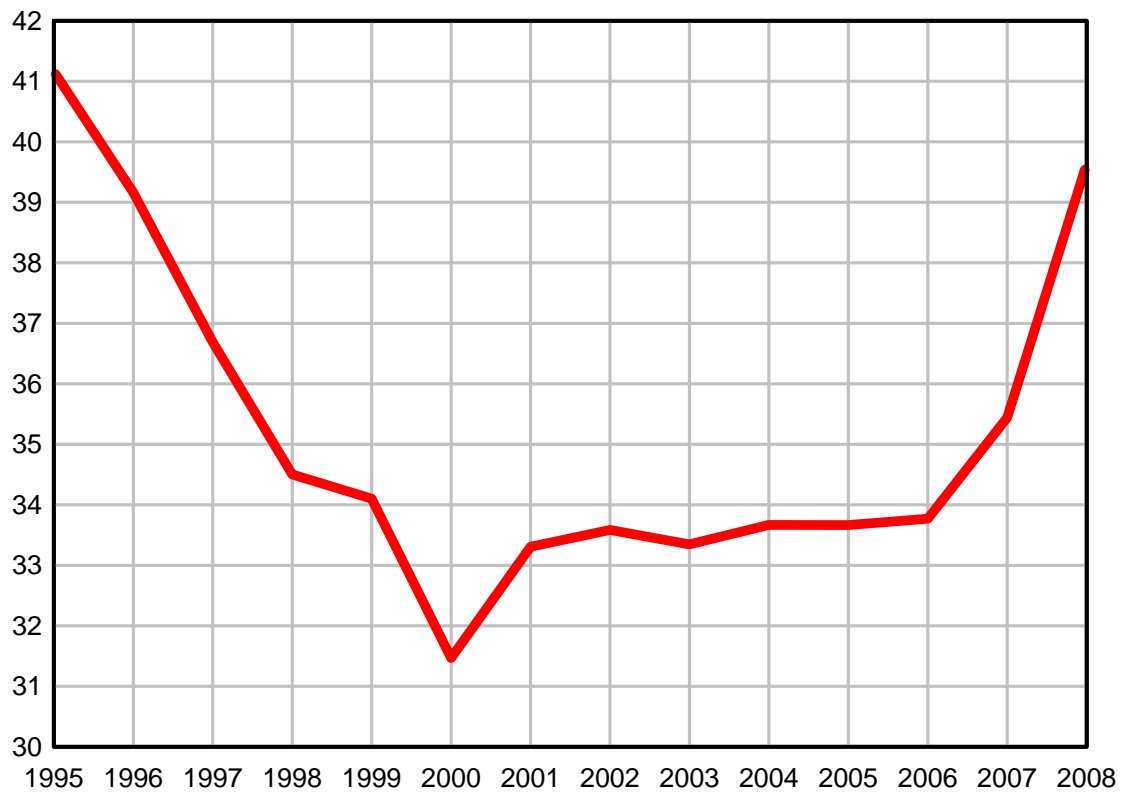


Figure 2: Total Government Outlays. Note: Expressed as a Ratio to GDP. Source: OECD Economic Outlook database.

