FISCAL MANAGEMENT IN A CHANGED ENVIRONMENT

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1. Introduction

Ireland's public finances deteriorated in 2001 as economic growth slowed due to a number of unforeseen shocks. A projected Exchequer surplus of €3.2 billion came in at just €0.8 billion and the indications so far in 2002 suggest that a projected small surplus will actually turn out to be a substantial deficit. The sudden and unexpected deterioration in the public finances was due to a sharp easing of growth in tax revenues and higher growth in Government spending. At a broader level it has highlighted the fact that over the past five years the buoyancy of tax revenue on the foot of a booming economy, allowed attention to be diverted away from the incessant upward trend in government current spending. The unsustainable nature of the trend in spending has been brought into sharp focus by the fall off in tax revenues over the past year. With the budget now moving into deficit the risks to the public finances have become obvious and not surprisingly attracted considerable attention during the recent General Election campaign. The Programme for Government is considerably less specific and much more vague than the individual manifestos released before the election. This may reflect a somewhat belated recognition that the public finance situation has become quite difficult and that there will be a serious fiscal constraint on the new administration.

Notwithstanding the short-term problems in relation to the fiscal situation, it is clear that in the medium term, careful management of the public finances will be necessary. In an environment of slower economic growth, and as a consequence slower growth in tax revenues, there will be fewer financial resources at the disposal of Government. On the other hand the demands on the spending side will remain strong. There is intense public pressure for improved public services and heavy lobbying for full delivery of the National Development Plan. In an environment of slower growth in tax revenues and subject to the constraints of the Stability and Growth Pact, it is certain that all demands cannot be met and Government will be forced to prioritise and also to ensure that value for money becomes the key criterion for all spending. The task of

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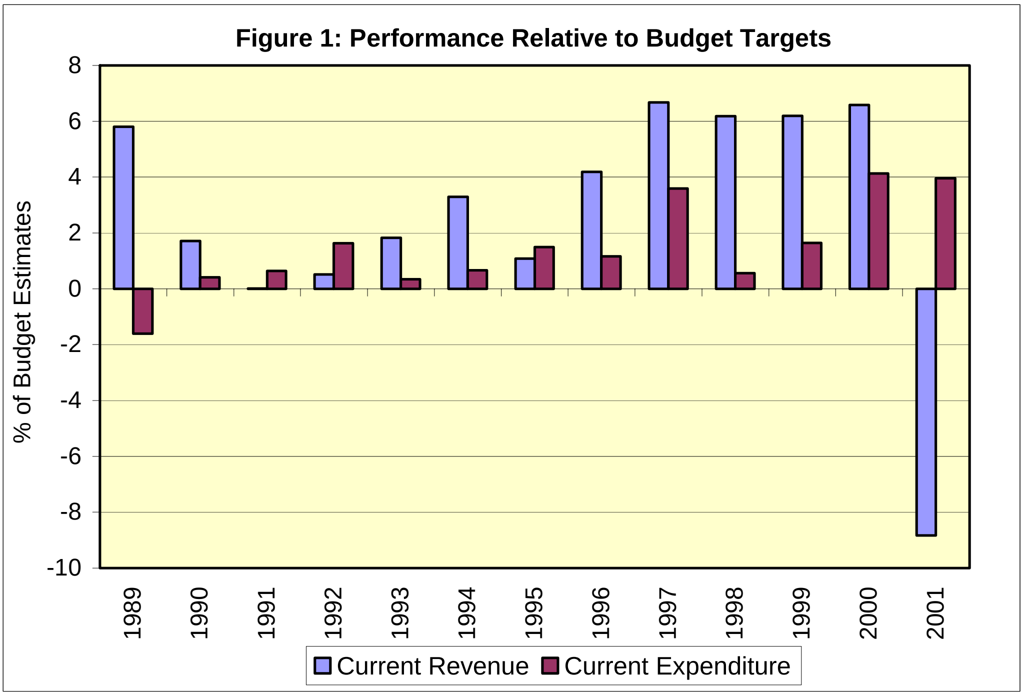
prioritisation would be facilitated by more stringent control of government current spending, but the experience over the past five years would suggest that this might not be easily achieved.

