1. BUDGET 2002: MACROECONOMIC CONTEXT AND FISCAL STANCE

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1.1 Introduction

Budget 2002 was always likely to be a difficult budget to frame as the Irish economy began to slow from the record economic growth rates achieved over the last half decade. These difficulties have increased as the slowdown in economic growth is likely to be much more severe than that anticipated at the time of the last Budget in December 2000.

Growth prospects in the major world economies have declined dramatically throughout 2001 and the uncertainty generated by the recent terrorist attack on the United States has increased the prospects of significant negative economic spillovers internationally. As a small open economy, the prospects for international trade are a critical determinant of economic activity within Ireland such that the diminished external growth prospects provide a negative backdrop for the framing of domestic budgetary policy.

The spotlight placed on Irish fiscal policy as a result of the disagreement with the European Commission on the EU Broad Economic Policy Guidelines (BEPG) has placed an additional pressure on the setting of Budget 2002. In addition, expectations by the Irish public of a continuation of the policy of income tax rate cuts and increased public expenditure remain high, despite the likely deterioration in the short-term position of the public finances.

The aim of this paper is to outline the macroeconomic context in which Irish budgetary policy must be set and to determine the appropriate fiscal stance for Budget 2002. Section 1.2 outlines both the short- and medium-term macroeconomic outlook for the Irish economy taking account of the critical international context. Section 1.3 examines the difficulties in estimating revenue and expenditure patterns in Ireland in

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recent years. The turnaround from considerable forecast revenue overshoots in previous years to the likely substantial undershoot in 2001 is very significant for determining the opening position for Budget 2002. In Section 1.4 the difficulties in determining the appropriate fiscal stance for Ireland and which measure is best to use is discussed. The final section draws conclusions and recommendations for framing the upcoming Budget.

1.2 Macro-economic Context

The macroeconomic context for setting Irish budgets in recent years has been exceptionally favourable but the economy has reached a turning point in its growth prospects. Each budget needs to be set as part of a series in positioning fiscal policy to play a role in delivering a sustainable, non-inflationary environment to promote economic growth prospects. In addition to this strategic role, short-term factors will require that fiscal policy be responsive to changing economic circumstances. While the medium-term outlook continues to remain broadly favourable for Ireland there will be some difficulties to be encountered in the short-term. We now look at these in turn beginning with the short term prospects.

1.2.1 SHORT-TERM ECONOMIC OUTLOOK

The international economic outlook has weakened significantly in 2001. The slowdown that began in the middle of last year in the US has continued into 2001 and spread throughout the international economies. Economic growth has slowed dramatically in the US and also to a lesser extent in the EU. The Japanese economy remains weak with deflation still a problem while the outlook for the emerging economies of Eastern Europe and Latin America is also less favourable. Thus far, little sign of recovery has emerged, with prospects for growth in 2002 highly uncertain. The recent terrorist attack in the US and the anticipated military response has created a huge uncertainty for the global economic outlook.

The slowdown in the US economy has been most pronounced in the manufacturing sector, which has been in recession for some time. Industrial production and equity prices have fallen sharply while business and consumer confidence levels have declined. Investment levels have fallen throughout the year, particularly in the Information and Communications Technology (ICT) sector. In the second quarter of the year gross private investment fell by 12 per cent, suffering from low corporate profitability and excess capacity, particularly in the ICT and broader manufacturing sectors.

In response to slowing growth the US Federal Reserve loosened monetary policy by implementing a series of interest rate cuts this year. In addition, tax cuts implemented in the second half of the year will provide a further stimulus to the economy. Thus far, however, little sign of recovery has emerged. The main contributors to the low growth in the second quarter were personal consumption, government spending and residential investment. Prior to the September 11th terrorist attack, US consumer confidence had proved remarkably resilient given the declines in the corporate sector. Recently, however, labour market conditions have deteriorated with the US unemployment rate increasing from 4.5 per cent to 4.9 per cent in August 2001. It is feared that further declines in consumer confidence and spending may push the US into recession.

A technical recession of two-quarters of negative growth is now more likely in the US and the prospect of a more prolonged slowdown into 2002 has been increased by the recent terrorist attacks. While the prospects are highly uncertain we forecast GDP growth of 0.9 per cent in 2001 and a recovery to 2.2 per cent in 2002 for the US economy, see Table 1.1. These rates are below the US economy's potential growth rate of around 3 per cent.

Table 1.1: National and International Context 2001-2002

	GDP		Consumer Prices		Unemployment		Interest Rates		Current Account Balance as % of GNP	
	2001	2002	2001	2002	2001	2002	2001	2002	2001	2002
USA	0.9	2.2	2.1	1.7	4.5	5.0	4.2	3.8	-4.1	-4.3
Euro Area	1.8	2.2	2.4	1.3	8.4	8.3	4.0	3.8	-0.2	-0.1
Japan	-0.2	0.6	-0.5	-0.2	5.1	5.1	0.1	0.1	2.2	2.3
UK	2.0	2.4	1.6	0.8	5.2	5.5	5.2	5.0	-1.7	-1.9
Ireland	6.5	4.3	4.8	3.3	3.7	4.2	4.0	3.8	-1.1	-2.0

Following GDP growth of 3.4 per cent in 2000, economic activity slowed in the euro area in 2001. The impact of the slowdown in the external environment, the lagged effects of monetary tightening and the deterioration of purchasing power as a result of increased oil prices have been contributory factors to an overall weaker economic environment. Significant slowing of domestic demand and exports has shown that the euro area economy is not impervious to outside developments.

