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FISCAL POLICY FOR A SLOWING ECONOMY

*Philip R. Lane**

1. Introduction

The aim of this paper is to consider the implications for fiscal policy of a deceleration in output growth. This is an important topic, since membership of EMU means that fiscal policy is the now main policy instrument for macroeconomic stabilisation. It is relevant, since there are several warning signals that suggest that the probability of an economic slowdown has increased. Although there are elements that are common to other member countries of EMU, Ireland is a special case in many ways in view of its outlier status in terms of extraordinarily rapid growth over the last decade. Moreover, output growth has been outpaced by tax revenues and major public expenditure items, such that the potential scale of adjustment in fiscal policy is non-trivial.

The major contribution of this paper is to focus attention on two key dimensions of fiscal policy. First, we emphasise that the appropriate direction for fiscal policy in the event of an output slowdown turns on an accurate decomposition of the dynamics of output and fiscal positions between trend and cyclical components. Second, especially in the context of EMU, we argue that the appropriate fiscal stance requires a disaggregation of cyclical output deviations between 'demand' and 'supply' shocks. In particular, we highlight that the restoration of competitiveness in the event of a negative supply shock may require a reduction in the absorption of labour by the public sector.

The structure of the rest of the paper is as follows. In Section 2, we briefly review the evolution of Irish fiscal policy in recent years. Section 3 describes the economic factors that suggest Ireland is entering into a new phase of lower output growth. In Section 4, we turn to the analysis of optimal fiscal policy for a slowing economy. Finally, some conclusions are offered in Section 5.

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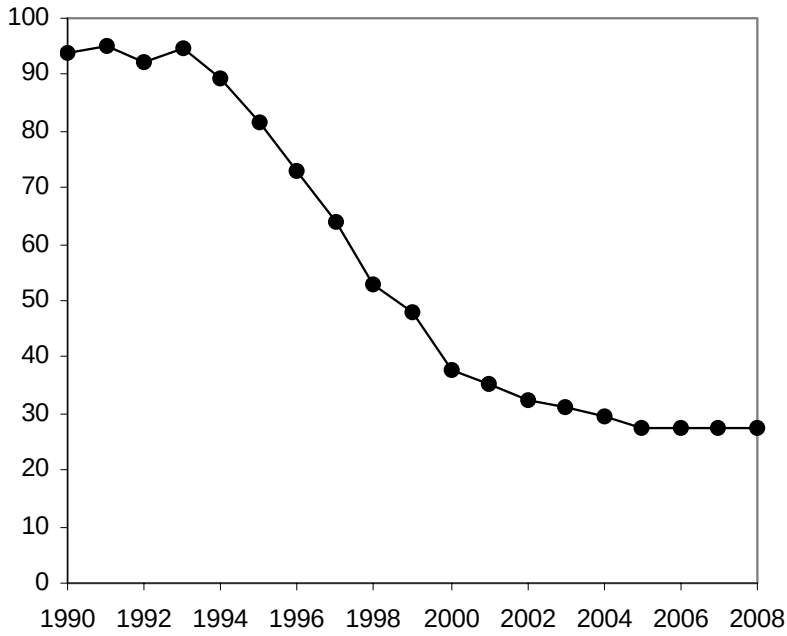
2. The Dynamics of the Irish Fiscal Position

At one level, the health of the Irish public finances is extremely impressive. Most obviously, Figure 1 shows that the level of gross public debt has trended downwards over the last 15 years and now lies below 30 per cent of GDP.[1] Indeed, the pace of output growth and the EMU-induced decline in interest rates allowed debt reduction to continue even in the face of the remarkable reversal in the primary fiscal balance during 2000-2001 (Figure 2). Since 2002, the primary balance has been fairly stable at a shade under 1 per cent of GDP.

Figure 1: Gross Government Debt as a Ratio to GDP

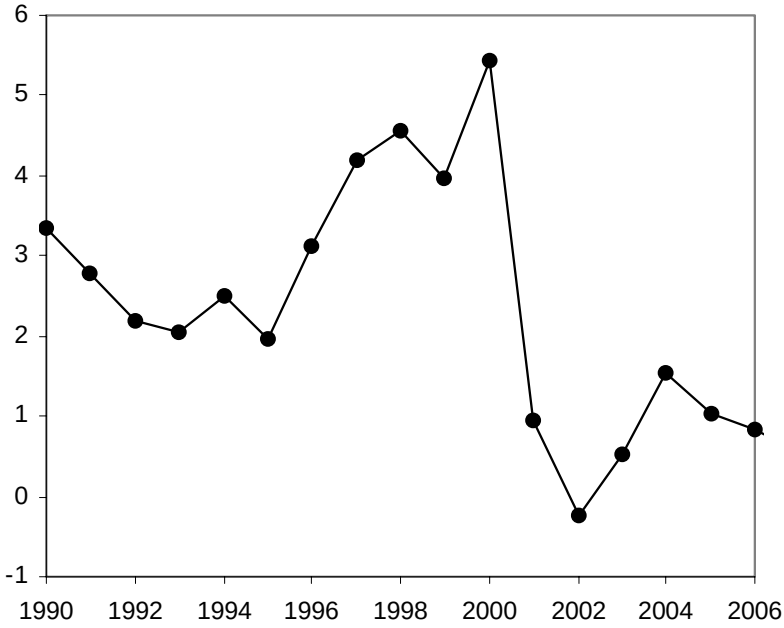


Source: AMECO.

However, the stable primary balance masks a trend increase in the scale of government spending. Figure 3 shows that total government spending has increased by more than 2 percentage points of GDP since its trough in 2000, while Figures 4 and 5 show that wage government consumption and public transfers have increased by 20 per cent and 16 per cent respectively since 2000 (measured as a ratio to GDP). Public investment has also expanded, albeit at a slower pace in the most recent years (Figure 6).

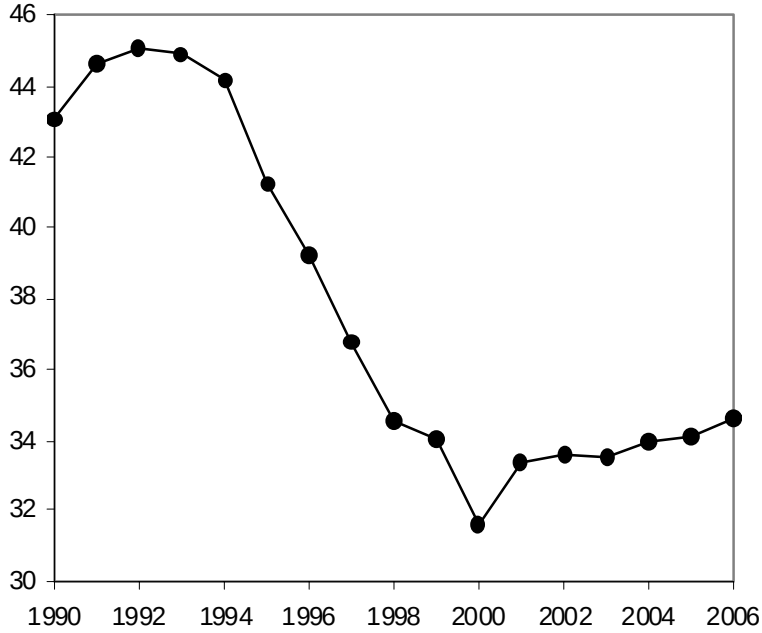
[1]A net measure of public financial liabilities would be even lower, in view of the substantial assets accumulated by the National Pensions Reserve Fund that stood at about 13.5 per cent of GDP at end May 2007. Taken together with the assets in the Social Insurance Fund, the ESRI calculates net public financial liabilities to stand at 12.8 per cent of GDP in 2006 and projected to fall to 7.3 per cent of GDP by 2008. This calculation does not take into account implicit liabilities, such as pensions.