This article is not about the appropriate level of public spending in the economy, that is an issue that will be determined by the level of taxation that the citizens of the country are prepared to bear. Rather, it seeks to explore how public spending might be controlled in differing economic circumstances, and how available monies should be spent to ensure the most efficient and effective returns from scarce resources. Section 2 looks at the reasons why control of public spending has become such an important issue for Ireland. Section 3 examines the role of fiscal policy in a monetary union, stressing the requirement that it has to support the key objective of monetary policy in EMU. Section 4 goes on to examine the effectiveness of fiscal rules and their less than impressive track record in Ireland. It also identifies some of the most serious claims on public spending in Ireland going forward. Section 5 looks at the risks in trying to control public expenditure and identifies one theoretical framework for assessing public spending. Finally, Section 6 brings together the various strands and identifies some broad recommendations for the Irish authorities. The key conclusion is that the quality of public spending should hold precedence over the quantity of spending.

2. Why is Control of Public Spending Needed?

The budget day presentation of the public finances now contains a familiar story about how expenditure and revenue targets have been overshot. Analysis in Duffy *et al.* (2001a) shows the extent of the overshoot during the 1990s (see Figure 1). There have been a number of reasons for this. Some of these reasons are unforeseen expenditure items, but more fundamental reasons can be posited. These include poor economic forecasting, conservative budgeting and a propensity to spend any windfall tax receipts in the year in which they arise (Tax Forecasting Methodology Group, 1998; Honohan, 1999). The Tax Forecasting Methodology Group has estimated that for every 1 per cent increase in GDP growth, tax revenues increase by 1 per cent. In addition, the improvement in the fiscal situation over the past decade has made the need to control spending less compelling. The reality is that in an environment of fiscal plenitude public expenditure control attracts little popular or political support.

The OECD amongst others has warned that the improvement in the global fiscal situation over the past decade may have had more to with strong cyclical, rather than structural, influences. In other words, buoyant revenue growth may mask the true underlying fiscal situation. This is particularly relevant to Ireland's recent experience, and has stark implications for the country as it enters into a period of more modest economic growth than that experienced in the second half of the 1990s. With economic growth of circa 4.5 per cent likely in the medium term, growth in tax revenues will be more modest. More immediately, in an environment where the fiscal situation is moving into a position of deficit, and given the borrowing constraints inherent in the Stability and Growth Pact, there is a very compelling case to be made for more stringent control of public spending, unless of course the country is prepared to accept a higher tax burden. There would appear to be limited public appetite for a higher tax burden to finance increased levels of expenditure, and indeed the parties of Government have effectively ruled out the possibility of such a course of action.



Source: D. Duffy, *et al.* (2001a).

The political economy of spending control is complicated. The electorate would not react well to cutbacks in spending, particularly after a decade of buoyant economic growth and rising expectations. Once committed to, spending is very difficult to reverse as it becomes part of the permanent cost base of the country. Furthermore, spending cuts may have negative repercussions further down the road. In 1987, the fiscal retrenchment that played such an important role in changing the fortunes of the Irish economy involved a freeze on recruitment to the public service, an early retirement scheme for some public sector workers, a deferral of special pay awards, and extensive cutbacks and postponement of public infrastructure projects, including public housing (Honohan, 1999). More controversially, it also included hospital closures and cutbacks in health spending and as MacSharry recognised, "in Irish politics there is no more emotive issue than hospital closures or cutbacks in health spending" (MacSharry and White, 2000). Spending decisions can have negative repercussions, and it could be argued that the spending cutbacks in 1987 have contributed to the congestion costs now being borne by the economy, and the current crisis in the health service. In 1987, spending cutbacks were implemented based on the best evidence available, but in hindsight mistakes were made. For example, teachers were given early retirement, but later on more teachers had to be hired to fill the shortfall. However, the spending cutbacks in 1987 did have a very positive impact on confidence and perceptions, and sent a strong signal of the government's determination to transform what was a very difficult fiscal situation. The demonstration effect was important.