In response to the weaker economic conditions, the European Central Bank (ECB) cut interest rates by one percentage point so far in 2001. Although the headline Harmonised Index of Consumer Prices (HICP) rate of inflation has remained stubbornly above the 0-2 per cent target of the ECB throughout the year, it is expected that inflationary pressures will recede, allowing for further loosening of monetary policy. For the year as a whole it is forecast that the euro area economy will grow by 1.8 per cent in 2001 and by 2.2 per cent in 2002.

These forecasts are subject to considerable downside risk however. First, the extent of the downturn in the US will have considerable influence on growth in the euro area. Second, the record deficit in the US balance of payments current account makes a sharp appreciation of the euro more likely over the coming year, thus eroding the competitive position of European exporters. If the euro experiences a larger appreciation than forecast, or the US downturn is more severe than anticipated, then output growth in the euro area will suffer further.

The Japanese economy is expected to remain fragile over the next two years with growth in output at just above half a percentage point in 2002. The UK economy is expected to have GDP growth in line with the euro area over 2001 and 2002 at 2.0 and 2.4 per cent respectively.

The outlook for the Irish economy this year and next is for a slowdown in GDP growth to more modest levels as compared with the record growth achieved in 2000. Evidence of a slowdown in the economy is already apparent through slowing exchequer returns, industrial production, export growth, and retail sales. In addition, falling house price growth, a potential slump in the commercial property sector and a downturn in the demand for credit all point to reduced domestic activity. However, some overheating pressures remain as indicated by a high relative rate of inflation with our main trading partners and a rising external current account deficit on the balance of payments. Employment growth continued to slow this year, while the unemployment rate has stabilised around 3.7 per cent.

Economic growth in terms of GDP is forecast to grow by around 6.5 per cent in 2001. While this rate is close to half the record rate of last year, the sharp slowdown in the economy throughout 2001 is masked somewhat by the carryover impact of the high 2000 growth performance. In large part the fortunes for the Irish economy rest upon the performance of the ICT sector. Throughout 2001 Ireland experienced a slowdown in export growth and inward investment, primarily the result of weakened activity in that sector. A large proportion of ICT exports are intended for European markets. Given the slowdown in European domestic demand some fall in ICT spending can be expected. In turn, the extent of the economic downturn in the US will affect the magnitude of the slowdown in Europe.

Thus far the continued weakness of the euro has maintained competitiveness for exporters in Ireland and softened the impact of reduced demand. A sharp appreciation of the euro in the context of high wage growth would lead to a significant loss of competitiveness for the Irish economy. Such an appreciation in addition to the possibility of the US downturn being more severe than expected would imply lower GDP growth in 2002. While considerable uncertainties exist about the international economic prospects, it is likely that output growth in Ireland will fall below trend in 2002. We estimate that trend growth in terms of GDP is of the order of 5 per cent, with forecast real GDP growth of 4.3 per cent anticipated in 2002.

Budget 2002 is therefore likely to be the first in eight years to have to give consideration to an economy growing below trend.

1.2.2 MEDIUM-TERM ECONOMIC OUTLOOK

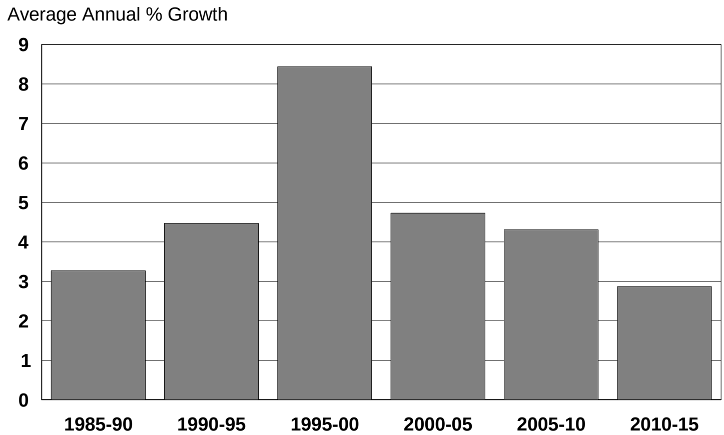
The ESRI has recently published the Medium-Term Review (MTR) for the Irish economy 2001-2007 (Duffy *et al.*, 2001). This review points to a slowdown in the rate of economic growth in Ireland. The combination of significant domestic resource constraints along with an increasingly uncertain external economic environment will guide the Irish economy towards a more sustainable growth rate.

The Benchmark forecast in the MTR shows the Irish economy gradually slowing from the exceptional growth rates of the last five years. Such a scenario is consistent with the short-term outlook described above though the forecast growth rates are not identical as these have been revised in light of events since August. However, in the medium term this must be considered a relatively benign scenario, as there is now the very real possibility that the US economy will face an unpleasant adjustment process over the next few years.