Figure 2: Primary Balance as Ratio to GDP



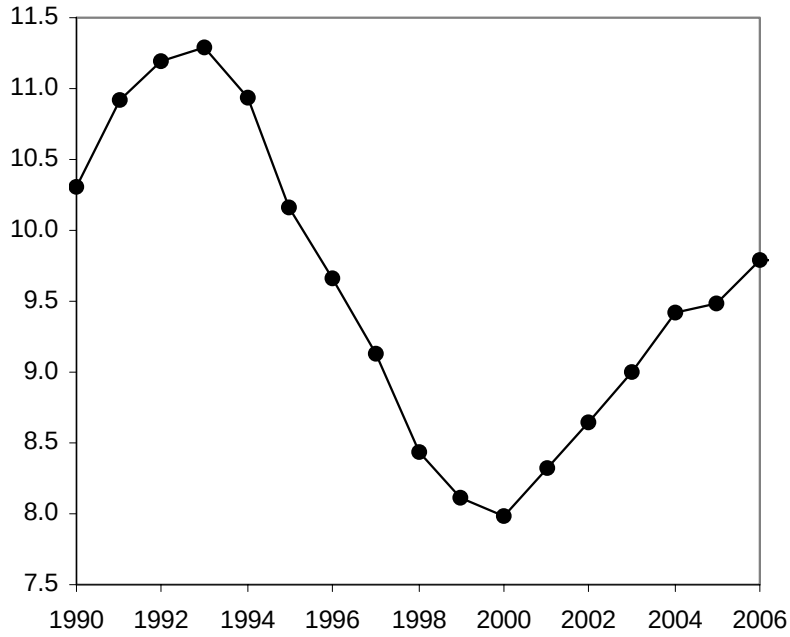
Source: OECD.

Figure 3: Ratio of Government Disbursements to GDP



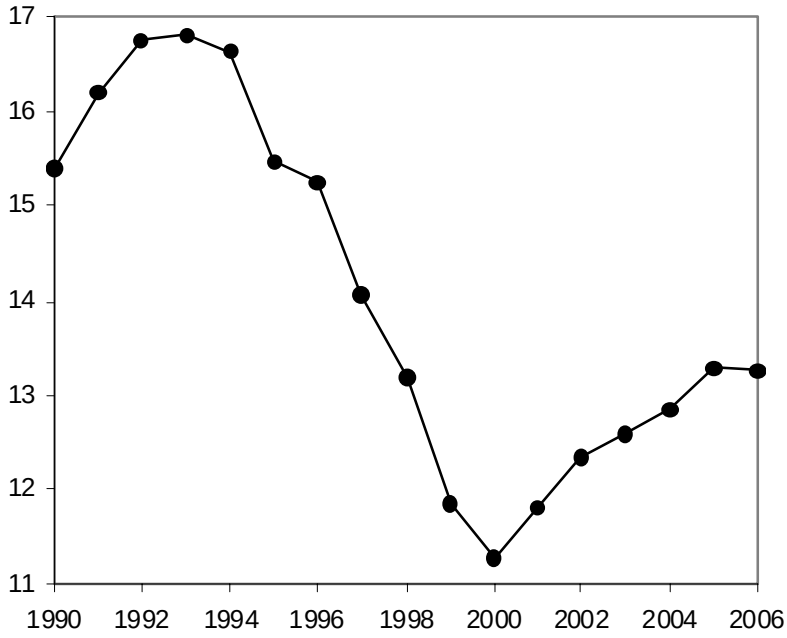
Source: OECD.

Figure 4: Ratio of Wage Government Consumption to GDP



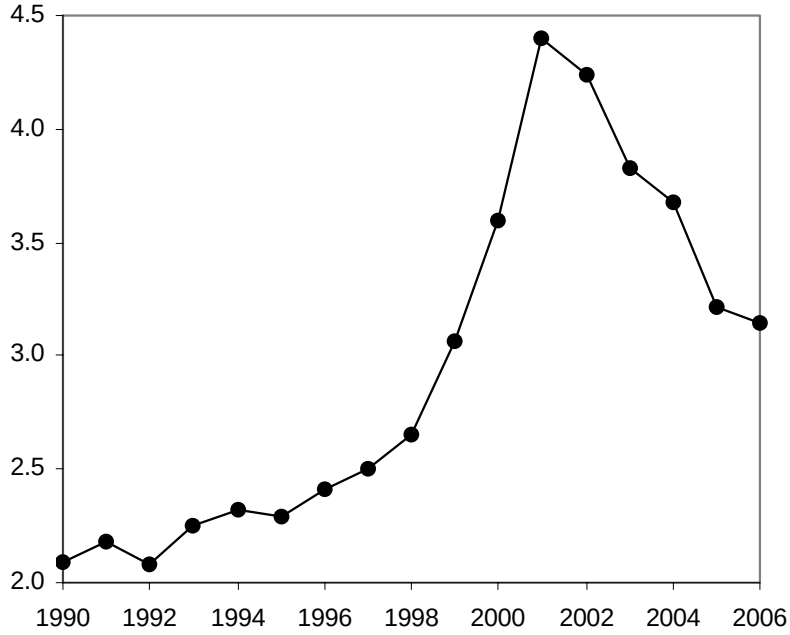
Source: OECD.

Figure 5: Ratio of Government Transfers to GDP



Source: OECD.

Figure 6: Ratio of Government Investment to GDP



Source: OECD.

Table 1 shows the annual rate of nominal growth in public spending over 1998-2006. Taking the most recent years (2003-2006), total government spending has grown markedly faster than nominal GDP – the biggest deviation is in the public sector wage bill, which has been growing 50 per cent more quickly than GDP. On the other side, public investment has not grown in nominal terms over this period, in part a response to the high pace of growth during the 1998-2002 period and in part reflecting various logistical and planning constraints in the public investment process.