The positive evolution of the Irish economy and public finances over the past decade has facilitated a significant reduction in the corporate and personal tax burden, and strong growth in expenditure in the latter part of the decade. From an economic efficiency perspective, the tax cuts have been positive and have resulted in vastly improved incentive structures in the economy. The IMF (2001) argued that tax and expenditure policies in Ireland have been associated with impressive gains in labour force participation and economic growth. It is argued by some that controlling public spending is not appropriate given that spending on public services as a percentage of GDP is already lower than the EU as a whole (see Table 1). However, the tax take in Ireland is also considerably lower as a percentage of GDP than in the EU. The implication is that if Ireland is to satisfy its commitments under the Stability and Growth Pact and target a balanced budget in the medium term, an increase in spending as a percentage of GDP will have to be accompanied by a corresponding increase in taxation. This is the essence of the "Boston versus Berlin" argument. Ireland has built its success on a policy of reducing the burden of taxation, but the corollary of this policy is that spending on public services has been constrained. This is the choice that has been made, based on the reality that an economy cannot simultaneously enjoy a low overall burden of taxation and a high level of public spending. That is not to suggest that the burden of taxation cannot be spread in a more equitable manner or that the quality of services obtained from a certain level of spending cannot be improved. In fact, this article will argue that the latter can be achieved if correct procedures are applied.

Table 1: Size of Government Sector

Year 2000	Ireland % of GDP	EU Average % of GDP	United States % of GDP
General Government Total Outlays	30.0	44.2	29.4
General Government Tax and Non-Tax Receipts	34.7	44.8	31.6

Source: OECD *Economic Outlook* 2001/1.

The IMF (2001) reviewed the improvement in fiscal positions around the world in the 1990s. The analysis contained a number of interesting findings, some of which are of particular relevance to Ireland. It concludes that a defining characteristic of the worldwide fiscal adjustment in the 1990s was that it was primarily based on expenditure restraint that was facilitated by widespread reforms directed at strengthening fiscal frameworks. These institutional changes include measures focused on debt ceilings and deficit targets, expenditure rules, and the transparency of fiscal management. Furthermore, the IMF argues that in general a focus on expenditure reductions rather than tax increases tends to result in more durable fiscal adjustment.

Ireland's fiscal consolidation in the 1990s was based on debt ceilings and deficit targets as laid down in the Maastricht Treaty. It also involved tax cuts, but did not involve subsequent tight control of expenditure following the initial efforts made in 1987 and 1988. Arguably, the

Maastricht Convergence Criteria did not place enough discipline on the Irish public finances. If tighter control of current expenditure had been maintained or if greater efficiency had been obtained, the public finances could have been even stronger by the time EMU commenced such was the buoyancy of tax revenue. However, the incentives to pursue a tighter or more efficient fiscal policy were not compelling, as the surpluses were already rising and debt levels falling. Ultimately, Ireland was one of a small minority of countries that qualified for EMU on its genuine merits, rather than through creative accounting.

3. Fiscal Policy in a Monetary Union

The manner in which fiscal and monetary policy interact has been an issue of considerable debate for decades, but it has assumed a new importance in the context of monetary union in Europe. Monetary union has entailed the loss of one important tool of national macro-economic policy, namely monetary policy, and an increased reliance on a second, namely fiscal policy at the national level. There are divergent views on the role and effectiveness of fiscal policy in general, but particularly as it applies to a monetary union. Keynesian theory focuses on the effectiveness of an activist approach to macro economic management to stabilise the economic cycle and address market failures. In other words fiscal policy is viewed as an important tool of economic management that should be utilised in an interventionist manner. New–classical thinking on the other hand stresses the potential for Government failure and argues for the effectiveness of a non-activist or a rules-based approach to fiscal management. The latter view is now the accepted orthodoxy in most developed economies, driven by the belief that discretionary fiscal policy very often has a strong deficit bias.