The analysis suggests that the Irish economy has capacity to continue growing more rapidly than its EU neighbours, albeit at a slower pace than previously. Potential output, which averaged over 7 per cent between 1995 and 2000, is likely to fall to about 5 per cent for the period to 2005, before slowing further to around 4 per cent a year between 2005 and 2010. Hence, the Benchmark forecast growth in GNP, at an average of 4.8 per cent per annum out to 2005, see Figure 1.1, implies that the economy will perform a little below potential in the coming years.

The result will be some rise in unemployment, peaking in 2005 at around 5.8 per cent of the labour force. In the subsequent five-year period the economy could grow more rapidly than potential, averaging 4.3 per cent a year, returning the labour market to full employment. However, as in the past, output will respond more rapidly both to the slowdown and the recovery than the labour market, and once unemployment rises temporarily it will take a number of years before full employment is restored.

Figure 1.1: Average Annual Volume Growth Rates in GNP



Source: *Medium-Term Review* (2001).

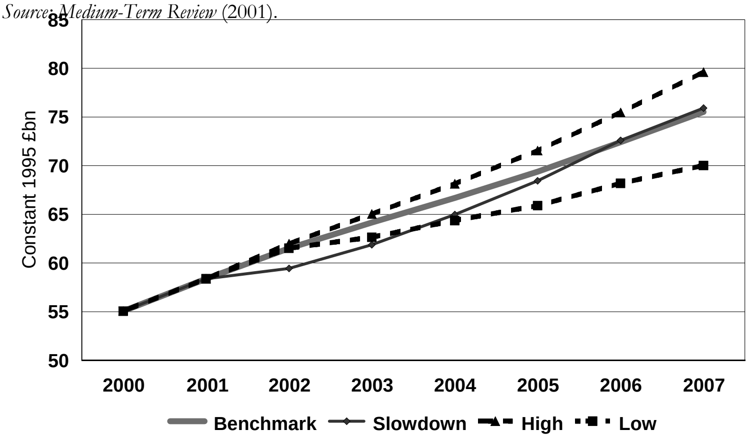
An alternative Slowdown scenario was also considered, whereby the US economy undergoes a more severe downturn than under the Benchmark forecast, with economic growth only recovering to its potential in 2003. Given the terrorist attack on the US, it now appears that the actual outturn may be closer to this scenario than to the Benchmark. This scenario entails a major reduction in foreign direct investment into Ireland, as well as a significant decline in world trade, creating an atmosphere of considerable uncertainty. With rising unemployment many would feel insecure and the result would be a rise in personal saving and a temporary fall in the demand for and price of housing.

Under this scenario, growth next year would fall to just under 2 per cent in 2002. However, the economy would begin to recover in 2003 and, from 2004 onwards, growth would be more rapid than in the Benchmark. The loss of potential output would be made up by 2005. The unemployment rate would peak at around 7.6 per cent of the labour force in 2003, before returning to the full employment level by the end of the decade. This scenario could also push the general government balance into deficit in 2004.

The projected growth path of GNP under the different scenarios is demonstrated in Figure 1.2. In addition to the Benchmark and Slowdown scenarios described above two further scenarios are also considered for illustrative purposes. The High Growth scenario involves an expansion of the economy's growth potential by one percentage point per annum through additional immigration. However, this exacerbates the current infrastructural deficiencies, and the conclusion is that there will only be a clear welfare gain from higher growth if it is achieved through higher productivity. The Low Growth scenario involves excessive growth in labour costs combined with insufficient investment in infrastructure. This would result in a significant loss of competitiveness, and the economy would grow at about one percentage point below its medium-term potential.

Figure 1.2: Alternative Forecasts for GNP

Source: Medium-Term Review (2001).



This analysis suggests that the Irish economy is robust. Relatively prudent domestic policy actions should be sufficient to prevent the economy following either of the "high" or "low" growth scenarios. From Figure 1.2 it is clear that the medium-term growth path for both output and employment is very similar in both the Benchmark and Slowdown scenarios, with Ireland performing better than the EU average for the rest of the decade. The conclusion is that any temporary slowdown in the world economy should not damage medium-term growth prospects, and the economy will be back to its medium-term trend growth path by 2006.

The recent move to a full employment economy has meant that labour supply has become a key determinant of the growth potential of the economy. In the 1990s it grew at around 3.5 per cent a year. However, average growth will decline to 2.2 per cent per annum out to 2005, before falling further to 1.4 per cent between 2005 and 2010, see Figure 1.3. The most notable decline will be in the contribution of female labour force participation to labour supply. As a result of significant increases throughout the 1990s, ... on rates are currently among the highest in the EU, thus leavin... be for further increases. In addition, the natural i... he ... ce ... e steadily over the coming decade, d... fal... h ... 980. However, the forecast continuat... ific... mi... m... tantial positive contribut... gro... ur...

