Setting a Course for Irish Fiscal Policy

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The economic and fiscal environment that faces Minister Brian Lenihan in designing his first budget is much changed relative to the favourable economic conditions that were enjoyed by his predecessors over the last decade. In 2007, GDP grew at a very respectable 6 percent rate. According to last Friday's Central Bank forecast, GDP will fall by 0.8 percent in 2008, with a further contraction projected for 2009. Moreover, the decline in real incomes is even more extreme, once the output growth rate is corrected for profit outflows and the increase in the relative price of imports, with the ESRI forecasting a decline in real income in excess of 2 percent in 2008.

This shift in economic performance is truly remarkable, with very few instances to match this decline in the recent history of OECD economies. In part, the downturn can be attributed to external factors but the most important factor is the contraction in the housing sector, with Figure 1

showing the past behaviour of Irish output and income growth relative to the world aggregate, together with projections for the 2008-2013 period

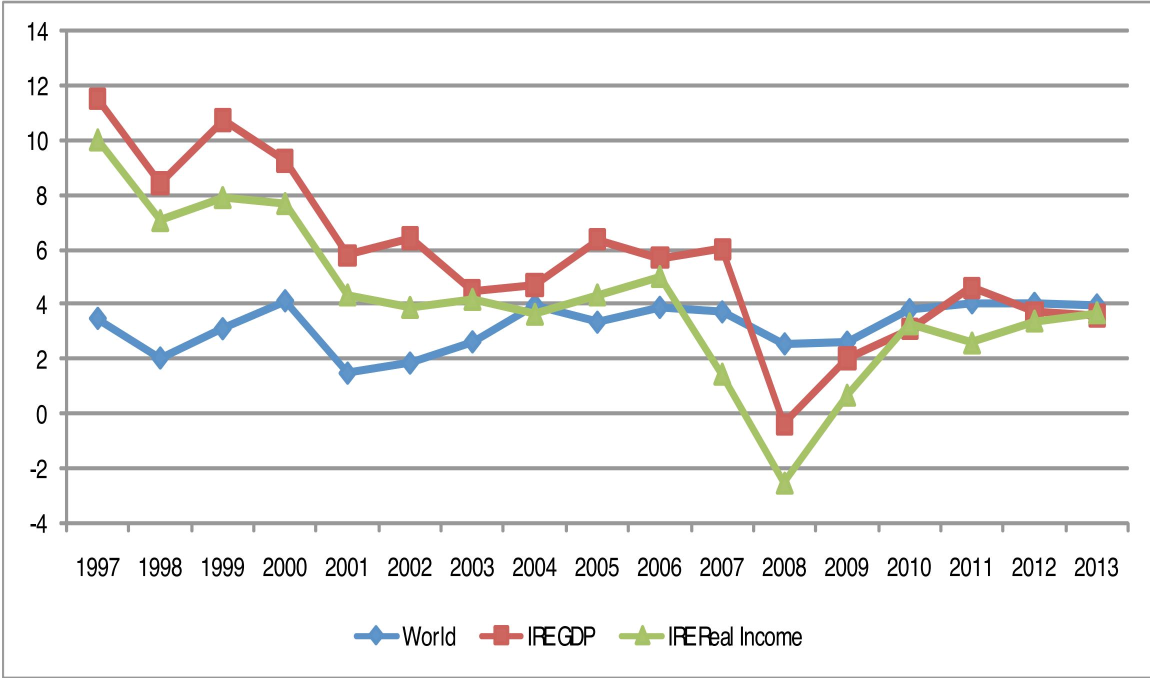

Figure 1. Growth in GDP (Ireland, World) and Real Income (Ireland), 1997-2013. Source: CSO, ESRI and IMF's World Economic Outlook.

Given the scale of this economic downturn, it is not surprising that a government budget deficit has emerged. During a downturn, it is natural that tax revenues fall in line with the decline in activity and that spending on unemployment assistance increases. However, the 11 percent decline in tax revenues in 2008 cannot be solely attributed to normal cyclical factors. Rather, the scale of the decline reflects the collapse in property-

related revenues. As is shown in Figure 2, the composition of core tax revenues has undergone a striking shift, with the share of income taxes

