NOT A RE-RUN OF THE 1980s

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The question posed by the organizers of this conference is: what should the Irish budget deficit for 2009 be. Given the huge sums beign bandied around in terms of guaranteeing all the creditors of Irish-controlled banks, there is a sense of unreality in returning to the Maastricht criteria and small numbers like 4 and 5 per cent of GNP. Yet, of course, tax and spending are real and immediate, whereas guarantees relate to the contingent and future. Furthermore, the inertia in tax and spending policies means that decisions here impact not just next year's budget but that for many years to come.

In the spirit of comparative advantage, I would like to place the discussion in a historical context. After the public finances were restored in the late 1980s, awareness of how crippling a fiscal crisis can be for the economy and society was universal. This awareness (combined with the astronomical levels which unemployment had reached) underpinned the social partnership which traded quite tight pay restraint for tax reductions over the following decade or more.

The period 1977-84 saw the most rapid increase in tax take as a percentage of GDP – from less than 40 to more than 55 per cent of GDP on the most inclusive definition. In the political economy of the time, tax rates and the tax take were residuals. This was true both in the expansionist phase 1977-81 and the subsequent containment phase.[2]

In the expansionist phase, Government expenditure was constrained only by ambition; actual spending began to outrun budgeted quantities by a very large margin – over 7 per cent in 1981. Tax collection scrambled to limit the yawning deficits.

In the containment phase, the deficit became the key target: how much could the government get away with borrowing without triggering a massive loss of external confidence. Then how much could spending be reduced within political constraints. Once again taxation became the residual.

With a growing share of the government's deficit flowing out in debt servicing, the negative fiscal impulse from 1981 dampened the economy by more than had been expected. The small open economy proved to be more sensitive to fiscal policy than theory suggested—the coincidence of the Thatcher recession in the UK didn't help. The spiralling tax rates also chilled investor confidence. These effects had been under-rated by policymakers.

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[1] This is part of the IRCHSS-sponsored Project: "Turning Globalization to National Advantage: Economic Policy Lessons from Ireland's Experience."

[2] It would take us too far afield to look also at the earlier, briefer blowout in the oublic finances, in 1974-6. This was in many ways more

In a re-run, there are a number of things on our side.

– First, low debt and low taxation. We have some headroom for extra borrowing (just as well, given the sudden ballooning of the borrowing requirement). We also have room for somewhat higher general tax rates without becoming uncompetitive or creating major disincentive side-effects.

– Second, EMU membership with its low interest rates. As long as borrowing is on a credible and convergent medium-term path there is no danger of a big blow-out in government borrowing interest rates – that was a big factor working against us in the 1980s.

– Third, despite myopia, memories of the last fiscal crisis have not entirely faded and a broad political consensus around the need for adjustment will be easier to secure this time.

– Fourth, the labour market remains as open as ever, and adjustment to lower employment will be possible at lower social cost this time, given the weaker attachment to Ireland of some recent immigrants.

– Fifth, in contrast to the situation in 1981, we have had a lengthy period of low general tax rates. This a consequence of the way in which boom-related tax revenue (stamp duties, capital gains, corporation tax) surges allowed government to offer lower general tax rates (income, VAT and excises) in social partnership negotiations in return for pay restraint -- up to 2000.[3]

– Sixth, the sizable surge in budgeted and actual spending that occurred in 2007-8, and which has greatly worsened the finances, presumably represents activities which have not yet attracted an entrenched lobby.

– Finally, let's not forget the physical, intellectual and human capital investments that have been made over the past few decades, and which, combined with improved functioning of the labour market, have enabled per capita income to triple. These remain valuable.

There are other factors that are not so helpful:

– Although the late 1970s saw a property boom, it was nothing compared with the one from which are now suffering a hangover.

– Like the situation in the 1980s, we enter this adjustment while our trading partners are turning down and commodity prices have been soaring.

[3] These were tax reductions that had become affordable as the revenue base expanded through the long boom. Some taxes are more proportionate to income levels; some to growth. As the revenue flowed in from growth-sensitive taxes, the rates on level-related taxes were lowered. This increased the sensitivity of the average tax rate to economic fluctuations. The extent of the fall in revenue this year and next reflects this structural shift in taxation which will have to be reversed.

So what did we learn then about how to deal with fiscal imbalance that we can now apply:

- We have learnt that tax rate increases do damage confidence, but lack of a credible medium-term fiscal strategy is worse.

- We also learnt that, small and open though Ireland is, the level of economic activity is influenced by fiscal policy.