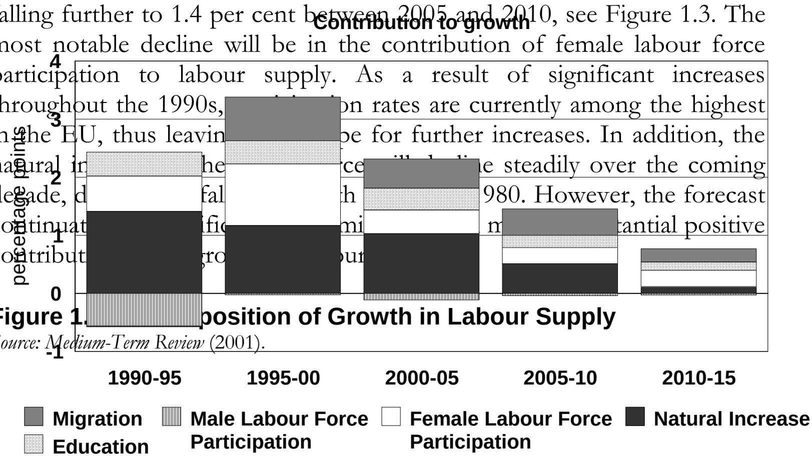


Figure 1. ... position of Growth in Labour Supply

Source: Medium-Term Review (2001).

The other key determinant of the growth potential of the economy is productivity. The growth in productivity in the 1990s was also well above that experienced in our EU neighbours and this exceptional performance was due to a range of different factors, among them the belated impact of investment in education. Average productivity growth is forecast to decline slightly from its peak in the late 1990s as high-technology industries mature and the economy continues to become more services intensive. This combination of labour supply and productivity growth gives us a potential growth rate of 5 per cent out to 2005 and 4 per cent between 2005 and 2010.

Both the short- and medium-term prospects for the Irish economy contain significant degrees of uncertainty for the likely state of the public finances. It is, however, the case that while the likelihood of a serious short-term deterioration in the budgetary position is high, the medium-term prospects remain favourable. While Ireland is experiencing a downturn in its economic and fiscal fortunes, it is still a long way from experiencing difficulties in meeting its obligations under the terms of the EU Stability and Growth Pact (SGP), see Cronin and McCoy (1999).

Indeed, many other European economies are likely to have considerable difficulties in avoiding breaches of the SGP. It is becoming apparent that the strength of the public finances in Europe in recent years was as much a cyclical phenomenon as a reflection of sustainable structural changes. As Barrell (2000) outlined, the European economies benefited greatly from the protracted boom within the US over the previous decade. The US fiscal surplus itself has shrank dramatically over the last few months, rendering redundant, for now, the debate that emerged on how to deal with the anticipated large budgetary surpluses (Alesina, 2000)

1.3 State of the Public Finances

Against the backdrop of considerable international uncertainty and the sharp slowdown already apparent in the Irish economy, the traditional difficulties in determining the state of the public finances for budgetary decisions is even more acute this year. The significant overshooting in the outturns of the public finances as compared with those anticipated on budget day which have been a feature of Irish forecasting in recent years has suddenly reversed. The prospect of substantial undershooting of revenues and overshooting of expenditure in 2001 is likely to contribute to a more difficult opening position for Budget 2002.

1.3.1 DIFFICULTIES IN ESTIMATING BUDGETARY REVENUES AND EXPENDITURES

The improvement in the government finances through the 1990s has been well documented, although it appears from Figure 1.4 that this improvement was somewhat unexpected at each budget time. A contributing factor to this has been the strength of economic growth in recent years. This brought about higher than anticipated tax revenues at a time of Maastricht-constrained current expenditure. As outlined above, in the medium term the economy is forecast to move to more sustainable growth rates, below the very rapid rates experienced in recent years.

However, in the short term economic growth is expected to be significantly slower, reflecting the poor international economic outlook.

Economic forecasting, be it of growth or government finances, is a difficult exercise. The problems in forecasting the public finances has been recognised by the public sector and a group was established to examine the tax forecasting methodologies used by the Department of Finance (1998). The analysis of this group found that one of the main causes of the under-forecast of tax revenue was the under-forecast of growth in the economy.

Figure 1.4: Overshooting in Current Revenue and Expenditure

(Outturn less Budget estimate expressed as a percentage of Budget estimate)

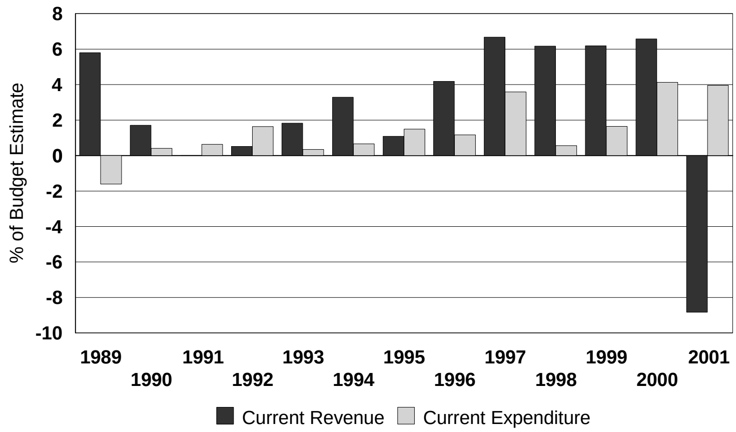


Figure 1.4 updates analysis presented at the 1999 ESRI/FFS Budget Perspectives conference (Duffy, 1999) on the extent to which budgetary targets have been missed. Since 1992, budget estimates have been exceeded. As is evident, the overshoot has been particularly large with regard to revenue, reaching 6.7 per cent in 1997. Between 1990 and 1995 the annual average overshoot in revenue was 1.4 per cent. In the period 1995-2000 this had risen to 5.1 per cent. On the expenditure side the annual average overshoot rose from 0.9 per cent to 2.1 per cent. In 2000 the expenditure overrun was 4.1 per cent of the budget estimate. This amounted to £652 million. The overshoot in both revenue and expenditure has widened in the latter half of the 1990s.

