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“Macroeconomic Adjustment and Fiscal Policy in Ireland”

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# Macroeconomic Adjustment and Fiscal Policy in Ireland

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## 1 Introduction

Ireland is experiencing a horrendous recession. There has been a sharp decline in employment and output since 2007. In turn, the level of unemployment has grown rapidly, with many others opting to exit the labour force or emigrate. Accordingly, decisions about the course of economic policy have rarely been as important as in the current situation.

While progress needs to be made on many fronts, the two main current policy challenges are to guide the Irish economy towards a sustainable growth path, while also stabilising the public finances.

While simple to articulate, the pursuit of these goals is quite challenging in view of the special features that characterises the Irish economy. First and foremost, Ireland is a member of the euro area which means that the currency devaluation option pursued by countries such as the UK, Sweden and Iceland is ruled out: fiscal policy is the main economic policy instrument available, supplemented with other real-side economic policies such as competition policy and the potential gains from a social-partnership approach to delivering economic adjustment.

Second, despite the calming of international markets in recent months, Ireland is paying a substantial risk premium on its sovereign debt. Moreover, the prospect of a global public

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debt issuance glut may lead to further differentiation in bond spreads, with those countries lacking fiscal credibility facing the prospect of yet more expensive funding conditions. This risk is compounded for Ireland by the contingent public liabilities that are associated with the re-financing of the banking system.

In relation to macroeconomic adjustment, the economy is undergoing a painful transition. The pre-crisis economy was distorted by over-expansion in the construction sector and a debt-financed domestic consumption boom. The elimination of non-sustainable above-trend growth would be tough enough but the scale of the recession has been exacerbated by the global recession, the domestic banking crisis, the strength of the euro, pro-cyclical fiscal tightening and a high level of uncertainty about future economic prospects.

The future path for private-sector activity must involve an expansion of the tradables sector, since long-term living standards ultimately rely on the type of productivity growth that is fostered by export-orientated activity. The scale of the required adjustment is large, involving the expansion of exporting activity into new sectors and new destinations. It should include the growth of new firms exporting services, as well as building on our successes in currently-exporting sectors.

In order to achieve this transition at the lowest cost in terms of persistent unemployment, it is important that the cost of employing Irish workers declines. It was natural that earnings rose quickly during the boom period — but the crash in domestic construction and consumption-focused activity levels means that a decline in pay levels is required in order to boost demand for Irish workers.<sup>1</sup> The alternative is to tolerate a prolonged period of high unemployment, with the associated severe costs for the individuals affected and the wider social and fiscal damage.

Measured in euro, pay levels in countries such as the UK, Sweden and Iceland have declined as a result of currency depreciation against the euro. For Ireland, the pay adjustment process is more difficult since it requires reductions in actual nominal pay rates (defined to include all sources of compensation) — as a member of the euro area, the option of currency devaluation is not available. While this is a novel situation, it is part and parcel of membership of euro area, which has been an important source of financial stability during this crisis period.

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<sup>1</sup>I have in mind a broad definition of earnings, including all types of compensation to workers. In addition, a broad definition includes the earnings of the self-employed, where a decline in fees and charges corresponds to a decline in wages for employees.

As a complement to pay reductions, it is also vital to more vigorously tackle monopoly power in many sectors of the economy, since a reduction in markups and monopoly rents (often shared between owners, managers and workers in these firms) is an important source of real depreciation and improved competitiveness.

The experiences of Germany and Portugal inside the euro area and the lessons from other episodes of exchange rate overvaluation around the world indicate that it is much better to undertake a rapid adjustment process rather than drag out the adjustment period through a glacial pace of pay moderation. In particular, the prospect of a multi-year sequence of declining or stagnant real incomes is a recipe for non-resumption of consumption spending. In contrast, mimicking the beneficial effects of currency devaluation through a decline in domestic nominal wages and prices will boost consumer confidence, since it would place the Irish economy on a sustainable growth path.

The nominal fetish must also be tackled in other areas. In relation to the public finances, tax planners need to take into account the sensitivity of VAT and income tax revenues to pro-cyclical behaviour of local inflation in a monetary union by building up sufficient reserves during the good years in order to tolerate amplified revenue declines during recessionary periods. In terms of debt management, it is also worth exploring the role of index-linked government bonds, where the payoff on the bonds are formulaically linked to the domestic price level. In relation to transfer payments, the appropriate focus should be on the inflation-adjusted value of such payments (with the specific inflation measure appropriately tailored to each recipient category).

The nature of the macroeconomic adjustment poses difficult challenges for fiscal policy. Ireland is not just undergoing a cyclical demand slump where the standard recommendation would be to undertake an offsetting fiscal expansion. Rather, the distorted nature of the pre-crisis bubble economy means that Ireland is also undergoing an economic restructuring, which requires a reduction in relative pay levels for the reasons outlined above.

Accordingly, fiscal policy must strike a balancing act between supporting macroeconomic adjustment while also limiting the impact of the demand slump. The situation is compounded by the large structural deficit, which will not disappear of its own accord once economic recovery kicks in. Rather, a combination of long-term tax increases and spending cuts are required to tackle the structural deficit, such that the government is simultaneously faced with tackling both cyclical and long-term problems in the public finances.

The urgency of tackling the structural deficit is reinforced by the fragile state of the

international sovereign debt markets. While spreads have narrowed considerably since the peak phase of the international financial crisis, the spread on Irish debt remains elevated and would increase yet further if the commitment to fiscal stabilisation were to be undone.