This debate assumed an added dimension for Europe when the momentum towards EMU gathered pace. The Delors report of 1989, which set the blueprint for EMU, espoused the new-classical view. It placed considerable emphasis on the need for disciplined fiscal policy and the imposition of constraints on Government deficits and debts. This formed the basis of the Maastricht convergence criteria and ultimately the Stability and Growth Pact. Monetary policy was given the explicit goal of price stability, while fiscal policy should focus on the need for sound public finances. This notion is encapsulated in the Stability and Growth Pact. The European Council at Amsterdam agreed a resolution establishing the Stability and Growth Pact in 1997. It stressed the importance of … *safeguarding sound government finances as means to strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies. Adherence to the objective of sound budgetary conditions that are in balance or in surplus will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 per cent of GDP* (Resolution 97/C 236/01, para. 1). The Stability and Growth Pact requires that each country submit a stability programme that will lay out the medium-term objective for the budgetary position of close to balance or in surplus, and the adjustment path that will be followed to achieve this objective for the General Government balance. The situation is now clear – fiscal policy has to support the objectives of monetary policy at a Europe wide level.

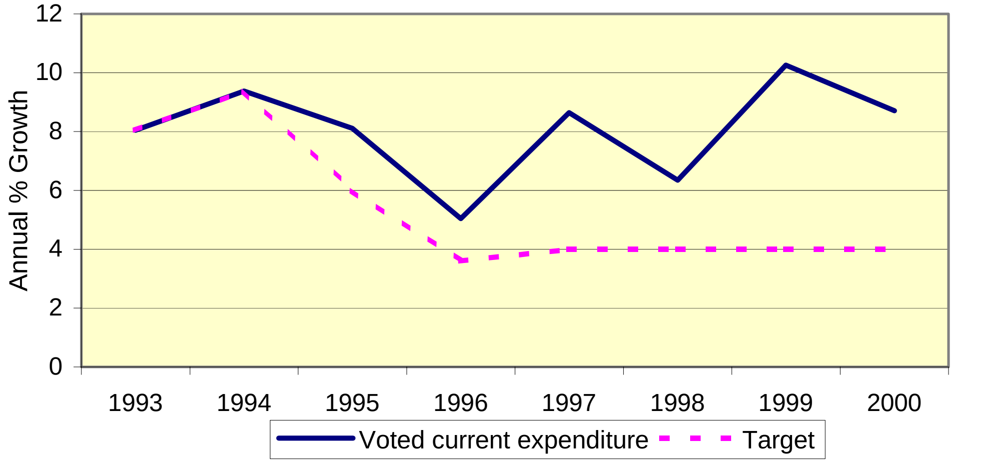
4. A Rules Based Approach to Fiscal Management

A rules-based approach to economic management seeks to confer credibility on the conduct of macro economic policy by removing the scope for discretionary intervention. Kopits (2001) argues that the goal of such rules is to achieve trust and build up credibility by guaranteeing that fundamentals will remain predictable regardless of the government in power. In the monetary policy arena, the European Central Bank's (ECB) inflation target fulfils these criteria, while the Stability and Growth Pact does so in the fiscal arena. It is still too early to conclude just how effective these two rules-based approaches are, particularly in relation to the latter. However, the stability of long-term interest rates in the euro zone would suggest that the markets attach considerable credibility to the policy-setting environment in the zone, as evidenced by the lack of a significant risk premium in euro zone assets. This is despite the fact that the ECB has rarely managed to bring inflation within the 0-2 per cent target zone, and doubts about how rigorously the Stability and Growth Pact might be applied in the case of the bigger nations. At a national level such a rules based approach has certain attractions. Kopits suggests that in many advanced economies, discretionary demand management has not acted in a counter-cyclical manner and has in fact been quite pro-cyclical and has exhibited a deficit bias. It can certainly be argued that this has been the case in Ireland in the latter years of the 1990s, a period when spending exceeded nominal growth in the economy and taxes were cut.