The rapid growth in the economy has masked the overrun in expenditure. This is partly due to the larger overshoot in current revenue, which has moved the public finances from an exchequer-borrowing requirement to an exchequer surplus. Honohan (1999) suggests that the overshoots indicate …*both conservative budgeting and a relatively high marginal propensity to spend unanticipated tax receipts in the year that they arise*. However, the situation has now changed with undershooting revenues exposing the extent of the expenditure overshoots. This is resulting in a deterioration of both the Exchequer and General Government budgetary positions.

Preliminary figures from the forthcoming ESRI *Quarterly Economic Commentary* (McCoy *et al.,* 2001), combined with estimates from last year's Budget 2001 suggest that large differences between budgetary forecasts and the expected outturn were a feature of the public finances again in 2001. It should be noted that the while an economic slowdown was expected, the severity of this slowdown was unanticipated. Thus, it now seems likely that there will be an undershooting in tax revenue compared to the Budget estimate. In contrast, government expenditure is still expected to overshoot its Budget estimate.

Since the rapid growth in the economy is not forecast to continue and given the commitments to place 1 per cent of GNP into the National Pension Reserve Fund (Lane, 1999), greater accuracy in forecasting the public finances is becoming even more important given international budgetary surveillance. The forecast of the public finances should not be expected to be a mechanistic exercise in any year given that discretionary budget changes are central to operating effective fiscal policy (Taylor, 2000).

1.3.2 LIKELY OPENING POSITION FOR BUDGET 2002

Strong growth in the economy has led to large exchequer surpluses over the last few years. As a consequence the burden of national debt, as measured by the debt to GDP ratio, has fallen dramatically. As Figures 1.5 and 1.6 illustrate, the outlook for the public finances in 2001 and 2002 is markedly less favourable than in recent years. The exchequer balance is forecast to decline considerably this year and to move into deficit in 2002 on the basis of the economy growing below its trend. The implication for Budget 2002 is that significantly less room exists for tax cutting measures and expenditure increases than in recent years.

The public finances were in their most healthy position in decades in 2000, as a result of the record growth in the economy, which allowed for a generous budgetary outlay last year. The capital borrowing requirement meant that the exchequer surplus measure was equal to £2.4 billion or 3 per cent of GDP. The broader general government surplus for 2000 was £3.7 billion or 4.5 per cent of GDP. In addition, the corresponding general government debt declined from 49 per cent of GDP in 1999 to 39 per cent of GDP in 2000.

Exchequer returns indicate that tax revenue grew by just 2.2 per cent in the first nine months of 2001 as compared with the same period in 2000. Given that tax revenue grew by 15.8 per cent in the year 2000 as a whole, the latest exchequer returns are indicative of a wider slowdown in the economy. The slowdown in tax revenue has been most pronounced in excise duties, which contracted by 7.4 per cent in the first nine months of the year as compared with 2000. Furthermore, the growth of revenues from income tax, corporation tax and value added tax has all significantly slowed this year.

Figure 1.5: Exchequer and General Government Balances 1990-2002
(as a percentage of GDP)

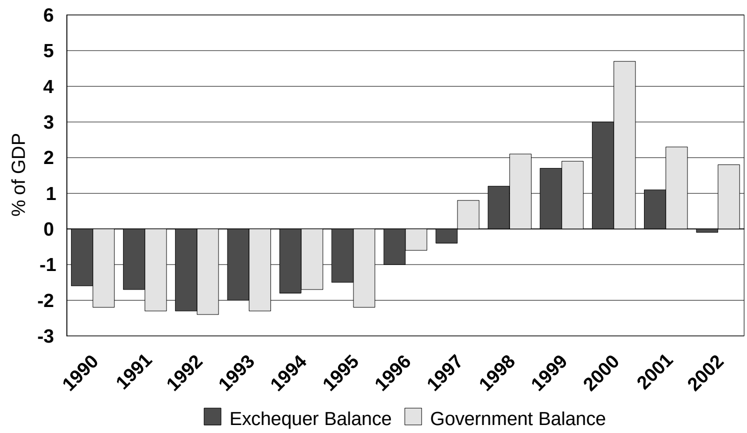
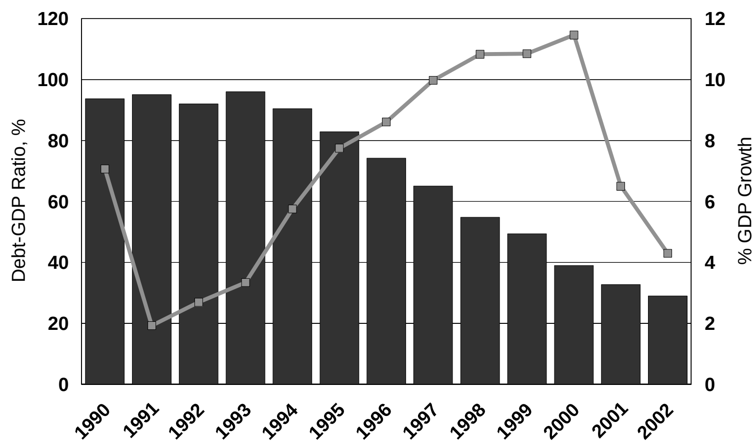