Ratio of Tax Revenues to GDP

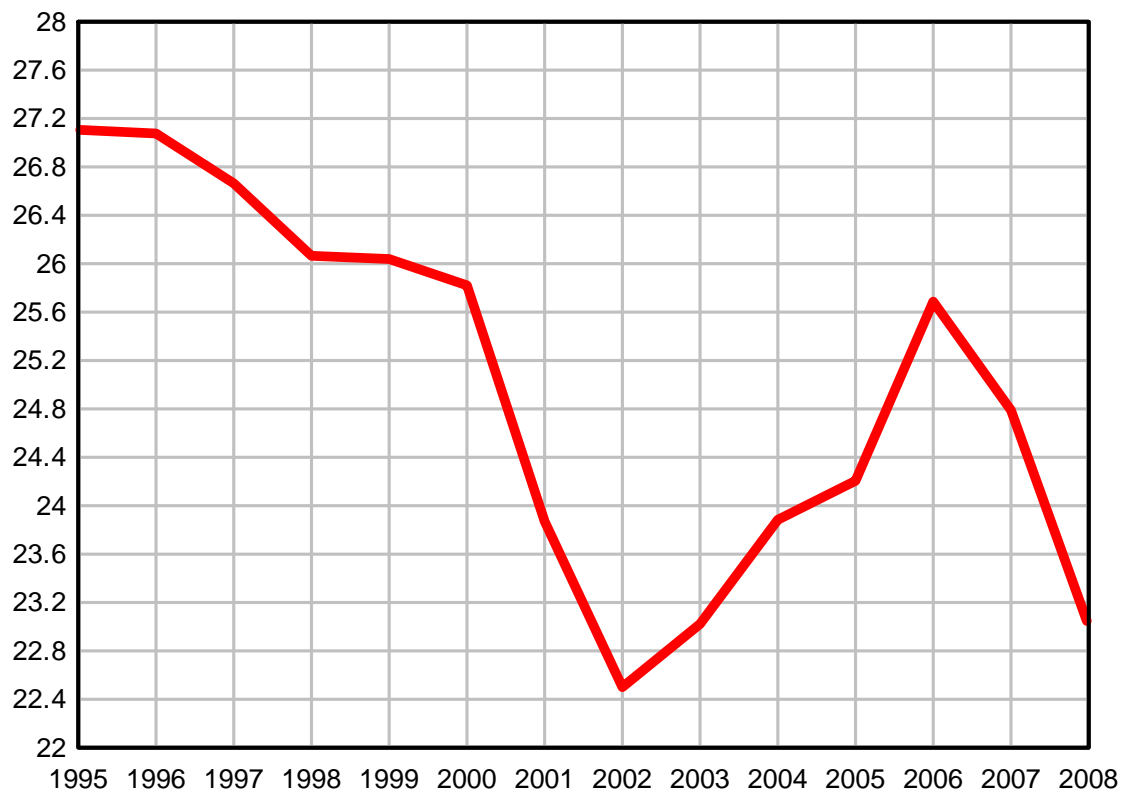


Figure 3: Tax Revenues, 1995 to 2008. Note: Author's calculations based on data from the Department of Finance.

