

Macroeconomic Adjustment and Fiscal Policy in Ireland

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Overview

- Goal 1: shift Irish economy onto a sustainable growth path
- Goal 2: stabilise the public finances
- [Other goals: NESC list]

- * Feature 1: membership of European monetary union
- * Feature 2: substantial risk premium in sovereign debt market
- * Feature 3: prospect of global public debt issuance glut
- * Feature 4: Major banking crisis, with associated contingent public liabilities

Macroeconomic Adjustment

- Economy distorted by expansion in construction sector and debt-financed consumption boom during the pre-crisis phase
- Public finances similarly distorted by windfall revenues (now disappeared)
- Long-term living standards depend on expansion of tradables sector (extensive margin)
- Current recession: elimination of non-sustainable above-trend growth but exacerbated by global recession, strength of the euro, high domestic risk aversion and pro-cyclical fiscal tightening
- Major challenge: stem rise in unemployment and avoid self-perpetuating persistence of high unemployment

Role of Macroeconomic Policy: International Patterns

- Non-EMU countries: currency devaluation helpful
- EMU: German adjustment: real devaluation via cumulative negative inflation differential
- EMU: stagnation of Portugal – resistance to wage declines, but prolonged period of little growth
- Irish historical experience: wages respond eventually (but gradually) to high unemployment
- Policy challenge: rapid wage adjustment can avoid locking-in of high unemployment

Real Devaluation

- Broad definition of 'wages': all types of earnings
- Complementary actions: vigorous anti-monopoly policies; elimination of 'rents' lowers relative price level
- Productivity reforms in nontraded sector also helps to deliver real devaluation
- Labour the main domestic economic resource; tackling unemployment requires expansion in labour-intensive activities
- Discrete expansion in tradables sector: extensive margin

The Nominal 'Fetish'

- Monetary union a fundamental regime change
- Low area-wide inflation: real devaluation requires negative inflation and nominal wage reductions
- Improving living standards: real incomes, not nominal
- [Implications for tax revenues]
- [Index-linked debt securities]

'Ideal' Fiscal Policy

- Support macroeconomic adjustment: if real devaluation required, involves reductions in public sector pay levels
- [Integration in labour market; present value of tax burden a strong influence on wages and investment]
- Operation of automatic stabilisers

Discretionary Policy

- Temporary reductions in employer tax costs
- Support for preserving employment where demand shocks temporarily severe
- Improving productivity through public investment

Irish Fiscal Policy: Pursuit of 'Constrained Optimality'

- Large structural deficit
- Emergence of substantial risk premium
- Contingent liability via guarantee of bank liabilities
- History of 'delayed adjustment'
- Insufficient surpluses during good times means that aggregate discretionary component of fiscal stance must be pro-cyclical
- Pro-cyclicality in public sector wages during boom requires correction
- Projected long-term increase in public spending due to ageing population: ideally, structural surplus

The Fiscal Debate

- Fiscal errors during the pre-crisis period very regrettable
- Failure of bank regulation very regrettable
- Counter-cyclical fiscal policy during boom would have enabled a more counter-cyclical discretionary fiscal response to the crisis
- Consumption impact of fiscal correction: non-credible fiscal package will not eliminate savings 'overhang'
- Public sector pay cuts facilitates broader labour market adjustment and transition to sustainable growth path
- [2010 pay cuts: implement in stepped fashion, with month-by-month phased reductions]