Figure 1.6 General Government Debt and GDP 1990-2002



Tax revenue was probably depressed in the first half of the year by temporary factors, such as the effect of foot and mouth containment policies on excise duties and also certain timing issues with regard to corporation tax. However, the greatest conundrum in the exchequer figures is the slow growth of income taxes at 3.6 per cent. It is difficult to reconcile this figure with the strong wage and employment data throughout the economy. Some rebound may be expected in the fourth quarter of the year but tax revenue is forecast to slow below budgetary estimates nonetheless.

On the expenditure side, the exchequer returns indicate that current expenditure grew by 11.4 per cent in 2001 as compared with the first nine months of 2000. This comprises of a fall in the central fund and a substantial rise in current supply and services of around 19 per cent. In part, the persistence of inflationary pressures has contributed to expenditure increases being underestimated by budgetary forecasts. Expenditure on the current supply of services is expected to overrun original estimates because of an increased allocation of resources at the finalisation of the Expenditure Estimates for 2001. However, this increase will in some part be offset by the decision to reduce capital expenditure. In addition, capital resources will be £500m higher in 2001 as a result of the sale of the state-owned Industrial Credit Corporation (ICC) and Trustee Savings Bank (TSB). These privatisation receipts will offset somewhat the effect of increased current expenditure on the exchequer balance but will not impact on the general government balance.

Given the considerable uncertainties it is forecast that the exchequer surplus will decline to £1 billion or 1.1 per cent of GDP this year. This means that the exchequer surplus in 2001 will fall short of last year's surplus by over £1.4 billion. This may be a rather sanguine view as it depends upon a rebound in the revenues in the latter half of 2001. Tax revenue growth of 4 per cent for the year is forecast. Current expenditure is expected to grow by 14.6 per cent with the impact on the exchequer surplus somewhat offset by privatisation receipts and reduction in capital expenditure.

The broader measure, the General Government balance, which includes the National Pension Reserve Fund and the Social Insurance Fund, is expected to be £2.2 billion or 2.3 per cent of GDP. This is 2 percentage points lower than anticipated in the Stability Programme update produced as part of last year's Budget 2001 (Department of Finance, 2000). The general government debt is forecast to decline from 39 per cent of GDP in 2000 to 33 per cent in 2001.

In terms of the opening position for Budget 2002, it is forecast that current trends will lead to a moderate deficit in the exchequer balance in 2002. This projection is made under a number of assumptions. First and foremost a sharp slowdown in GDP growth to 4.3 per cent is expected in 2002. Overall tax revenue is expected to grow by 5.6 per cent. In large part this slight increase in tax revenue growth as compared with 2001 reflects the recovery of excise duties. In addition, inflationary pressures and wage increases are expected to maintain the strong growth of VAT and income tax receipts in 2002.

Current expenditure is expected to rise by 7.2 per cent in 2002. On one hand, lower interest rates and a declining burden of national debt will contain expenditure on the central fund. However, prior commitments with regard to public sector wage agreements, in addition to increases in public sector employment, are expected to lead to growth of 9 per cent on current supply of services spending.

Capital expenditure is expected to rise by 5.7 per cent to over £5 billion. With no privatisation receipts and other capital receipts in decline, the capital borrowing requirement is set to increase by over £1 billion. In comparison the current budget surplus is expected to decline by less than £200 million in 2002.

In summary, the opening exchequer balance for next year is projected to be a moderate deficit of £150 million or just 0.1 per cent of GDP, see Table 1.2. As compared with the projected outturn for 2001, this would imply a reduction of almost £1.2 billion in the exchequer balance. The bulk of the decline in the exchequer balance is expected to come from increased capital borrowing. Large capital receipts from the privatisation of state companies have flattered budgetary positions in recent years. While our estimates for current revenue and expenditure are optimistic, the decline in capital receipts, particularly from privatisation, will lead to a sharp reduction in the exchequer balance.

The broader based general government surplus is expected to equal £1.8 billion in 2002 as compared with £2.2 billion in 2001. This is a significantly smaller decline when compared with the exchequer balance. The difference between the projected general government and exchequer balances reflects the exchequer's contribution to the National Pensions Reserve Fund and also the surplus in the Social Insurance Fund, both of which are expected to grow in 2002. The corresponding general government debt is forecast to decline from 33 per cent of GDP in 2001 to 29 per cent in 2002, a much more modest decrease in the debt than experienced in recent years.