Composition of Tax Revenue

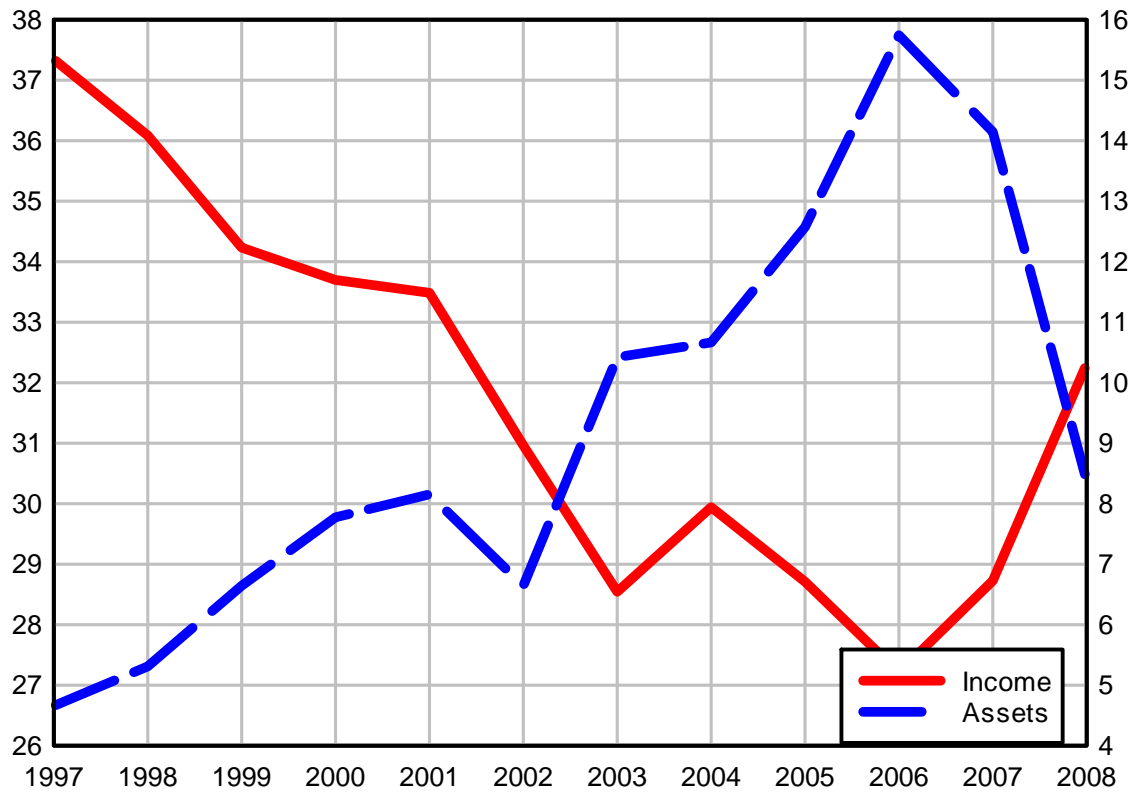


Figure 4: Composition of Tax Revenue. Note: Author's calculations based on data from Department of Finance.

Fiscal Multipliers

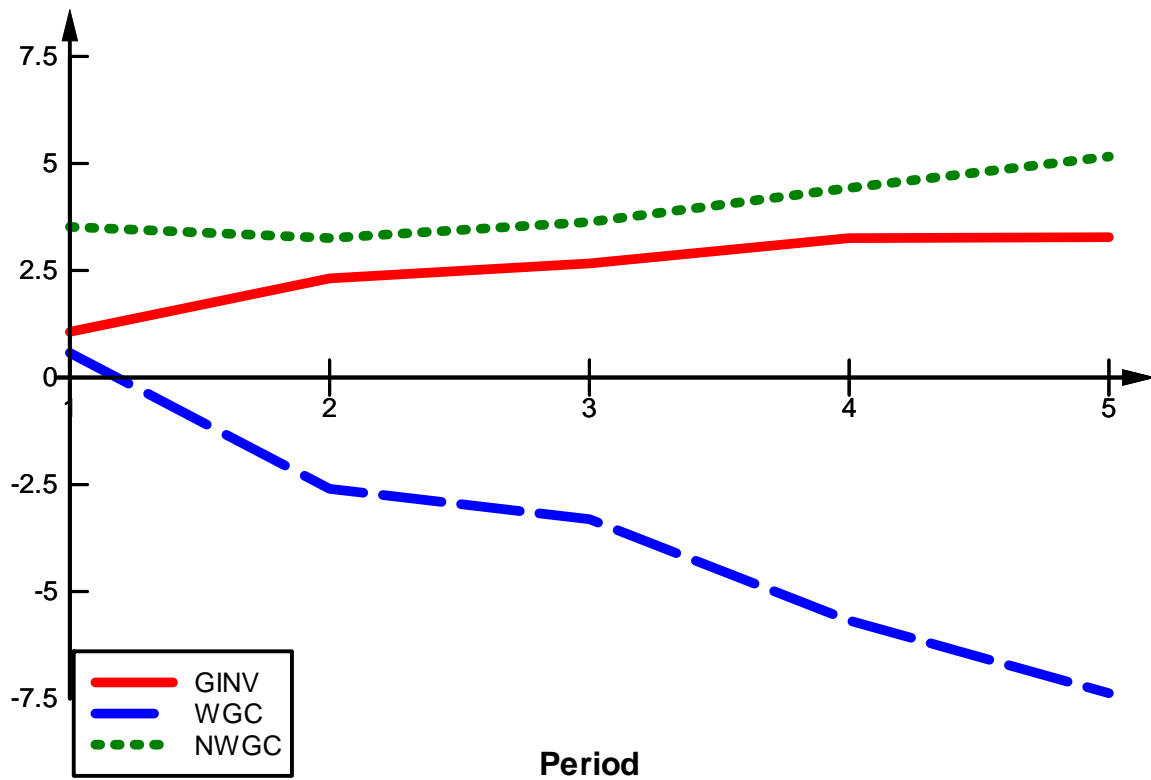


Figure 5: Fiscal Multipliers. Note: Impulse-Response Functions generated by Benetrix and Lane (2009).