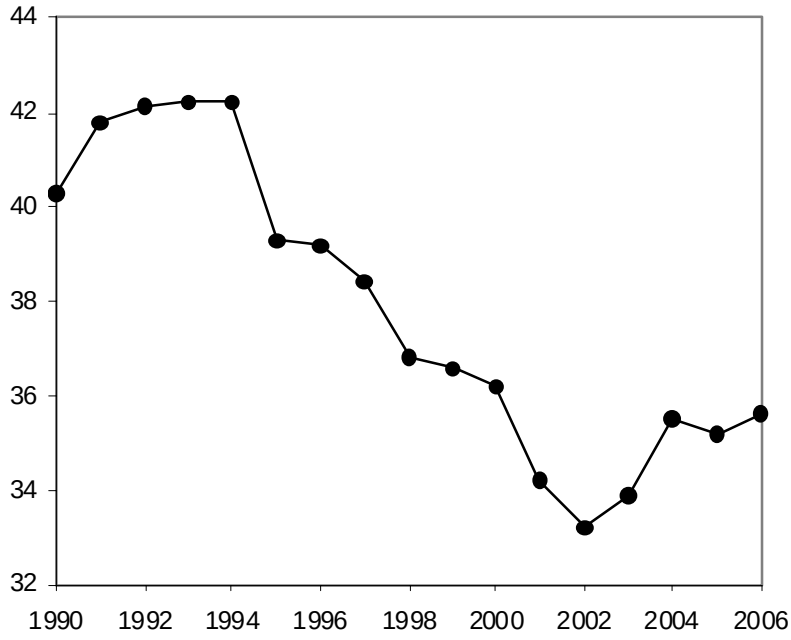
Table 1: Nominal Growth in Public Expenditure

	GDP	Total	Public Pay	Social Transfers	Investment
1998	16.3	9.3	7.4	8.0	23.5
1999	15.1	13.5	10.8	0.6	32.8
2000	15.4	7.1	13.5	10.6	35.4
2001	11.7	18.1	16.5	16.4	36.6
2002	11.3	11.8	15.6	16.2	7.2
2003	6.9	6.8	11.2	9.6	-3.3
2004	6.3	7.7	11.3	7.6	2.1
2005	9.2	9.7	9.9	14.6	-4.5
2006	8.0	9.6	11.4	8.0	5.5

Source: OECD.

The increase in public spending has been accompanied by a sizeable increase in the scale of government revenues, which have increased from a low of 33.2 per cent of GDP in 2002 to 35.6 per cent of GDP in 2006 (Figure 7). Table 2 shows the annual growth in nominal tax revenues. Taking the 2003-2006 period, indirect taxes, income taxes and corporation taxes have all grown at rates that are roughly in line with nominal GDP growth. However, total tax revenue has grown 50 per cent more quickly than GDP: this has been made possible by the extraordinary buoyancy in capital gains taxes and stamp duties: the former has grown by 344 per cent since 2002, while the latter has grown by 218.6 per cent.

Figure 7: Government Receipts as a Ratio to GDP



Source: OECD.

Table 2: Nominal Growth in Government Revenue

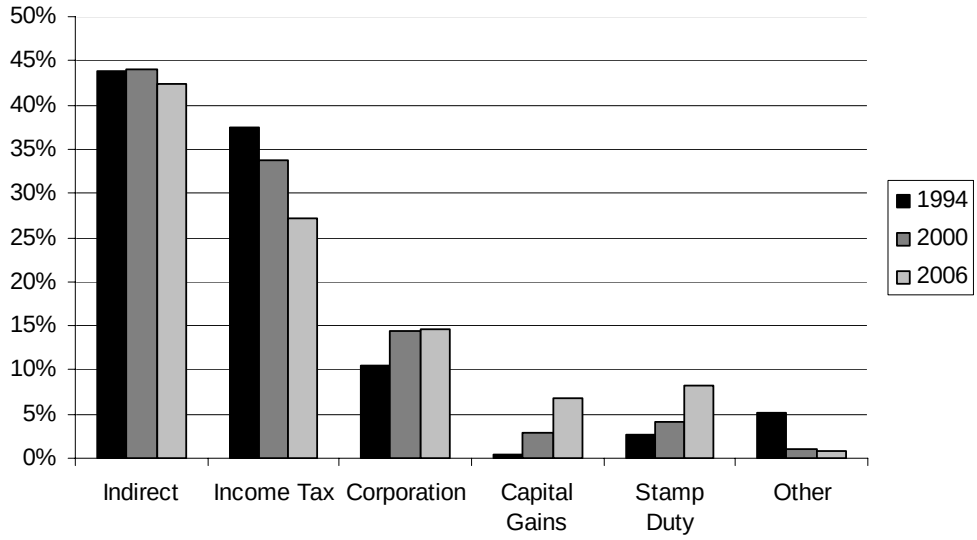
	GDP	Total Tax	Indirect	Income	Corp.	Capital Gains	Stamp Duty
1998	16.3	13.0	13.5	9.9	21.6	37.0	26.0
1999	15.1	15.1	13.5	10.2	31.2	67.1	33.1
2000	15.4	14.9	11.9	13.5	13.0	54.4	21.2
2001	11.7	3.2	0.2	2.6	6.9	5.4	10.8
2002	11.3	4.9	10.9	-3.0	15.6	-25.9	-4.9
2003	6.9	9.6	6.2	1.1	7.5	113.1	44.7
2004	6.3	10.8	8.9	16.2	3.3	2.9	23.7
2005	9.2	10.3	9.8	5.8	3.0	29.5	30.5
2006	8.0	16.0	9.2	10.0	21.7	56.3	36.4

Source: Department of Finance.

As is shown in Figure 8, the differential growth rates across categories has led to a remarkable shift in the composition of tax revenues in recent years. In particular, the share of income taxes in total tax revenue has declined from 37 per cent to 27 per cent over 1994-2006, with the slack being taken up by a 4 percentage point increase in corporation tax, a 7 percentage point increase in capital gains tax and a 5 percentage point increase in stamp duty.

Taken together, the rapid growth in tax revenues and major expenditure items in recent years has provided an extraordinarily favourable environment for the public sector and policymakers. Accordingly, the transition to a period of more modest growth may pose transition problems. That said, an important achievement is that the attainment of a low level of public debt provides a solid anchor in terms of fiscal sustainability. We return to these issues in Section 4.