Table 1.2: Budget Positions 2000-2002

	2000 Outcome	**%Change**	**2001 Forecast**	**%Change**	**2002 Opening Position**
Current Revenue	21,741	4.8	22,775	5.2	23,956
Current Expenditure	16,251	14.6	18,630	7.2	19,980
Current Surplus	**5,491**	-24.5	**4,145**	-4.1	**3,976**
Capital Receipts	2,053	-16.3	1,719	-43.6	970
Capital Expenditure	5,141	-6.1	4,825	5.7	5,100
Capital Borrowing	**3,088**	0.6	**3,106**	33.0	**4,130**
Exchequer Surplus	**2,403**	-56.8	**1,039**	-114.8	**-154**
as % of GDP	3.0		1.1		-0.1
General Government Surplus	**3,667**	-41.4	**2,150**	-15.3	**1,820**
as % of GDP	4.5		2.3		1.8
Gross Debt as % of GDP	**39.0**		**32.7**		**29.0**

1.4 Appropriate Fiscal Stance

Determining the correct fiscal stance is always an imprecise activity. Fiscal stance is a measure of the discretionary changes in budgetary policy, though there is no universal acceptance on its measurement. It is used to assess the likely expansionary or contractionary impact of budgetary policy on economic activity. The appropriate stance needs to account for factors like the state of the public finances, the stage of the economic cycle and the growth prospects for the economy reflecting its stage of development. The backdrop for Budget 2002 in terms of these three factors is mixed.

As we outlined in the previous sections the public finances are in a strong position in terms of a low debt ratio and are close to balanced budgetary positions. However, they are deteriorating unexpectedly reflecting a changing cyclical position as the economy moves towards below trend growth but also because of unknown factors. In terms of stage of development, the transition of the Irish economy in recent years is still not complete as reflected in the still substantial infrastructural deficits in contrast to other EU member states. Making up on this infrastructural deficit will require significant capital expenditure over the longer term (Cronin and McCoy, 2000).

In addition to the domestic factors determining the appropriate fiscal stance, participation within EMU is also a constraining factor on setting Irish budgetary policy (Fitz Gerald, 2001). While we can sketch the broad parameters, the main problem is that there is no generally accepted method of calculating what part of the budget balance is due to short-term transitory factors caused by cyclical events and what part is structural resulting from decisions made by the fiscal authorities. Making this distinction is important in measuring fiscal stance.

1.4.1 MEASURING FISCAL STANCE

The standard approach is to estimate a cyclically adjusted or "structural" budget balance. This is referred to as the "gaps and elasticities" approach that involves estimating an output gap measure and then using this along with elasticity measures to adjust budgetary items. This measure is defined as what the budget balance would be, were the economy operating at capacity, typically defined as full employment output or trend output. Many international institutions, including the Organisation for Economic Co-operation and Development, the EU Commission and the International Monetary Fund produce estimates of cyclically adjusted budget balances based on this definition.

Fiscal stance can only be interpreted meaningfully in comparison to policy decisions in a previous time period so it is the change, not the level, of the budget balance that is the relevant consideration. This assumes that the previous year's policy mix is permanent, and considers the current year's budget relative to this baseline. If the structural budget balance increases (decreases) in a given year, then this would imply a tightening (loosening) of fiscal policy in that year's budget. To arrive at an estimate of the total stance of discretionary fiscal policy over a number of years, these changes can be aggregated over time.

Alternatively, an incremental measure of fiscal stance can be estimated directly. Blanchard (1990) suggests a methodology that avoids the difficulties associated with the calculation of capacity, which he calls an "indicator of discretionary changes in policy". This is defined as the difference between the budget balance if unemployment had not changed from the previous year, thereby eliminating the cyclical component of the budget, and the previous year's budget balance.

The method that we favour, based on Kearney *et al.* (2000) estimates fiscal stance by use of a macroeconomic model to simulate the effects of an indexed budget, where indexation is based on the previous year's budget. The difference between the indexed budget balance and the actual budget balance is a measure of fiscal stance. A positive (negative) difference indicates a loosening (tightening) of fiscal policy. This measure is based on the incremental approach and so can be cumulated over time. The advantage in using a macroeconomic model for estimation is that it allows for the implementation of detailed indexation rules for different items of revenue and expenditure.

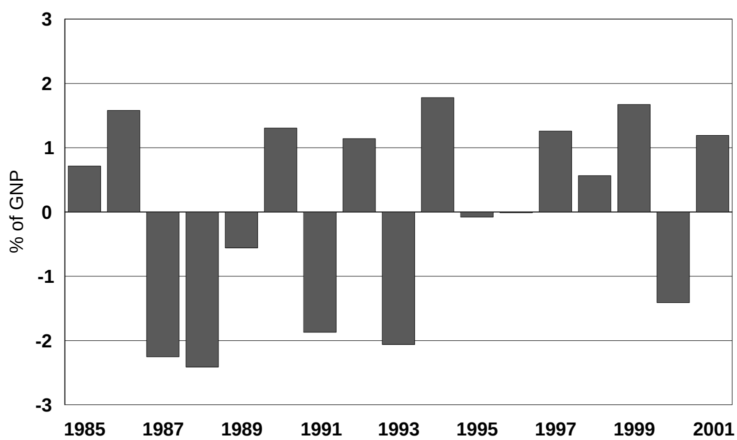
We consider the ESRI HERMES model estimates to be the most reliable for Ireland, given the detailed indexation rules upon which they are based. The other measures rely on broad budget balance aggregates that do not capture the underlying structure of the budget. The gaps and elasticities measures rely on average elasticity relationships applied to aggregate data and approximate calculations of trend or potential output are used. The rapid growth in economic activity and the high mobility of the factors of production mean that there is considerable uncertainty on what is the sustainable, potential growth rate in Ireland. This makes the gaps and elasticities measures less reliable for assessing fiscal stance in a period of considerable changes as during the "Celtic Tiger" phase. The Blanchard indicator depends upon an assumed stable relationship between changes in unemployment and economic activity, which is not appropriate for Ireland.

