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“Current Challenges for Irish Fiscal Policy”

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Challenges for Irish Fiscal Policy

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1 Introduction

May 2009 is a good time to review recent developments in Irish fiscal policy and set the stage for the next phase of fiscal adjustment. Much has happened since the government took its first steps towards shifting the orientation of fiscal policy in Summer 2008. However, it is also clear that we are only in the early stages of a long period of fiscal austerity, with many tough decisions remaining to be taken and the implementation of the announced fiscal plans yet to be fully executed.

In what follows, I analyse the challenges facing Irish fiscal policy. In terms of a conceptual framework, it is important to combine a public finance perspective with a broader appreciation of the macroeconomic impact of fiscal policy. Most fundamentally, an appropriate analysis of Irish fiscal policy must fully recognise the overarching nature of European monetary union (EMU) in defining the macroeconomic policy environment.

2 The End of the Bubble Period

The bubble period generated substantial distortions in the Irish economy.¹ The construction sector grew too big, drawing in resources from the rest of the economy. The growth in asset-based revenues led to rapid expansion in those sectors benefiting from high levels of public spending. Rapid credit growth fuelled the growth of sectors to service domestic consumption.

With the end of the bubble period, a major macroeconomic policy challenge is to re-orientate the economy towards a more sustainable path. In particular, lower levels of domestic spending require an expansion in the tradables sector if the economy is to effectively redeploy its resources. Moreover, for a small economy, productivity growth is most likely in export-orientated activities, in view of the limitations of the size of the domestic

¹See, amongst others, Honohan and Leddin (2006) and Lane (2007, 2008, 2009).

market. Accordingly, a policy priority is to improve the level of competitiveness. The level of competitiveness is influenced by many factors other than the level of wages and it is desirable that policy initiatives promote the implementation of the recommendations of the National Competitiveness Council (see also Lane 2004) in relation to measures to improve productivity and tackle monopoly power that keeps mark ups high in many sheltered sectors. However, since labour is a primary domestic input into production, a reduction in labour costs can play an important role in improving competitiveness. Moreover, it may be possible to engineer a shift in labour costs more quickly than is possible in relation to the some of the other structural cost factors in the economy. Accordingly, a primary macro-economic role for fiscal policy during the current crisis is to contribute to the re-alignment of labour costs, which is important for the medium-term recovery of the economy.

It is important to emphasise that the appropriate role for fiscal policy varies with the structural challenges facing an economy (see also Spilimbergo et al 2008). Under different circumstances, one can envisage that the fiscal debate in Ireland would be focused on other issues. In particular, a more conservative fiscal policy during the boom would have contributed to a less-distorted labour market, in the absence of the over-heating pressures generated by high pay settlements and rapid employment expansion in those sectors benefiting from the surge in public spending.² In similar vein, the public finances would have been less damaged by the end of the bubble, if the asset-related revenues had been saved and if unsustainable cuts in core taxes had been avoided.³ Accordingly, better management of the public finances during the boom could have generated the conditions

²At a sectoral level, the provision of tax incentives for the property sector also contributed to the excessive growth in construction activity. On the macroeconomic impact of public spending in the long run, see Galstyan and Lane (2009a, 2009b). On the short run impact, see Benetrix and Lane (2009a, 2009b).

³Lane (1998) recommended the establishment of a rainy day fund to save cyclical revenue booms, in view of the importance of conserving fiscal firepower to combat severe recessions and deal with the occurrence of national banking crises.

under which fiscal policy could have been deployed during the current crisis in a more counter-cyclical fashion. Alas, this turned out not to be the starting point at the onset of the crisis, such that the appropriate fiscal response in Ireland is quite different to some other countries in which the state of the public finances have permitted a more pro-active response to the global downturn.

3 The Adjustment So Far

The scale of the fiscal deterioration required a demonstration by the government of its commitment to restoring fiscal sustainability. The urgency of this task was compounded by the increase in funding risk. Funding risk grew in line with the general nervousness in international financial markets, especially in view of the anticipated surge in debt issuance by governments around the world and the risk of contagion by which roll-over and issuance risk in one region may adversely affect other issuers. A major factor for Ireland has been the overhang of the liabilities of the banking sector, in view of the fiscal risks associated with potential liquidity problems in the banking sector. Accordingly, public debt management has required a broad strategy to both demonstrate the government's capacity to restore order to the public finances, while at the same time engineering a re-structuring of the banking sector.

The required steps on the fiscal side were clear. First, in view of the collapse of asset-related revenues, it was imperative to restore the core tax base. Second, after a long period of rapid growth in current and capital spending, there was a need to re-calibrate the appropriate levels of public spending. In turn, a central task on the spending side is to recognise the importance of unwinding the growth in the price level for public spending components. In particular, the more adjustment that can be achieved in public sector wages and procurement prices for goods, services and capital projects, the less is required in terms of compromising the level of services and the volume of public capital accumulation.

The government's response has been in four stages (see also the discussion in Lane 2009): the imposition of within-year spending controls in Summer 2008; the October 2008 budget; the January 2009 package; and the April 2009 supplementary budget. The cumulative correction in the budget balance is about 5 percent of GDP. Even with this large correction, the projected deficits for 2009 and 2010 stand at 10.75 percent of GDP which underlines the scale of the dire fiscal situation.

The nature of the adjustment has some remarkable features. As is highlighted by Callan et al (2009), the burden of the adjustment so far has been quite redistributionist, with the largest tax increases targeted on those on higher and middle incomes and only limited adjustments to welfare spending. On the spending side, there are substantial cuts in capital spending - to the extent that tender prices are falling, the fall in the volume of public capital growth will be significantly less than the decline in nominal spending. In relation to current spending, the imposition of the public sector pension levy constitutes a *de facto* pay reduction for public sector workers. Through this mechanism, the scale of service level reductions that are required has been mitigated.