Figure 8: Structure of Tax Revenues



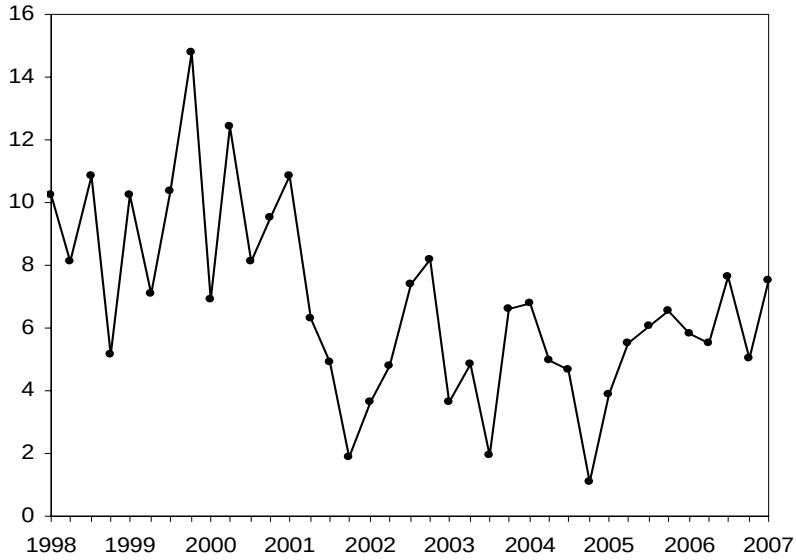
Source: Department of Finance.

3. Signs of a Slowdown

There are clear signs that the economy is decelerating, albeit from a very high rate of aggregate output growth to a level that is still very respectable by European standards. Indeed, Figure 9 plots the Irish growth experience over 1998.1-2007.1: there are two clear phases with a breakneck rate of output growth averaging 9.5 per cent during 1998.1 to 2000.4 and a more measured rate of expansion averaging 5.3 per cent over 2001.1 to 2007.1. However, there is a widespread consensus that the Irish economy is entering a new phase: for instance, the ESRI's Summer 2007 *Quarterly Economic Commentary* projects that GDP growth will decline to 4.9 per cent in 2007 and 3.7 per cent in 2008, with gross national income (adjusted for shifts

in the terms of trade) growing at 4.2 per cent and 3.3 per cent in these years.

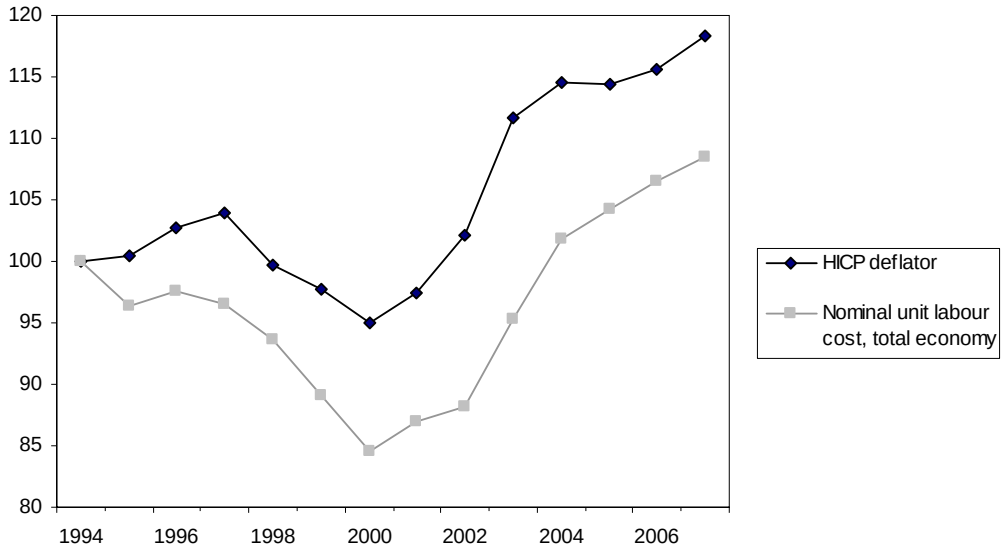
Figure 9: GDP Growth, 1998.1 to 2007.1



Source: Central Statistics Office.

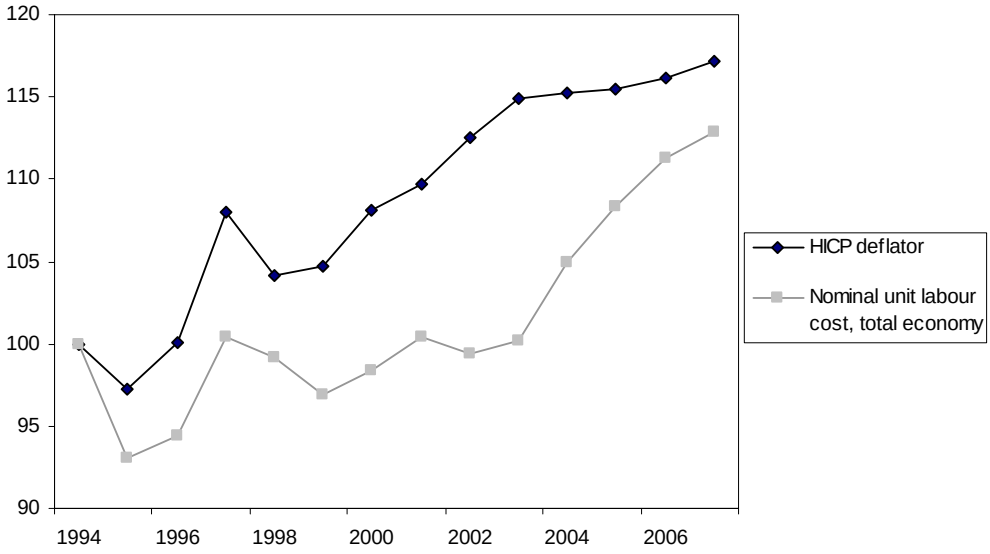
Even beyond these near-term forecasts, there are two primary factors that suggest that Ireland is entering a phase of moderate growth, bundled with a non-trivial degree of downside risk. First, there has been a substantial decline in competitiveness in recent years, as measured by relative price or wage levels. Figure 10 shows that Ireland's real exchange rate vis-à-vis its major trading partners has appreciated by 22 per cent since 2000 if measured in terms of relative consumer price levels and 25 per cent if measured in terms of relative nominal unit labour costs. Although the appreciation of the euro against the dollar has had much to do with loss of competitiveness, there has also been significant real appreciation against the other member countries of the euro area. Figure 11 shows that the consumption-based real exchange rate has increased by 8 per cent since 2000, while the unit labour cost relative index has grown by 14 per cent against this group of countries. The loss of competitiveness is also visible in the trade data. Figure 12 plots Ireland's share in global exports, in addition to key export destinations (EU14, United Kingdom and the United States). There is a clear pattern in the data, with the export share going into decline since 2002/2003.