Figure 1.7 shows a measure of the short-term fiscal stance computed by simulating the ESRI macroeconomic model (Duffy *et al.,* 2001). The indexed budget is computed assuming no change in average tax and expenditure rates from the previous year, and applying the actual growth rate to the revenue and cyclical expenditure base. The use of average tax and expenditure rates ensures full indexation of the tax and welfare system. The non-cyclical expenditure base grows at trend growth rate.

The concept underlying this indexed budget is that, in the absence of any policy changes, revenues and cyclical expenditure items will grow in line with actual output growth while non-cyclical expenditure items will grow in line with trend output growth. The difference between the indexed and actual EBR is an indicator of discretionary change in policy.

Using this measure, the last five budgets 1997-2001, with the exception of 2000, have all been expansionary in their impact. The estimated contractionary stance implied for Budget 2000 contrasts with estimates computed in July 2000 that Budget 2000 was stimulatory (Kearney *et al.,* 2000). This is due to unanticipated inflation increasing the tax base in 2000, resulting from a higher inflation outcome than anticipated at the time of the budget.

Figure 1.7: Difference between Indexed and Actual EBR



Source: Medium-Term Review (2001).

The impact of unexpected inflation changes can alter the fiscal stance position quite dramatically. The problem can be more severe on the budgetary position when inflation is significantly lower than forecast in the budgetary process. In this case the indexation to the forecast inflation could impart a significant fiscal impulse, leading to an unintended expansionary budget with a deteriorating budgetary balance.

It is estimated that the last five budgets imparted a cumulative stimulus of over three percentage points of GNP to the economy, indicating the highly pro-cyclical fiscal policy pursued in Ireland in recent years (Lane, 1998). The IMF (2001) using their "gaps and elasticities" measures has also argued that Budget 2001 was expansionary, in contrast to their assessment of the previous four budgets.

Given the rapid slowdown in the economy, the most prudent position for Budget 2002 should be to aim for a broadly neutral stance which would let the automatic stabilisers in the economy operate. These so-called automatic stabilisers would reduce the budget balance as taxes decline in line with lower output growth and expenditure increases as unemployment rates began to rise back above 4 per cent. If the economy were to fall considerably further below its trend growth, then an expansionary fiscal policy would be warranted in a switch to a countercyclical response.

1.5 Conclusions

Budget 2002 is the first budget in eight years that will be framed against the prospect of the economy growing below its trend growth rate. Despite the evidence of the slowdown in the domestic economy and the uncertainties with regard to the international outlook, expectations remain high among the public of a giveaway budget in advance of a general election. The scope for generous tax cuts and expenditure increases as in recent years has certainly diminished.

The appropriate response for fiscal policy would be a broadly neutral stance, which would involve indexing of the tax and expenditure items to ensure that there is no change in real terms when price and wage changes have been accounted for. Full indexation would cost around £900 million, allowing for some tax reductions and expenditure increases, but this would still be less than half the scale of Budget 2001.

The opening position for Budget 2002 is likely to involve a small exchequer deficit. This is based on what, in the light of the current uncertainties, may be viewed as an optimistic view on economic growth prospects in 2002. While a deficit in the exchequer balance is a stark change in direction on recent years, in itself it need not be a major concern, reflecting as it does a sharp downturn in economic activity. The state of the public finances remains sound and there are few grounds for concern about their sustainability given the low debt ratios.

The medium-term prospects for the economy remain good, so the necessity to continue with improving the economy's supply capacity should be acknowledged (Fitz Gerald *et al.,* 2000). Proposals for a sharp retrenchment in public expenditure would be short-sighted, particularly on capital projects, given that this is likely to be a short-term drop below the economy's trend growth rate.

As we have argued over the last year, our recommended stance for fiscal policy is to encourage adherence to the expenditure outlined in the National Development Plan. Having called for a deferment of taxation commitments under the Programme for Prosperity and Fairness last year (Kearney *et al.,* 2001), we feel that now would have been a more opportune time for these cuts as the economy slows.

If the economy were to slow much more significantly in the coming months a countercyclical budgetary response involving additional expenditure increases may well be required. Monetary conditions are already quite loose, so an aggressive expansion in fiscal policy does not seem warranted at this juncture. Our call, in line with the international agencies like the IMF, is for Budget 2002 to be a broadly neutral one involving a "giveaway" of no more than £1 billion including indexation as measured using the conventional budgetary definition.

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