ireland

External Competitiveness 1999Q1=100

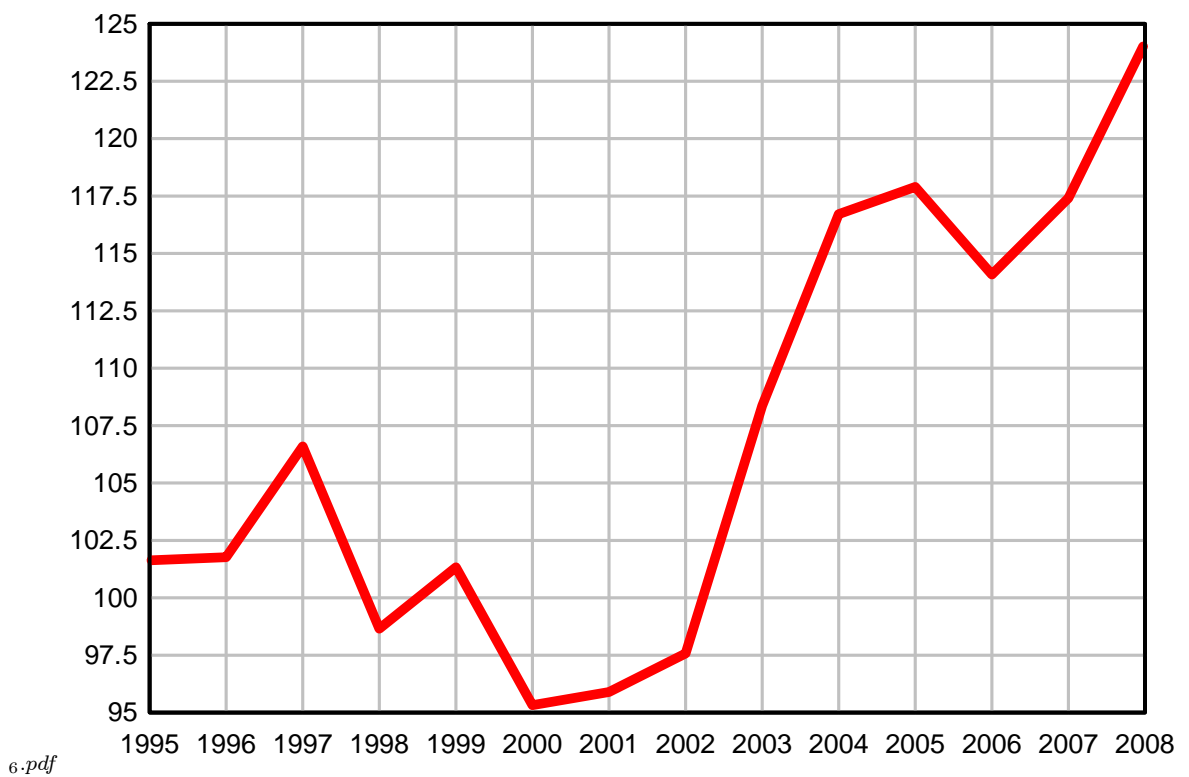


Figure 6: Harmonised Competitiveness Indicator. Source: Central Bank and Financial Services Authority of Ireland. Real HCI (deflated by consumer prices).

Net Taxes (Percent of Total Labour Cost)