Figure 10: Evolution of Broad Real Exchange Rate Indices



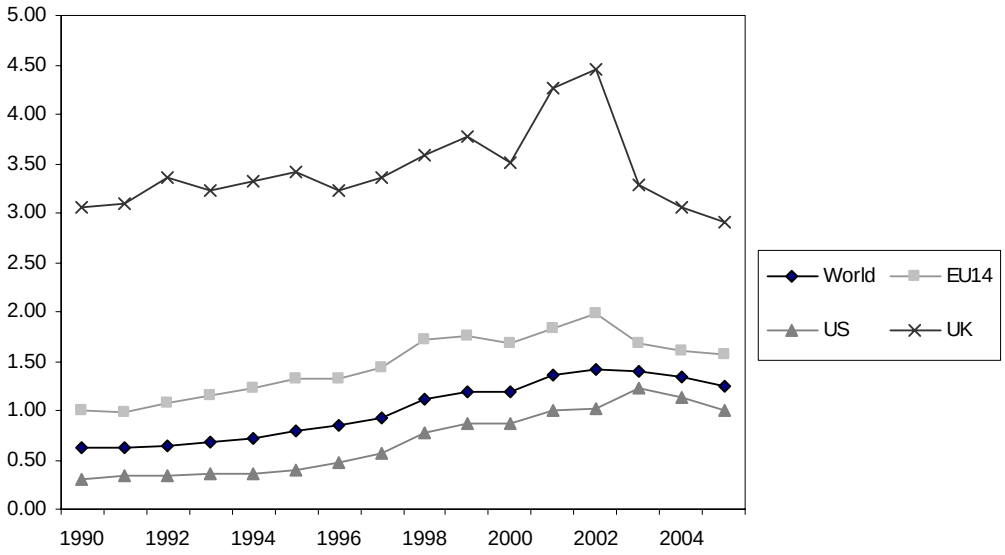
Source: European Commission.

Figure 11: Evolution of Narrow Real Exchange Rate Indices



Source: European Commission.

Figure 12: Ireland's Share in International Exports

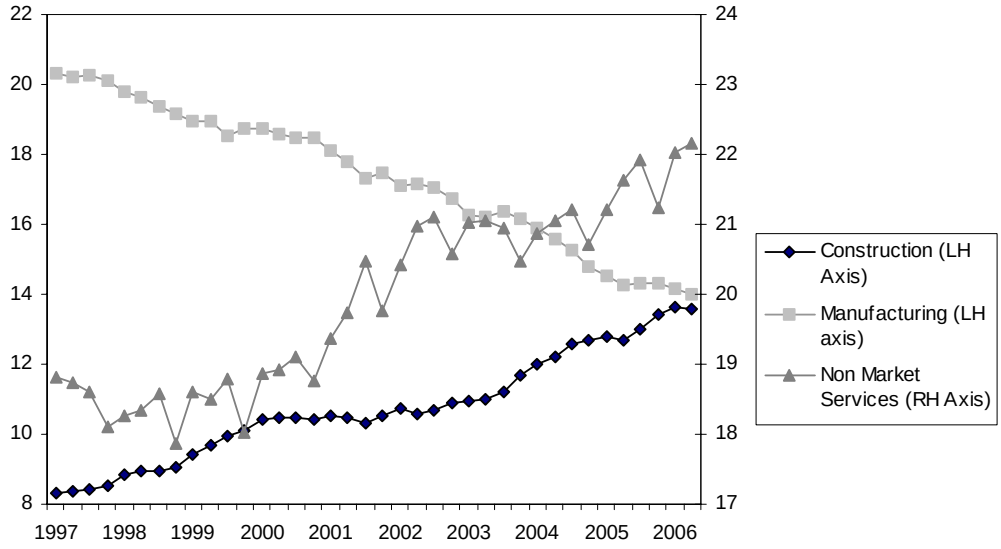


Source: Direction of Trade Statistics (IMF).

Second, as is illustrated in Figure 13, there has been a marked shift in the distribution of domestic economic activity since 2000. While total employment grew by 21.2 per cent over 2000.4-2007.1, this masks a reduction in manufacturing employment of 9.4 per cent and the very rapid expansion in employment in the non-market services sector (42.2 per cent growth) and the construction sector (58.4 per cent).[2] While the growth in the non-market services sector and part of the growth in the construction sector can be tied to the significant increase in government spending during this period, the construction boom has also been financed by a private-sector credit boom. Figure 14 shows that credit to the household sector more than doubled relative to the size of the economy over 2002.1-2007.1, rising from 35.5 per cent of GDP to 78.3 per cent of GDP. The growth in credit extended to the property sector was even more spectacular, growing from 11 per cent of GDP to 51.5 per cent of GDP over this period. As noted by Honohan (2006) and shown in Figure 15, the credit boom in recent years has been externally financed to a large extent, with the scale of external indebtedness of the domestic banking sector expanding rapidly. More generally, Figure 16 shows that the current account deficit has trended downwards in recent years.

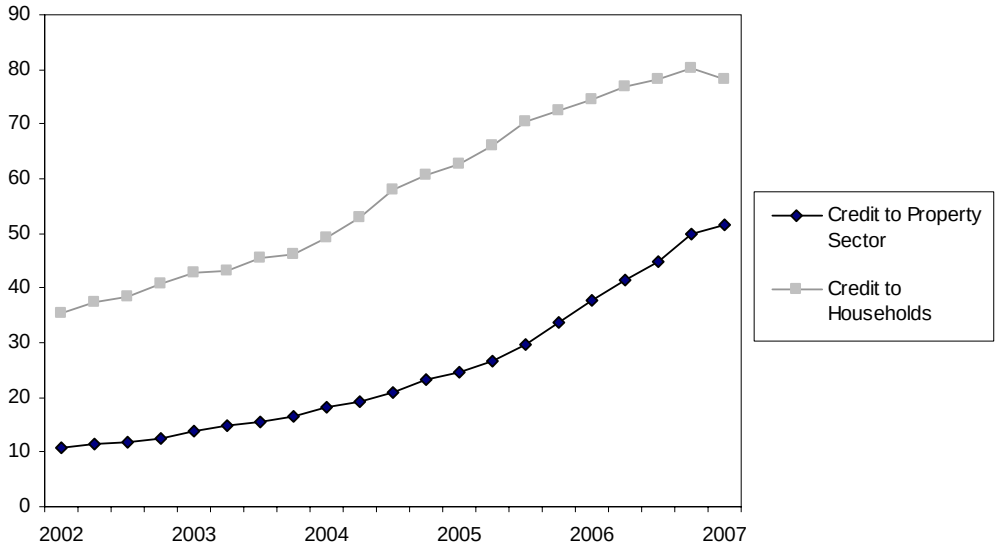
[2]Employment in the market services sector grew by 21.0 per cent during this period. The non-market services sector comprises public administration and defence, education and health.