It is clear from the experience over the past five years that Ireland does not have an effective strategy for fiscal management. The buoyancy of growth in tax revenue resulting from strong economic growth has diverted attention away from the need to control expenditure. This has resulted in a situation where a substantial Exchequer surplus disappeared over the past eighteen months due to a sharp deceleration in tax revenue growth and persistent strong growth in spending. Clearly, Ireland needs to adopt more stringent control over the public finances going forward. Adherence to the Stability and Growth Pact will set the parameters, but those parameters will be difficult to work within, in an environment of slower economic growth and tax revenues. This reality is complicated by the fact that the tax cutting strategy of the past three years has eroded the tax base in a manner that was not correctly forecast (see *The Irish Times*, June 10th 2002). Future fiscal management will have to be based on slower growth in public spending or higher taxes, or a combination of both. Given the incentive affects of the tax reform of the past five years, there is likely to be little political or popular support for higher taxes, hence the need for greater focus on spending control.

Curbing public spending is not easy and can have adverse and long-lasting side effects. Boyle and Kennedy (2000) have argued that while the retrenchment of public spending in the 1980s was a major factor in the recovery in the 1990s, two negative legacies were left behind. One is the deficit of public capital provision and the second is the failure to put in place effective mechanisms to control the evolution of current public spending. There have been attempts made over the past decade to introduce rules for public expenditure control in Ireland, but they have been largely unsuccessful. In 1994, the policy agreement underlying the formation of the coalition Government, *A Government of Renewal,* stated that the growth of current supply services spending would be constrained to a maximum of 6 per cent in nominal terms in 1995, and to an average annual rate of 2 per cent in real terms over the following two years of the Programme. When a new Government was formed in 1997, the Minister for Finance set a target of keeping growth in nominal net current spending

Figure 2: Net Growth Expenditure: Growth Performance V Growth Limit



to an annual average of 4 per cent over the life of the Government, and to reduce overall Government spending as a share of national output. The latter target was achieved due to the rapid growth in the economy, but spending growth was not contained. In Budget 2000, the Minister for Finance stated that adhering to the 4 per cent target in 2000 and in subsequent years would represent a considerable challenge, but that the Government was determined to meet it. Figure 2 shows that these explicit limits to expenditure growth have been observed more in the breach. However, this can be rationalised on the basis that economic growth consistently came in ahead of target, thereby rendering the targets inappropriate or overly conservative.

Arguably, these expenditure overshoots have in many cases been necessary and unavoidable. In Budget 2001, the Minister for Finance stated that the Government had decided that an increase in spending above the 4 per cent limit was justified in order to "make more rapid progress in key social spending areas, and to help secure industrial peace". *The Agreed Programme for Government between Fianna Fail and the Progressive Democrats* (2002) did not make any explicit promises on spending control, but instead committed the Government to adhering to the strictures of the Stability and Growth Pact. These strictures dictate that there is a sovereign commitment to keep the general government finances close to balance or in surplus over the economic cycle and to take corrective action where there is an actual or expected divergence from this goal.

Adhering to this commitment will not be easy over the next five years, when growth in tax revenues is likely to be more modest and pressures on spending intense. Over the coming years there will be numerous prior commitments on current and capital expenditure that will render control of spending very difficult. These include:

PUBLIC SECTOR PAY

Public sector pay has proved a very difficult issue to grapple with in the past and will become even more difficult going forward. Lane (1999) argues that it is notoriously difficult to pin down the appropriate growth rates for wages in the public sector, and significantly that public sector unions are sufficiently strong to exert considerable bargaining power in pay negotiations.

However, the public sector now has serious difficulty attracting and retaining quality staff, primarily because of the better pay and conditions that are perceived to be available in the private sector. This is a particular issue in the teaching and nursing professions, but is not confined to those two areas. The Benchmarking report currently under consideration is arguably a necessary step to move the public sector to a market related pay structure. This should help ensure that the public sector attracts people of the calibre necessary to deliver the level and quality of public services expected by the public. On the other hand, it is essential to take into account some of the conditions that public sector workers enjoy such as job security, lower levels of social insurance contribution and pension rights. Before committing to the recommendations of the benchmarking process, Government needs to ensure that the value for money concept is applied. In other words, some areas of the public sector need to increase productivity, offer an improved quality of service, and generally adopt work practices that apply in the private sector. Furthermore, if public sector workers attain private sector treatment, they should pay the same level of PRSI as private sector workers. In any consideration of benchmarking, there is obviously the reality that the state of the public finances may not allow its implementation without increasing taxes or diverting spending from other areas.