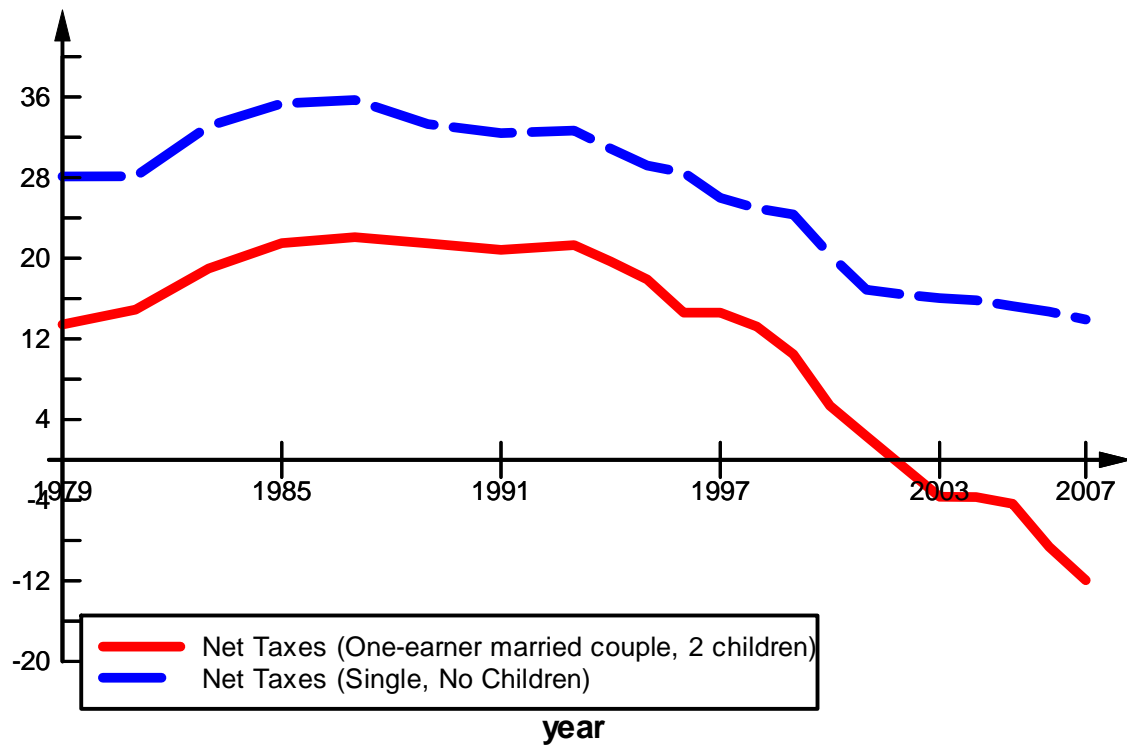


Figure 7: Net Taxes, 1979 to 2007. Note: 100 percent of average wage. Source: OECD *Taxing Wages* Database.

Components of the GG Budget Balance

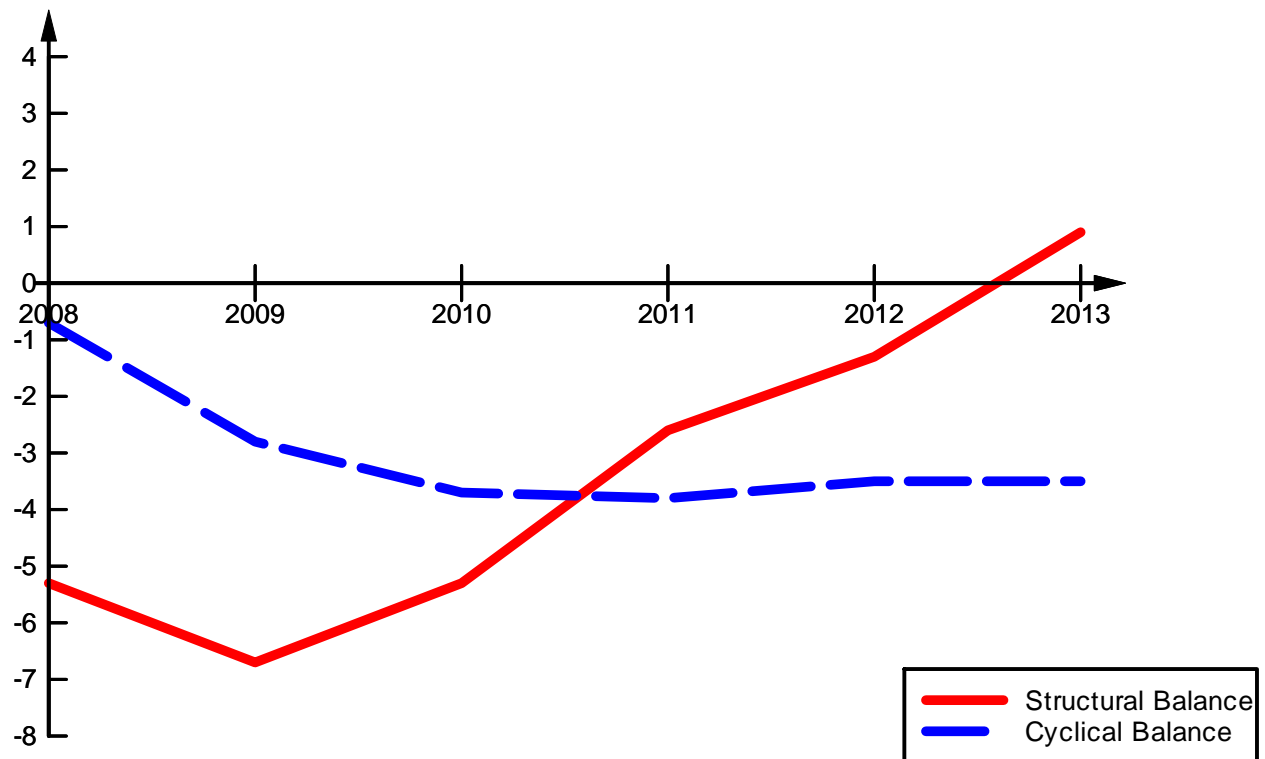


Figure 8: Components of the Budget Balance. Source: Author's calculations based on *Addendum to the Irish Stability Programme Update*.