Figure 13: Sectoral Employment Shares



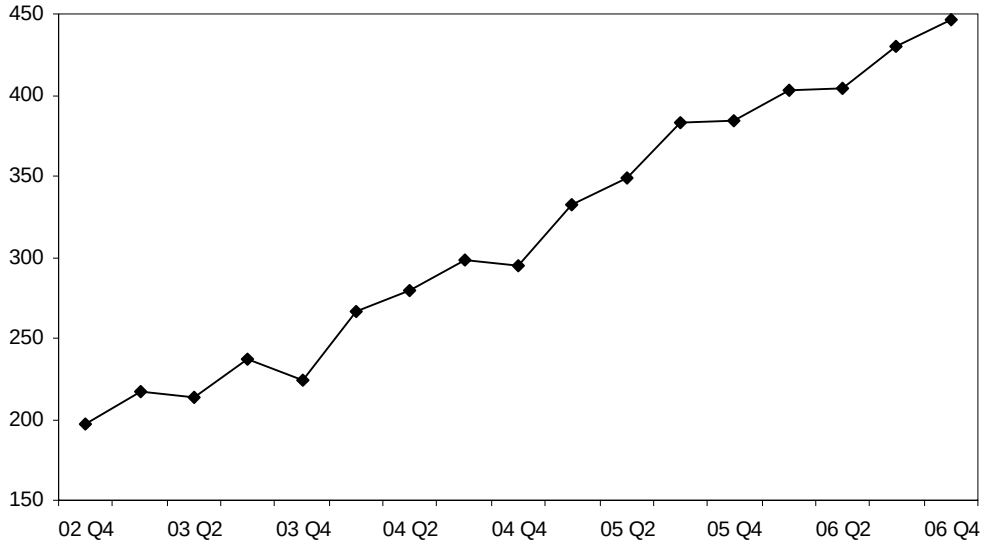
Source: *Quarterly National Household Survey*.

Figure 14: Credit as a Ratio to GDP. Credit to Property Sector Defined as Sum of Credit to Construction and Real Estate Sectors



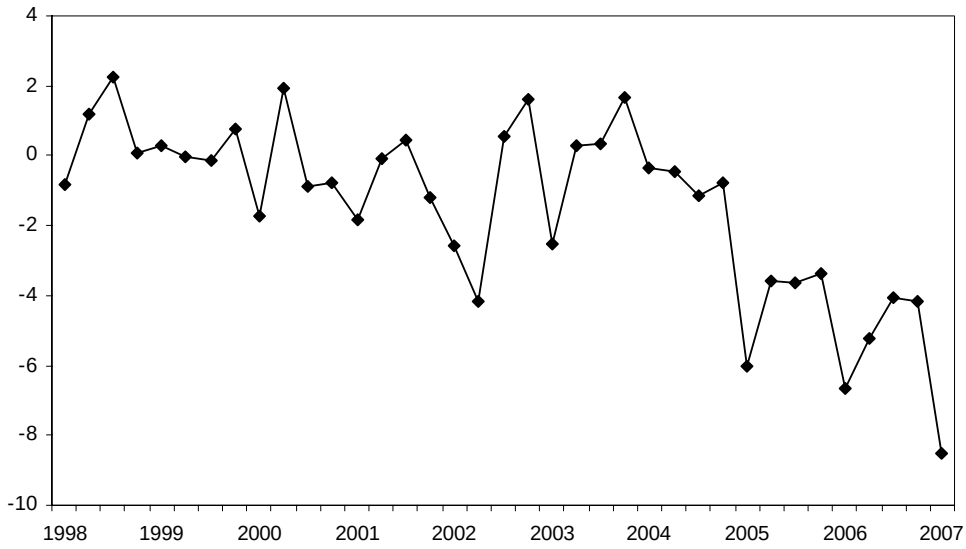
Source: Central Bank and Financial Services Authority of Ireland.

Figure 15: External Debt of Monetary and Financial Institutions (Ratio to GDP)



Source: Central Statistics Office.

Figure 16: Current Account Balance as a Ratio to GDP



Source: Central Statistics Office.

Taken together, the deterioration in external competitiveness and the shift in the composition of domestic economic activity suggest that Ireland faces a period of slower economic growth over the medium term. In part, this can be related to the slower rate of productivity growth that is attainable in the services and construction sectors. In addition, inventory-intensive sectors such as construction are naturally prone to cyclical fluctuations in the level of activity. Real appreciation and the prospect of slower relative wage growth should also act to reduce the rate of immigration, constraining labour supply. Indeed, Honohan and Leddin (2006) show important interaction effects between the housing sector and immigration that lead to an amplification of the output cycle.

Beyond the central projection of lower trend growth, this economic configuration also carries downside risks. For instance, while the world economy has been growing rapidly in recent years, a reversal in global economic conditions would pose special difficulties for countries with over-valued real exchange rates. For Ireland, this is compounded by the risk that the origin of such a reversal could be an unwinding of the US current account deficit and further dollar depreciation. Moreover, the growth in the level of indebtedness has increased exposure to shifts in global financial conditions.

This economic profile poses important challenges for the management of fiscal policy, which we address in the next section.

4. Optimal Fiscal Policy in a Decelerating Economy

The most direct fiscal impact of a decline in the rate of output growth is a downward revision in the path for tax revenues. The precise impact will depend on the source of the output slowdown. For instance, Girouard and Andre (2005) report estimated tax elasticities for Ireland of 1.44 for income taxes, 1.3 for corporation tax, 1.0 for indirect taxes and 0.88 for social security contributions. Taken together with an expenditure elasticity of -0.11 (reflecting increased unemployment claims), this generates a budget balance semi-elasticity of 0.38: a 3 percentage point slowdown in output growth is associated with an approximate 1.0 percentage point decline in the budget balance as a ratio to GDP.

Beyond the mechanical operation of these automatic stabilisers, the implications of an output slowdown for fiscal policy involves several analytical issues. As a starting point, a key principle is that the optimal fiscal policy for a decelerating economy turns on differentiating between trend and cyclical components in both output and the public finances, together with an appropriate evaluation of initial conditions. Although it is notoriously difficult to cleanly distinguish between the permanent and transitory components of output (especially for small open economies with elastic supplies of capital and labour), it is likely that both factors are operative in the current Irish situation. First, the strong rate of output growth in recent years exceeds plausible estimates of the trend level of output growth for the Irish economy, such that some element of deceleration is required to put Ireland on its trend growth

path. Second, the adjustment process may also involve a period of below-trend growth in order to restore lost competitiveness and re-balance the composition of economic activity.

A baseline neoclassical model would predict that the desired levels of current government spending and public investment should approximately grow in line with trend output growth over the medium-term.[3,4] For most expenditure items, this suggests that annual inflation-adjusted growth in public spending should be restricted to the projected rate of trend output growth. If output growth falls below trend, this implies a temporary increase in the ratio of public spending to GDP that will be eliminated with reversion to the trend path. This counter-cyclical pattern in public spending is re-inforced in the case of some expenditure items that have a natural counter-cyclical pattern (most obviously, unemployment claims).