DEMOGRAPHIC CHANGES

Work by Alesina (2000) indicates that over the past three decades the component of government spending that has fuelled the growth of government in OECD countries has been transfers, rather than public consumption of goods and services. Within this component, pensions are identified as the key spending area that is most out of balance in an intertemporal sense, because of the ageing population and generous benefits. One of his conclusions is that pension reforms have to be critical ingredients of long-term fiscal stabilisation in many OECD countries. The IMF (2001) amongst others has also pointed out the pressures of ageing populations and rising dependency levels on pension, health, and other areas of public spending in the years ahead. Ireland's demographics are more favourable than other European countries, but the longer-term trend towards an ageing population is still an issue. While the elderly dependency ratio is expected to fall further in the near term, it is projected to rise from 20 per cent today, to 25 per cent by 2016 and to 50 per cent by 2050 (Budget 2001). Based on this analysis, it is estimated that the Exchequer cost of public service and social welfare pensions will rise from 4.7 per cent of GNP today, to 8.1 per cent by 2026 and 12.5 per cent by 2056. This represents a considerable future burden on the Exchequer finances, but the creation of the National Pensions Reserve Fund will go some way towards addressing the issue. Lane (1999) has also suggested raising the retirement age and the consideration of a defined contribution pension scheme for public sector workers. Politically, both of those suggestions would prove very difficult, but should nevertheless be given due consideration.

PUBLIC SERVICES

The issue of the quality of public services has become a very topical one, particularly in relation to education and health. All of the main political parties identified health as the key issue in the recent election, but there is a tendency to throw money at services rather than identifying what the real problems are. Duffy *et al.* (2001b) point out current government expenditure on the health services has more than doubled since 1996, but with little effect. Wiley (2001) has argued that an increase in health expenditure may not be the solution to the difficulties in the health system. Rather there are issues of efficiency, productivity and management. Two-thirds of health spending goes to pay, so there is clearly a need to focus on efficiency and productivity, and on the improvement of the service at minimum cost. In the area of education, class size has dominated much of the debate, but as Lane (1999) points out, highly skilled, highly motivated and well-paid teachers do much to reduce the impact of relatively high pupil-teacher ratios. As in all other areas of public service spending, careful analysis and targeting needs to be applied. For example, rather than spending money on education in general, it would be more beneficial to target it at specific areas, such as disadvantaged children or specific disciplines such as science. At a broad level, the users of public services will have to accept the fact that the quality of public services on offer may be constrained by the size of the tax base to fund those services.

NATIONAL DEVELOPMENT PLAN

After a decade of very strong growth, infrastructure, both human and physical, has come under serious strain and will inhibit future economic growth and development. The National Development Plan (NDP) 2000-2006 aims to remedy these shortcomings. It is intended to spend €51 billion over the period of the Plan with €43 billion to be funded by the Exchequer. There is a solid consensus that the delivery of the Plan is essential for the future well being of the economy. The obvious danger is that for short-term political imperatives funding might be diverted from capital to current areas. Back in 1987, capital spending was cut, regardless of whether the rate of return exceeded the cost of capital or not. Such indiscriminate cuts in capital spending should be avoided. The Irish economy has reached a stage in its economic development where further tax cuts and current expenditure increases should be placed second in order of priority, behind capital spending. However, very careful assessment of all capital spending is required, with rate of return and value for money key priorities, particularly given the short-term pressures on the public finances. Government should consider the option of diverting resources in the National Pension Reserve Fund away from investment in international equities into domestic capital projects that deliver a return, while at the same time enhancing the long-term growth potential of the Irish economy. This would be a prudent use of taxpayers' monies, while at the same time sensibly providing for a longer-term pension liability. Others have argued against this (for example Lane, 2000).

In the early 1990s, the EU created an evaluation culture and the Irish Government became responsible to Brussels for every penny spent. Under the NDP, that evaluation culture is in danger of slipping, as the EU is not as involved due to its relatively low level of funding provision and its increased focus on Central and Eastern European countries. Criteria for assessing capital and other forms of spending have been identified by the EU, the OECD and the IMF amongst others and should be rigorously applied to the NDP. There is now an obvious danger that inflation will seriously increase the delivery costs of the plan.