Furthermore, the projected long-term increase in public spending due to the ageing of the population in the coming decades indicates that the government should be running a structural surplus in order to pre-fund the predictable growth in public spending on healthcare and pensions. Accumulating excessive levels of debt through the deferral of fiscal adjustment would result in a scenario in which future living standards face a double squeeze from the levels of taxes required to service of higher public debt and higher future spending needs.

For these reasons, the government's fiscal strategy must be more restrictive from a cyclical perspective than under ideal textbook conditions. This is a highly regrettable situation and reinforces the importance of re-designing the fiscal policy process in order to avoid such damaging pro-cyclicality during future economic cycles.

In terms of supporting macroeconomic adjustment, the de facto pay reductions already imposed on public sector workers through the pension levy and the cancellation of scheduled pay increases have been important steps. However, the scale of the unemployment crisis means that further reductions in public sector earnings will help to promote more rapid adjustment across the economy-wide labour market.

In relation to the next round of public sector pay reductions, it may be better to phase these in on a month-by-month basis. That is, an X percent overall target for 2010 would be parcelled out into small monthly reductions. Such gradualism would enable public sector workers to adjust to a lower income level in a stepped manner, making it easier to re-organise planned expenditures.

Moreover, pay reductions in the public sector will help to preserve the level of provision of public services, in view of the trade-off between pay levels and employment levels in determining the aggregate public sector payroll. It is also important to recognise that public sector reform can further help to preserve service levels and constitutes an important potential source of aggregate productivity growth and improve competitiveness. However, the payoff to the wider economy is limited to the extent that productivity growth in the public sector is simply captured through rent sharing and the insulation of public sector pay levels from conditions in the wider labour market.

To the extent that progress on fiscal stabilisation is achieved, it may indeed be possible

to consider some further policy initiatives to support the preservation of existing jobs and the creation of new jobs. However, this requires fiscal ‘space’ that can only be created through the narrowing of the structural deficit.

The 2010 Budget that will be announced in December represents a pivotal step in Irish fiscal adjustment process. It is important to recognise that major steps have already been taken since Summer 2008. On the tax side, there has been a substantial increase in (consolidated) tax rates, with the distribution of the tax increases skewed towards higher earners. Moreover, there is a limit to the extent that a marginal effective income tax rate in the neighbourhood of 54 percent (that currently kicks in at a relatively modest income level) can be raised if Ireland is to attract and retain the types of highly-skilled mobile professionals that are key to future economic growth.

Rather, the main objective on the tax side should be to greatly broaden the tax base. This involves eliminating or greatly restricting many of the tax expenditures identified by the Commission on Taxation. However, it also involves restricting the scale of tax credits, allowances and non-taxable income sources that result in many Irish workers contributing below the European norm in terms of net taxes as a proportion of income. In terms of new taxes, the scheduled introduction of a carbon tax is welcome, while a commitment to the early implementation of a well-designed annual property tax regime can help relieve pressure on other tax sources.

The structural budget deficit cannot be narrowed by tax measures alone. We have already outlined the case for a further reduction in public sector pay levels. However, the scale of the structural deficit is such that some contraction in aggregate service provision and public investment is also warranted.

Within the envelope of an overall target reduction in public spending, more radical actions in some areas may enable a smaller set of cuts in other expenditure lines, with the goal of ensuring that those expenditure lines that offer the highest economic and social benefits suffer the least.

In relation to the overall fiscal framework, the projected 2009 outturn (according to the ESRI’s Autumn Quarterly Economic Commentary) is for a general government deficit of €21,121 billion rather than the €18,413 billion envisaged in the April budget. Relative to GDP, this means that the deficit ratio will be 12.9 percent of GDP rather than the planned 10.75 percent of GDP. According to the latest ESRI projections, the target €4 billion overall package for 2010 will still leave the general government deficit at 12.8 percent of

GDP, rather than the 10.75 percent of GDP target for 2010 that was planned in the April budget.

In part, this slippage represents some deterioration in the forecast for GNP for 2009: the April budget assumed that the contraction in GNP in 2009 would be 8.0 percent but the latest forecast is for a 8.7 percent decline. (In contrast, the projection for GDP has actually improved since the April budget, reflecting the resilience of the multinational-dominated export sector.) However, the scale of the decline in projected tax revenues for 2009 indicates that structural deficit is larger than previously forecast. In turn, this suggests that the scale of the required structural fiscal adjustment in 2010 and the subsequent years is even larger than that envisaged in the April budget. In the other direction, the improvement in the 2010 forecast for GDP growth (-2.9 percent in the April budget, -1.1 percent in the latest ESRI projections) should mean that the cyclical component of the budget deficit will be smaller than previously anticipated.

As indicated, a €4 billion package in 2010 still leaves the deficit at 12.8 percent of GDP: in line with consensus thinking, a major proportion of the fiscal adjustment is being deferred until the economy recovers. However, a failure to attain this partial level of stabilisation will raise questions among taxpayers and investors about the medium-term commitment to return to a sustainable fiscal position. Fiscal instability and uncertainty about the future tax burden will only reinforce the current impulse towards a high level of precautionary saving and delay the recovery.

Once the crisis phase is over, a new fiscal debate will be required concerning the optimal level of long-term public spending in the economy. The main fiscal lesson from this horrendous boom-bust cycle is that the long-term component of public spending must be matched by long-term sources of tax revenues, since fiscal imprudence during the bubble years has been an avoidable amplifying mechanism that has magnified the scale of the crisis.