On the taxation side, the trend path for government revenue should approximately match the trend path for public spending.[5] Since the long-run output elasticity of aggregate tax revenues is approximately unity, this can be achieved by maintaining a constant set of tax rates that is set at the level that matches the trend ratio of government spending to GDP.[6] Taken in combination with a counter-cyclical path for the ratio of public spending to GDP, this delivers a pro-cyclical pattern for the ratio of the budget surplus to GDP.

These fiscal principles are subject to two important modifications. First, if the existing levels of public spending and taxation are off the trend path, the transition to the trend needs to be managed. Second, there may be circumstances under which it makes sense to temporarily push fiscal variables away from trend values in order to facilitate adjustment to certain types of economic shocks.

In relation to initial conditions, the prolonged period of under-investment during the 1980s and early 1990s means that the level of public capital in Ireland is below its equilibrium level. Accordingly, it is appropriate for public investment to grow more rapidly than its trend path for a sustained period in order to close the gap between the existing and equilibrium levels of public capital, although the optimal convergence rate is subject to 'time to plan' and 'time to build' constraints and may also be conditioned on the cyclical state of the economy. Moreover, since the convergence phase is of

[3]Hunt (2007) shows that the long-term equilibrium relation between public and private capital stocks may not be one-to-one, with the equilibrium level of public capital possibly growing at a slower rate than private capital.

[4]Of course, the trend output growth rate is itself a function of fiscal policy. All else equal, higher tax rates on elastically-supplied factors of production will be associated with lower trend growth. In relation to public spending, inadequate public infrastructure will also constrain trend output growth.

[5]If the trend growth rate exceeds the trend interest rate on public debt, a modest primary deficit is consistent with a constant debt-output ratio.

[6]See the Report of the Tax Forecasting Methodology Group.

limited duration, it may be efficiently financed through debt rather than through a taxation surge.[7]

With respect to current expenditure items, the appropriate trend path is determined by socio-political priorities, taking into account the trade-off between the level of the tax burden and the rate of trend growth. One candidate's interpretation of the recent fiscal experience is that the high rate of current spending growth in recent years reflects a reversion to a long-term trend ratio of current spending to GDP. By this account, the extraordinary rate of output growth and the sharp reduction in debt interest payments in the late 1990s saw current spending plummet as a ratio to GDP and the subsequent acceleration in current spending just reflects a catch-up phase. To the extent that this transition is complete, this suggests that current spending growth should be restricted to the estimated rate of trend output growth. However, to the extent that the target ratio has not yet been attained, a faster pace of current spending for a temporary period is consistent with optimally-designed fiscal policy. However, if the trend ratio of current spending to GDP exceeds the current level, this suggests that the tax burden also needs to increase as a share of GDP over the medium term.

An alternative view is that the high rate of current spending growth in recent years reflects some combination of trend optimism (that the observed high output growth rates might persist indefinitely) and pro-cyclical fiscal exuberance. Pro-cyclicality in discretionary components of fiscal policy is a widespread phenomenon (Lane 2003). This tendency can be explained by a range of political-economy models (Tornell and Lane, 1999; Talvi and Vegh, 2005; Alesina and Tabellini, 2006). For instance, one hypothesis is that voters distrust the capacity of the government to efficiently absorb large surpluses during upturns and prefer some combination of increased public expenditure and tax cuts; another is that lobbying pressures from powerful interest groups induce an inefficient loosening of the fiscal stance.[8] As is emphasised by Lane (2003) and Talvi and Vegh (2005), such pressures are likely to be more intense in economies characterised by volatile output patterns, since the potential scale of cyclical surpluses is substantially larger for this group. As a highly open economy with elastic supplies of labour and capital, Ireland naturally fits into this category since the potential range of variation for both trend growth and cyclical shocks is quite wide.

A pro-cyclical impetus in public expenditure may also have been reinforced by the very strong growth in tax revenues in recent years. Of course, the tax buoyancy largely reflects high output growth. However, it is plausible some additional temporary factors were also at work that propelled tax revenues to grow at an even faster rate. In

[7]However, if the level of taxation is trending upwards (for example due to the expenditure implications of an ageing population), the appropriate scale of borrowing is circumscribed.

[8]An additional factor is that the capacity of the government to withstand lobbying pressure may systematically vary with the electoral cycle.

particular, as was shown in Table 2 and Figure 8, it is clear that the growth in stamp duties and capital gains taxes in recent years has been at atypically high levels. This revenue windfall is clearly connected to the high level of transactions in the housing market, rising property prices and enhanced equity valuations in the corporate sector.

More generally, the importance of asset prices for tax revenues is increasingly evident across the group of advanced economies, both via direct taxes on wealth or capital gains but also through the impact of asset prices on consumption and other activity variables. For instance, Morris and Schuknecht (2007) estimate the impact of asset prices on tax revenues for a wide group of advanced economies. For Ireland, these authors find that a real estate price index and an equity price index have significant additional explanatory power for the path of tax revenues. In particular, taxes on financial and capital transactions are estimated to be sensitive to both the real estate price index and the equity price index, with significant short-run elasticities of 0.41 and 1.13 respectively.

In addition, asset price movements also affect the other tax categories: for instance, the short-run elasticity of corporation tax to the real estate price index is estimated at 0.62 and the long-run elasticity in respect of the equity price index is estimated at 1.19. In addition, the short-run elasticity of direct taxes on households to the equity price index is significantly estimated at 0.17, while the short-run elasticity of indirect taxes to the property price index is also significant at 0.19. Accordingly, a sustained revision in the path for wealth, asset prices and the volume of capital transactions may be expected to affect tax revenues across all categories. Moreover, to the extent that the adjustment process for these variables involves an overshooting phase of below-trend growth, this may involve a short-run plunge in tax revenues before reversion to the trend path.

In relation to the tactical deployment of discretionary fiscal interventions for stabilisation purposes, this debate has several dimensions. First, membership of the European Monetary Union means that Ireland no longer has the option to manage country-specific shocks through an independent monetary policy or manipulation of the nominal exchange rate. For this reason, interest in the potential stabilisation role of fiscal policy has been re-awakened, especially since fiscal policy may be expected to be more powerful in a currency union than under a floating exchange rate (Lane and Perotti, 2003). Second, the major reduction in public debt over the last 15 years means that a prohibitive complicating factor has been removed: in the presence of high public debt, even a temporary fiscal expansion may be counter-productive by raising fears about debt sustainability (Favero and Giavazzi, 2007). With the attainment of a low level of public debt, such fears are no longer present, such that a fiscal intervention may be more effective as a stabilisation tool.