5. Controlling Expenditure

The foregoing analysis identifies just some of the areas from where future expenditure demands will emanate and it is clear that the potential demands are significant. The big question of course is the amount of resources that will be available to finance this expenditure. Alesina (2000) has pointed out that the critical political battleground in every country is how to divide the common pool of fiscal revenues and how to allocate the tax burden. Even in a period of strong fiscal surpluses this is very problematical, as Ireland has discovered over the past three years.

In the short term it is difficult for Government to exert much influence over tax revenues, these will be primarily determined by the strength of the economic cycle. Of course over a longer period it is possible to expand the tax base, but the political economy of such a course would be quite difficult. Hence, it would appear that the slightly easier option would be to target spending. However, applying strict ceilings to spending may not be the best approach, primarily because such ceilings are very difficult to enforce and as the foregoing analysis suggest, do not have a good track record. Rather than applying strict ceilings to growth in public expenditure, it is more meaningful to apply strict criteria to the assessment of all spending, current and capital. The IMF (1995) suggests that public expenditure policy is at the core of any successful effort to achieve efficient and equitable fiscal adjustment. However, it is critical of countries that have carried out across-the-board reductions in spending without regard to the relative importance, at the margin, of various expenditures. It is also critical of those countries that chose the politically easier path of reducing expenditures on operations, maintenance and capital projects, or fixed nominal wages. Cuts in capital spending often reduce longer-term growth prospects, while cuts in real wages in the public sector can reduce productivity. The goal should be to achieve fiscal adjustment in the most efficient and sustainable way possible, with due consideration given to maintaining essential public services, protecting growth prospects, and achieving an equitable distribution of income.

The public sector's role in an economy is to employ human and capital resources to produce public goods such as economic stabilisation, judicial services, national defence, protection of the poor and other essential services. These services are essential so it is not sufficient to focus exclusively on the level of public expenditure. The productivity of expenditure should be the most important criterion for spending control. Public sector productivity may be defined by comparing outputs produced or objectives achieved, with given expenditures. To be productive, public sector operations must be carried out at the lowest possible cost and the mix of public sector outputs should be optimal. This suggests the need for thorough and objective analysis and assessment of all spending proposals.

Atkinson and Van den Noord (2001) have outlined an analytical framework for assessing public expenditure. While recognising that expenditure outcomes reflect collective choices that emerge from the political process and vary across countries, they believe that economic analysis can provide help in achieving objectives in a cost-effective manner. They believe that public expenditure can be considered in three dimensions. Specifically these are the macro-economic consequences of a certain level of expenditure, the allocative efficiency of spending or in other words the outcomes achieved for a marginal unit of public expenditure, and the technical efficiency of all spending projects.

For Ireland, the implications are clear and revolve around the need to ensure that scarce resources are used in an effective way. Spending should be viewed in output as well as input terms, waste should be avoided and the efficiency of all spending should be maximised, recognising that increased spending will have to be funded through increased taxes, and this will have certain macro-economic consequences.

6. The Irish Context/ Recommendations

The Irish Government has made progress in embracing some of these principles and others, in the assessment of public expenditure, both current and capital. In the area of current expenditure, the Strategic Management Initiative (SMI) was set up in 1996 to make the Civil Service better and more efficient. According to the Department of Finance the main aim is to establish a clear link between the day-to-day work of civil servants and the impact of the work on society. Performance indicators have been agreed which are intended to act as the link, and a number of indicators have been identified to measure how efficiently and effectively services are provided and how they are impacting on society. Based on the resources that have been spent over the past five years and the apparent lack of any appreciable improvement in the quality of many services, this process clearly still has major shortcomings that will need to be addressed. The SMI is applied to Central Government, while other layers of government such as the health boards and the local authorities are not captured. This is a serious shortcoming in the process.