4 The Next Phase

The April 2009 supplementary budget announcement also included the release of the fiscal framework for the 2009-2013 period. This plan envisages further substantial expenditure reductions and tax increases in 2010 and 2011, with substantial 'unallocated' corrections also pencilled in for 2012 and 2013.

The scale of projected expenditure reductions is substantial. Non-welfare current spending is projected to decline by nearly 5 percent in 2010 and nearly 9 percent in 2011. Capital spending is projected to fall (relative to October 2008 projections) by 20 percent in 2010 and 33 percent in 2011. On the tax side, tax revenues are projected to increase by 5 percent in 2010 and 10 percent in 2011.

In order to achieve these targets, the 2010 Budget is the critical step, in view of the knock-on impact of 2010 decisions for 2011. Since the recession is projected to deepen in 2010, this budget will be decided against the backdrop of an even worse macroeconomic environment than we are currently experiencing and the fiscal targets must take into account the impact of rising unemployment on welfare spending and tax revenues.

While the fiscal decisions taken during 2008-2009 have been constrained by the urgency of initiating the fiscal correction, the 2010 Budget will have the advantage of more information. In particular, the government will have received the reports from the Commission on Taxation and An Bord Snip Nua. The former will assist in moves to broaden the tax base, while the latter will help in guiding the required adjustments in public expenditure.

In planning for the next phase, many issues arise. First, the cross-country evidence shows that it is very difficult to implement tough fiscal plans (see Beetsma et al 2009). Moreover, deviations of outcomes from planned targets tend to be larger, the more ambitious is the scale of the planned adjustment, in view of the political difficulties in raising taxes and cutting spending programmes. Accordingly, a basic task for the government is to successfully implement its announced framework targets. In this respect, the core target variable is the structural deficit, in view of the inadvisability of responding in a pro-cyclical fashion to purely cyclical shifts in the budget balance.

Second, the preservation of public services calls for an adaptable and flexible approach to the management of public sector resources. While it is important to maintain aggregate targets for public spending, this can be combined with the redeployment of resources across sectors, such that the most acute services can be protected. In similar fashion, the control of overall public spending is consistent with the introduction of new spending programmes, through the re-allocation of resources from existing programmes. To this end, there is an important role for unions and management in the public sector, in order to ensure that the organisational capacity is optimised to achieve the highest-possible levels of service provision despite the contraction in aggregate resources.

Third, the preservation of service levels can be greatly facilitated by a further round of public sector pay reductions. While the government has announced a review of pay levels for senior grades, the scope of the pay adjustment needs to be broader than this group. Moreover, in the context of high unemployment and declining pay in many private-sector occupations, it is plausible that the risk-adjusted pay premium in the public sector remains quite positive despite the imposition of the public sector pension levy. The 2009 decline in the CPI also helps to moderate the real impact of nominal pay reductions on living standards.

Accordingly, macroeconomic and public finance considerations suggest that further cuts in public sector pay are appropriate. To this end, it would be better to implement any further pay reductions in the 2010 budget and seek to preserve pay levels thereafter, since the overhang of projected future pay reductions is not helpful for morale nor the restoration of consumer confidence.

Fourth, the planning of the next phase must taken into account the high level of uncertainty about future economic performance. In particular, the future level of potential output is open to much debate, as is the timing and speed of the recovery from the current recession. Moreover, fiscal uncertainty in Ireland is compounded by the unknown fiscal costs associated with the re-structuring of the banking sector. Finally, the stability of the external funding environment remains quite uncertain. In the short term, the capacity of the global debt markets to absorb the surge in sovereign issuance remains unknown. Over the longer term, global economic recovery may be associated with a large increase in nominal interest rates, both through higher expected inflation and the impact of the higher levels of public debt around the world. Accordingly, the financing costs of public debt could be much higher than current levels.

In view of this uncertainty, the bias in Irish fiscal policy should be towards greater prudence. In view of the rapid projected growth in public debt and the looming increases in future spending and taxation associated with the ageing of the population, there is plenty

of scope to allocate any unexpectedly-high tax revenues to debt reduction. Moreover, it is easier to correct under-spending than over-spending and grant tax reductions than seek further tax increases, such that it is safer to plan fiscal policies on the basis of scenarios that are conservative in terms of the prognosis for economic recovery.

5 Institutional Reform

Taking a longer term perspective, another important policy goal should be to develop a new institutional framework that can help ensure that Ireland avoids such a fiscal trap in the future. In particular, it may be useful to examine the experience in other countries that have adopted procedures to ensure that fiscal planning and implementation is robustly examined and analysed by independent agencies. Going even further, it may be helpful to establish legislative mandates that facilitate the accumulation of sufficiently large surpluses during good times, such that major economic downturns are not compounded by the need to tighten fiscal policy in a pro-cyclical fashion. Lane (1998, 2009) further discusses these issues.

6 Conclusions

In conclusion, I return to the policy implications of membership of the euro area. EMU has the potential to provide a lot of insulation to small open economies. In particular, the current crisis has underlined the value of monetary union in avoiding currency attacks and in supporting the liquidity of the banking system. However, membership of a monetary union that targets a low area-wide inflation rate does mean that downward nominal wage and price flexibility is an important component of the adjustment process when real exchange rate depreciation is required. In turn, fiscal policy must be supportive of such adjustment efforts, in order to ensure the current surge in unemployment is as short lived as possible.

Over the longer term, the current crisis has also highlighted the importance of running a much more prudent fiscal policy during expansion periods, in order to allow it to play a more counter-cyclical role during future downturns.

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