Third, in terms of selecting the appropriate form of fiscal intervention, it is important to correctly identify the source of the deviation of output from its trend path. In the case of negative

demand shocks – such as a recession in destination export markets – a temporary reduction in expenditure taxes or a shift in the timing of public spending may in principle play a helpful role. In contrast, if output is below trend due to a supply shock – such as a loss of competitiveness – then the fiscal prescription is quite different. In relation to public spending, there is evidence that a reduction in wage government consumption can relieve labour cost pressures in the private sector, stimulating competitiveness (Lane and Perotti, 2003, International Monetary Fund, 2006). Accordingly, it may be useful to temporarily restrict the growth of wage government consumption to below its trend path in order to facilitate a re-balancing of the economy towards the export sector. In contrast, to the extent that public capital formation is directed at productivity-enhancing projects, the restoration of competitiveness may be facilitated with a level of public investment that may even temporarily rise above its trend path.

With respect to the tactical use of tax instruments in the event of a supply shock, it is clear that a counter-cyclical pattern in tax rates is destabilising, since hiking tax rates during a downturn may amplify the output contraction and a temporary decline in taxes during a boom merely adds to overheating pressures. Indeed, this is the basis for the well-known tax-smoothing hypothesis that, for a given path of government spending, tax rates should be held constant over the business cycle (Barro, 1979). However, given the lack of alternative instruments, there is growing interest in the design of pro-cyclical tax rates. For instance, the European Economic Advisory Group (2007) endorses the use of *internal devaluations* by which the labour costs facing firms are reduced via a reduction in the tax wedge between take-home pay and the total cost of employment. In addition to a reduction in labour taxes, additional measures might also include a cut in corporation taxes. These may be especially effective in a highly-open economy with internationally-mobile capital and labour.

Of course, this general strategy was successfully implemented in Ireland during the 1990s, with major reductions in marginal tax rates an important ingredient in shifting Ireland onto a high-growth trend path. The key difference is that the temporary deployment of such fiscal instruments at the cyclical frequency is consistent with a range of trend paths for aggregate taxation and output growth: if the socio-political equilibrium involves a higher average tax burden, the competitiveness boost provided by an internal devaluation can be reversed once the economy has returned to its trend path.

However, there are several difficulties in implementing such tactical fiscal interventions. First, lags in the formulation and implementation of fiscal policy mean that a fiscal intervention may turn out to be ill-timed – the economy may have already entered an autonomous recovery before the 'rescue package' takes hold. For this reason, it is likely that such discretionary interventions are likely to be useful only in the event of supply shocks that are sufficiently large and persistent in nature. Second, the dynamics of the political system may induce an element of hysteresis in taxation and spending

levels – a temporary policy may prove difficult to reverse.[9] This has led to calls to delegate the cyclical element of fiscal intervention to technocrats, by the same logic that delegates monetary policy to an independent central bank.[10] Third, the empirical literature does not provide a clear guide as to the quantitative effectiveness of fiscal instruments (Perotti, 2007). This confers considerable uncertainty as to the success of any candidate intervention.

Going beyond direct budgetary instruments, the government has several additional options in restoring competitiveness and mitigating the employment impact of an economic slowdown. Along one dimension, productivity would be improved and business input costs reduced by tackling monopoly rents in non-manufacturing sectors through pro-competition policies. Since Table 3, shows that Ireland is ranked second only to Greece in terms of regulatory barriers in these sectors, there is considerable scope for pro-market reforms. In related fashion, a useful step in restoring competitiveness is the improvement of productivity in public sector activities, which would relieve the pressure on the labour market from the public sector. In this regard, the implementation of the recommendations from the in-progress *OECD Review of the Irish Public Sector* is a major priority.

Table 3: Barriers in Services Sector

Country	REG
Greece	4.1
Ireland	3.2
France	3.0
Switzerland	2.8
Portugal	2.6
Italy	2.6
Austria	2.4
Finland	2.4
Norway	2.3
Japan	2.2
Belgium	2.1
New Zealand	2.1
Spain	2.0
Sweden	1.9
Canada	1.9
Germany	1.7
Denmark	1.6
Netherlands	1.6
Australia	1.5
United States	1.4
United Kingdom	1.0

5 point scale. *Source*: Conway and Nicoletti (2006).

[9]Hercowitz and Strawczynski (2004) provide empirical evidence on the importance of fiscal ratcheting.
[10]See Lane (2006) for a discussion of this literature in the context of EMU.

An additional extra-budgetary policy challenge relates to the rapid growth in the minimum wage in recent years. Table 4 shows that Ireland has a high minimum wage relative to other advanced economies.[11] While Table 4 also shows that 97 per cent of Irish workers earn more than the mandated minimum, an economic slowdown that reduced demand for unskilled labour could lead to a situation where the level of the minimum wage represented a more substantial barrier to employment. Under such circumstances, it may be effective to re-assess the appropriate growth path for the minimum wage.[12]

Table 4: Minimum Wage Levels in Europe, 2006

		Monthly Rate % Binding
Luxembourg	1,570	11
Ireland	1,403	3.3
UK	1,361	1.8
Netherlands	1,301	2.2
Belgium	1,259	n/a
France	1,254	16.8
Greece	668	n/a
Spain	666	0.8
Malta	585	1.5
Slovenia	522	2.8
Portugal	470	4.7
Czech Rep	288	2
Hungary	258	8
Poland	246	2.9
Estonia	230	4.8
Slovakia	217	1.7
Lithuania	174	10.3
Latvia	172	12
Romania	114	9.7
Bulgaria	92	16

Source: Eurostat.

Clearly, the efficient deployment of cyclical fiscal policy can be best achieved in the context of a supportive socio-political environment. The well-established social partnership mechanism has the potential to enable fiscal policy to play a useful role in minimising deviations of output from its trend path, even if different groups may legitimately disagree about the nature of that trend path in terms of the optimal size of government and the structure of the tax system. Indeed, this role is very much in the spirit of the original motivation for the modern phase of social partnership, which was to lead the Irish economy out of the deep slump of the mid-1980s.

[11]The minimum wage has increased even further during 2007, with step increases in January and July 2007.

[12]The union movement supports the recommendation of The Minimum Wage Commission that the minimum wage should be set at 60 per cent of average industrial earnings. Since the industrial sector is in decline relative to the aggregate economy, it is not clear whether earnings in the industrial sector is an appropriate target for an economy-wide minimum wage.

While social partnership proved to be effective in facilitating recovery from a crisis situation, the question for stabilisation policy is whether it is also helpful in managing 'moderate' deviations from potential output.

5. Conclusions

Our analysis suggests that it is essential to embed the analysis of fiscal policy within a medium-term framework. Recent expenditure and revenue growth have clearly exceeded the expected medium-term trend path for Irish output growth. Accordingly, there is a clear choice between re-directing public spending towards a lower expansion path or accepting an increase in trend ratio of public spending to GDP, with the attendant implications for the aggregate tax burden. Second, we have argued that there may be a role for tactical fiscal interventions to minimise the cyclical deviations of output from its trend path. To the extent that competitiveness problems drive Ireland below its trend, the required fiscal intervention may involve below-trend growth in wage government consumption. Relative to recent fiscal trends, the scale of the adjustment in the growth of the public sector pay bill may be large.

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