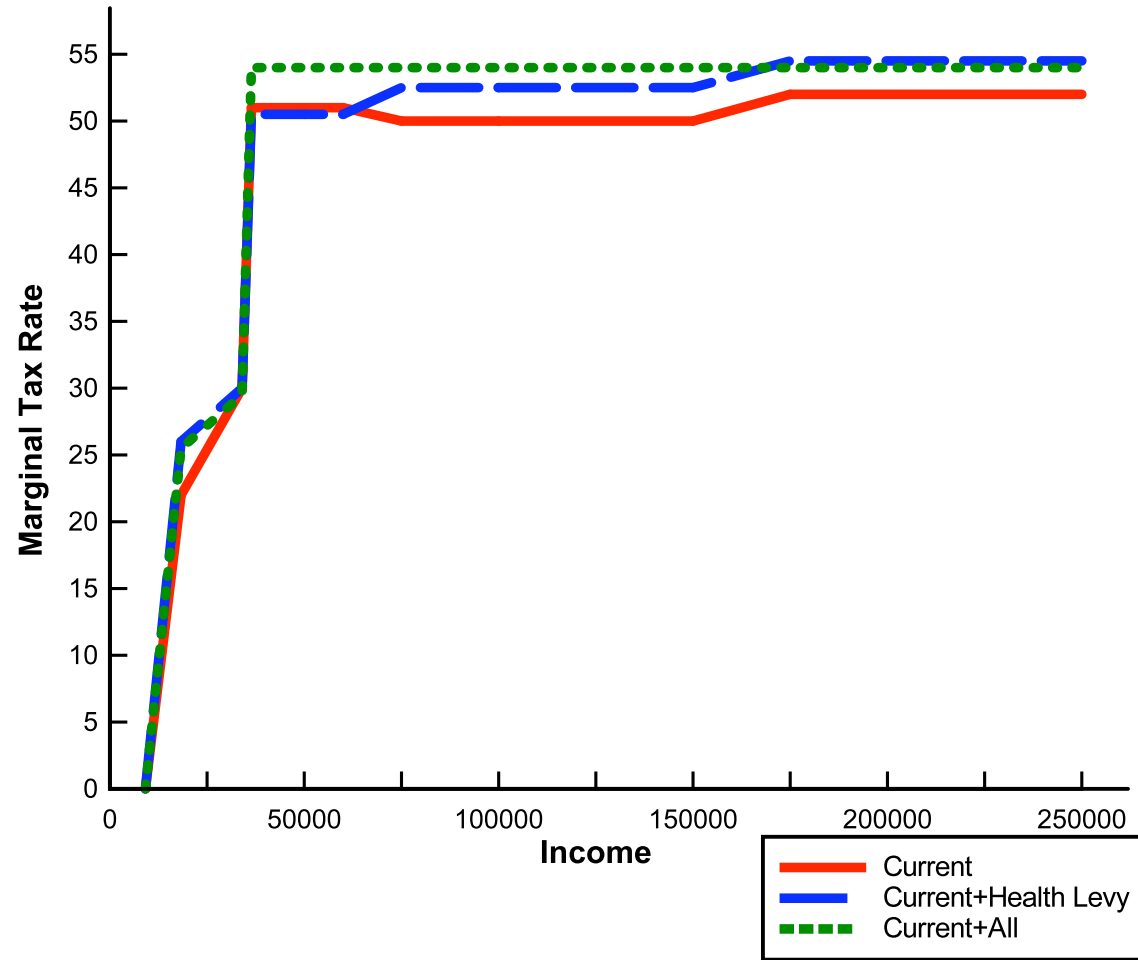
Fiscal Strategy

- Substantial 2008-2009 correction: 'do nothing' alternative would have seen GGB around 15%-16% of GDP
- Significant increases in (consolidated) tax rates
- But 2009 out-turn set for 12.9% of GDP, against 10.75% target
- In part, cyclical: GNP decline 8.7 percent, not 8.0 percent
- In part, structural - larger fiscal adjustment required over 2010 and subsequent years
- €4 billion package in 2010: GGB still at 12.8% of GDP, against initial target of 10.75% for GDP (despite improved GDP forecast)

Structural Adjustment

- Widening of tax base required: elimination of tax expenditures; narrowing of many allowances and credits
- Property tax, carbon tax, user charges
- Public spending: pay levels; levels of services, investment
- McCarthy Report
- Smart government: ranking of priority areas
- New programmes possible if funded by sufficient cutbacks in other areas

Marginal Tax Rate



Taxing Wages 2008

Status	S	S	S	S	M	M	M	M
Income	67	100	167	67	(100,0)	(100,33)	(100,67)	(100,33)
Children	0	0	0	2	2	2	2	0
Denmark	38.4	40.9	49.6	13.4	29.1	33.8	35.5	38.6
Finland	23.4	30.0	37.2	8.5	23.1	20.7	23.2	25.9
France	25.9	27.8	33.3	14.6	17.6	17.9	22.1	23.9
Germany	37.0	42.7	45.6	22.0	24.1	30.0	34.5	36.9
Ireland	7.0	14.6	26.9	-33.2	-4.7	-0.5	4.7	8.0
Italy	24.7	29.3	36.0	1.4	15.5	18.1	22.5	24.4
Netherlands	31.8	36.1	41.1	9.0	28.1	27.6	30.4	32.6
Norway	25.9	29.7	36.0	10.5	22.1	23.0	25.0	26.9
Spain	13.9	19.0	24.3	6.6	11.2	14.3	14.5	15.9
Sweden	23.8	26.7	37.2	12.5	19.1	18.6	21.0	24.3
United Kingdom	22.9	25.6	30.3	2.9	19.1	18.0	21.3	22.9
United States	22.3	24.7	30.5	-0.6	11.3	16.1	18.7	22.4
EU15	24.7	29.7	36.5	6.6	17.5	19.3	22.8	25.2
OECD - Total	21.8	26.4	32.1	4.2	14.5	17.0	20.3	22.8

Conclusions

- Promote rapid adjustment in the labour market (alternative of prolonged period of high unemployment very undesirable)
- Demonstrate Ireland's reputation for economic pragmatism
- Domestic consumption and investment also relies on a clear commitment to a sustainable growth path
- Fiscal policy should support this transition, while recognising the weak current state of the economy
- EMU has provided important benefits during this crisis: but requires adaptability in labour market and fiscal position