There is a strong consensus amongst most economists on the need to control public spending, but few worthwhile suggestions have been made on how to achieve this objective. Having an arbitrary rules-based approach to controlling public expenditure has not worked in Ireland, despite attempts by successive governments since 1994. A model for controlling expenditure based on some arbitrary limits on spending is unlikely to work going forward, unless coupled with transparency, accountability, a penalty mechanism and a legal backing. While the fiscal targets in the Maastricht Treaty had little theoretical basis, they were in theory backed up by the ultimate sanction of disqualification from EMU membership for non-compliance. This proved effective, unlike the announced targets employed in Ireland. An alternative, which could also be complementary, is to adopt stringent procedures for evaluating all spending in order to ensure the most efficient and productive use of scarce financial resources. A number of agencies, including the EU, the OECD, and the IMF have developed analytical frameworks for assessing all public spending and while the Irish authorities have adopted some best practices, there is clearly some distance to go.

Rather than controlling overall spending, it would be more effective to control individual spending programmes. At the level of overall spending, performance indicators are not meaningful, but at the spending programme level, performance and cost indicators are more easily identifiable. In relation to spending on services such as healthcare, it has been proven that increased expenditure does not necessarily result in better services. A root and branch examination of the entire health service is required before any extra resources are committed. For semi-state enterprises, firm commitments need to be given to change structures and work practices. Privatisation of all services that could be better provided by the private sector should be considered. At the local authority level there is no reason why services such as refuse collection should not be privatised. Of course, the social service element of public services will have to be provided by the state. Selling state assets is acceptable and indeed desirable if the service can be provided more efficiently by the private sector and most importantly if the proceeds are put to productive use, such as infrastructure. In all areas of public spending, value for Money has to be the defining characteristic. An independent Dail committee to evaluate all spending proposals, both current and capital, is one option that might be considered going forward. Any process must have the power and authority to enforce recommendations. It is clear from the report of the Comptroller and Auditor General that there has been much wasteful expenditure within the public sector in recent years, but it is not obvious that any corrective actions have followed these reports. A more focused approach to control and evaluation of public expenditure would benefit the Irish economy, raise the quality of life, and create a more dynamic, efficient and modern public sector.

7. Conclusions

In times of plenty, the control of public spending was not an issue. However, in the changed economic circumstances that Ireland has entered, the control of public spending has become essential. In the first six months of 2002 tax revenues were running 7 per cent below the same period a year earlier, while current spending was expanding at a rate of 21 per cent. In the context of the Stability and Growth Pact and for the future stability of the economy, these trends cannot continue. Growth in spending has to be brought under control or taxes will have to be raised to maintain fiscal balance. Apart from the economic arguments, there is limited political or popular support for higher taxes, so it appears that the burden of adjustment will have to fall primarily on the spending side.

Imposing strict ceilings on spending growth has not proved an effective approach in the past, but clearly growth in spending will have to be taken down to levels of not more than 8 per cent as quickly as possibly, given that tax revenues are unlikely to grow by any more than 8 per cent over the medium term. Once this has been achieved, all spending needs to be subjected to rigorous evaluation to ensure that value for money is attained. Output will have to be considered as well as inputs in all areas of expenditure. Delivery of the NDP is important, but it is wrong to conclude that all capital spending is good. Capital spending needs to be assessed in a stringent manner to ensure that it is not eroded by inflation and that only worthwhile projects are delivered. Where possible, there should be potential for gaining monetary returns from capital projects, through increased use of tolling. Government should consider the option of diverting resources in the National Pension Reserve Fund away from international equities into domestic capital projects that deliver a return, while at the same time enhancing the long-term growth potential of the Irish economy. This would be a prudent use of taxpayers' monies, while at the same time sensibly providing for a longer-term pension liability.

Fiscal management will provide the new government with a key challenge over the life of the Government. In an environment of scarcer resources increased emphasis will have to be placed on the quality of spending rather than the quantity, while at the same time taking account of the fiscal obligations inherent in Ireland's European obligations.

The fiscal situation now facing Ireland is at least as great as that faced in 1986 and if the correct decisions are not taken quickly, the consequences could be very damaging for the long-term health of the economy.

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