Components of Public Expenditure

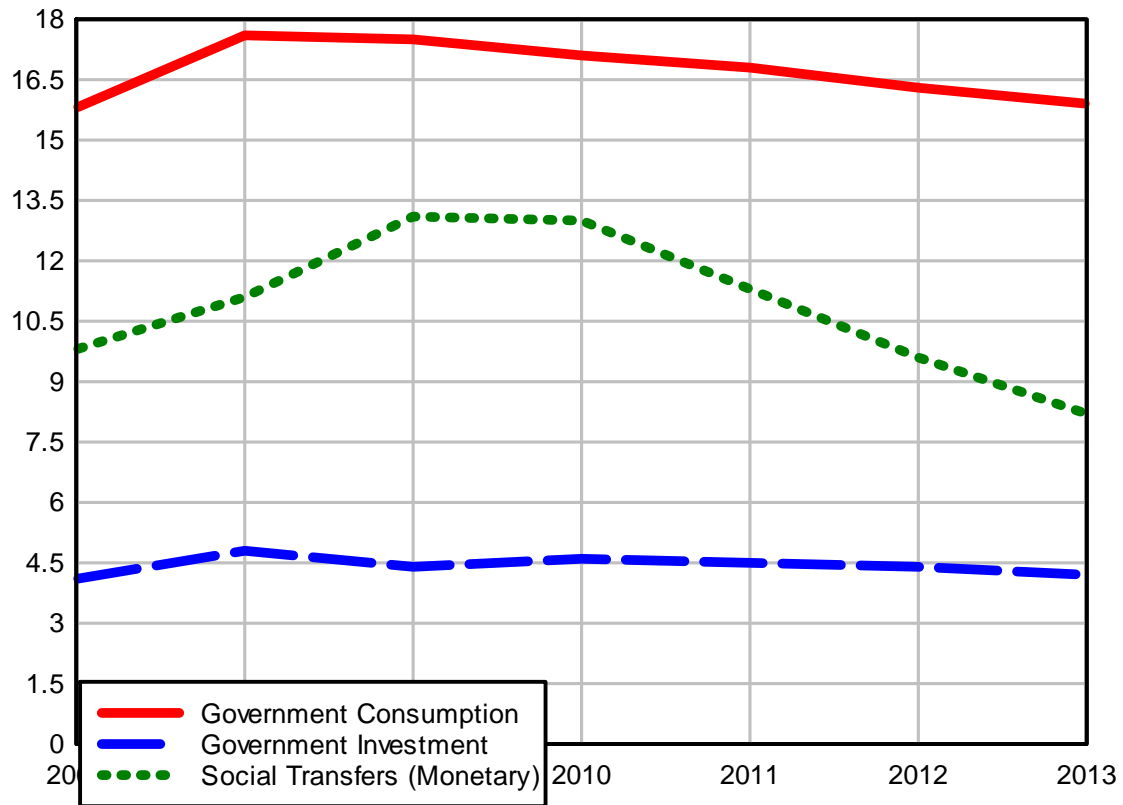


Figure 9: Projected Public Expenditure. Source: Author's calculations based on *Addendum to the Irish Stability Programme Update*.

Table 1: Net Taxes.

Family-type	S	S	S	S	M	M	M	M
children	no	no	no	2	2	2	2	no
Wage	67	100	167	67	100-0	100-33	100-67	100-33
France	44.4	49.2	53.1	35.8	41.9	39.4	43.7	43.9
Germany	47.4	52.2	53.1	34.5	36.4	41.5	45.3	47.3
Ireland	15	22.3	33.1	-35.8	-1.1	7.4	12.8	15.6
UK	30.8	34.1	37.9	15.5	28.3	26.4	29.9	30.8
US	27.8	30	35.3	7.6	18.1	22.2	24.5	27.8
OECD	33.8	37.7	42.1	18.2	27.3	29.5	32.4	34.5
EU-15	38	42.5	47.7	21.7	31.9	33.4	36.6	38.5

Note: Taxes Minus Cash Transfers as a percent of total labour costs. Source: OECD Taxing Wages database.