The fiscal stance for 2009 should therefore avoid improvisation and short-termism in either taxation or spending. It should send clear messages to domestic and foreign economic agents allowing them to plan with confidence about future tax and spending over the coming 5 years. This means, I believe, having a target for the level of public expenditure and of taxation as a share of GDP in the medium term.

Here a plausible reference point would be the levels reached in the mid-1990s. I believe that spending as a % of GNP fell below easily sustainable levels by the end of the 1990s; however, the bounce-back has been too rapid. I suggest a goal such as the average of 1994-98 outcomes (I favour no particular political party here: this period includes periods in which 5 different parties participated in government). Rounding up a little, this would generate about the same as % of GDP as the 2008 level.

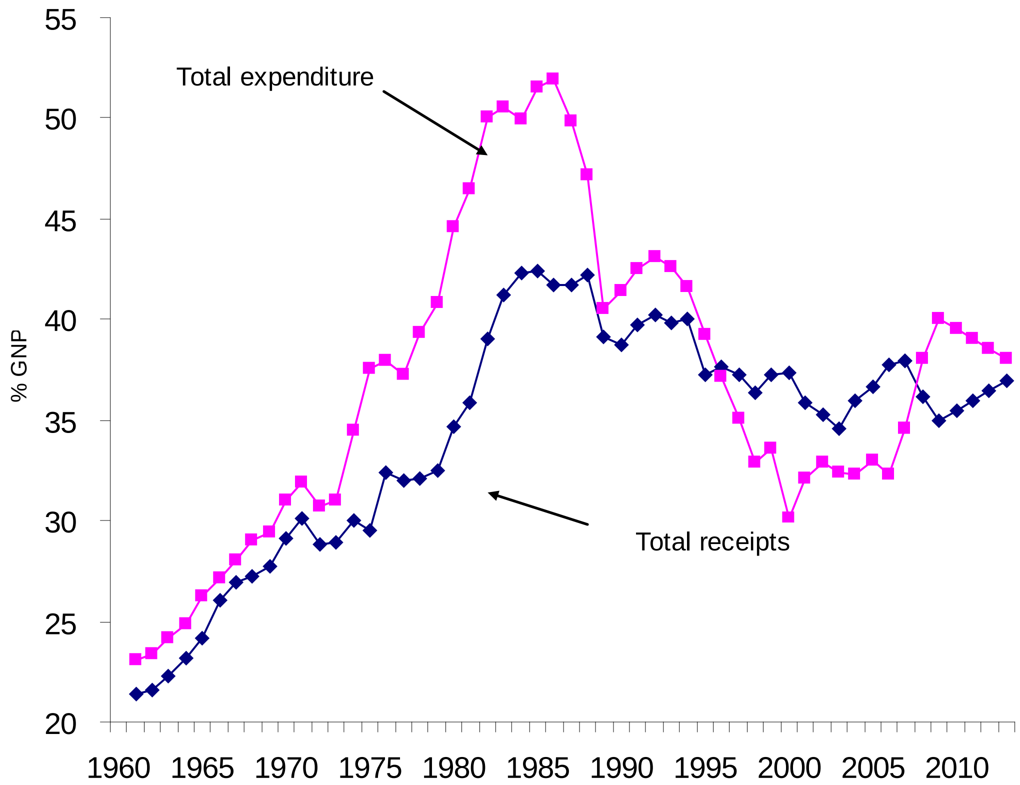
Likewise, because the social partnership process induced a heavier than sustainable reliance on highly activity-sensitive revenue sources, tax revenue has now dipped well below what is needed to fund the spending level indicated in the previous para. A return to the average of 1994-98 (or indeed to the outcome for 2007) would require an increase of about 2 percentage points in the tax/GNP ratio from where it fell to this year. (This will require some higher reliance on more stable sources of tax revenue, to make up for what has been lost on stamp duties and capital gains taxes – likely on a permanent basis.)

Getting from here to there, should not be planned over a period shorter than 5 years. This is not least because the automatic stabilizers will, given the global and domestic downturn, push both spending and tax away from these new medium-term targets for next year.

If this means a borrowing requirement in excess of 5 per cent next year, a percentage point lower in 2010 and so on (Figure) so be it. It will result in a significant, but limited and convergent increase in the debt-to-GNP ratio (Figure). Membership of the eurozone will prevent the sharp interest rate response that we saw last time (Figure).

In sum, budgetary strategy should not be in short-termist or crisis-response mode. Instead it should be based on a politically and financial coherent medium-term framework that allows the automatic stabilizers to function, assures medium-term fiscal stabilization, enables long-term goals to be achieved and is credible to the market.

Central Government: Receipts and Expenditure, 1960-2012
(National Accounts basis, excluding financial transactions)



National debt 1960-2012