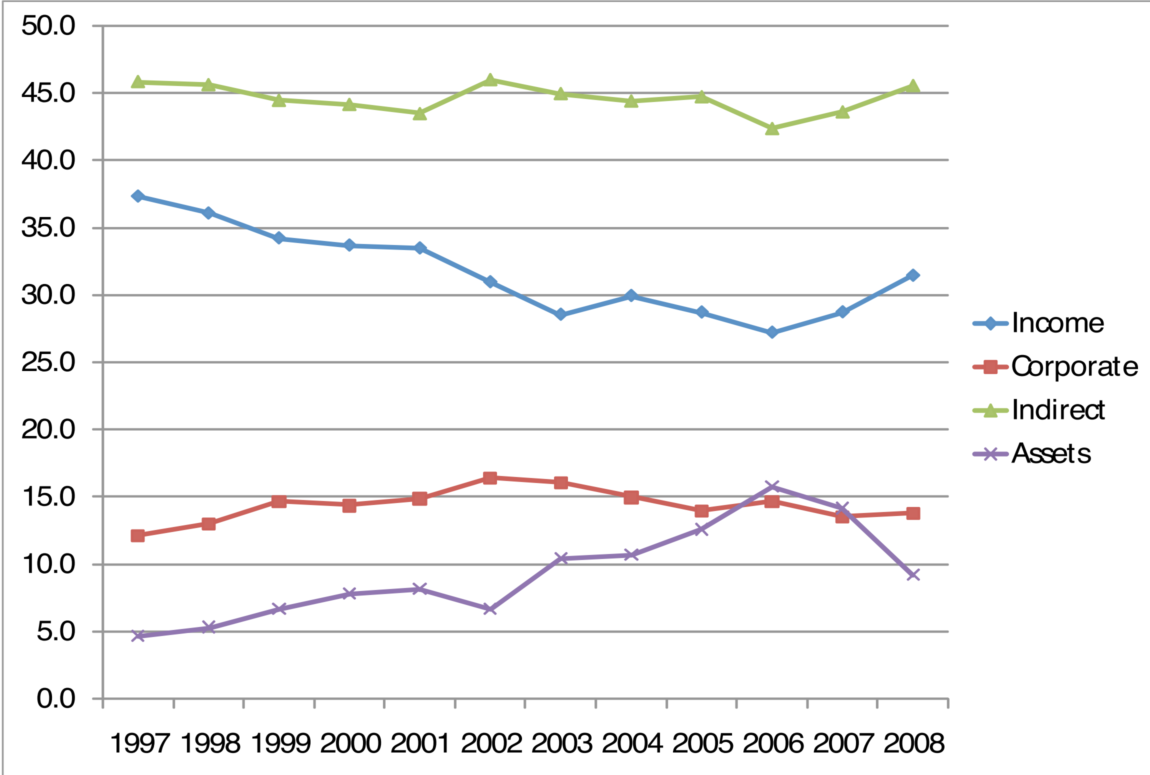

Figure 2. Shares in Core Tax Revenues, 1997-2008. Source: Author's calculations based on data from Department of Finance.

falling from 37.3 percent to 28.7 percent between 1997 and 2007, while the share of asset-related tax revenues increased from 4.7 percent in 1997 to 14.1 percent in 2007. Since the housing boom will not be repeated, asset-related revenues will not recover to the levels seen in recent years and the government faces the difficult task of finding replacement sources of tax revenues.

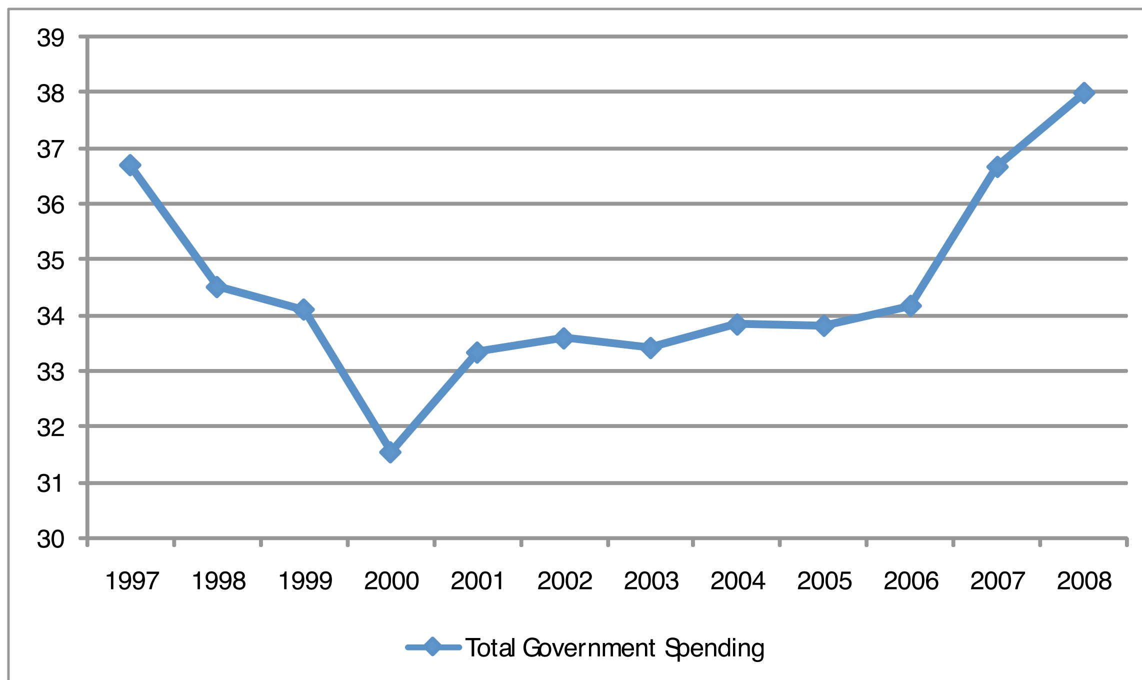

Figure 3. Total Government Spending as a Ratio to GDP. Source: OECD Economic Outlook.

The overall fiscal problem has been compounded by a rate of expansion in current spending in recent years that has exceeded the trend path for GDP, as is shown in Figure 3. In effect, the windfall in tax revenues that was generated by the housing boom allowed the government to increase many lines of current spending while still running a sizeable current budget surplus. Even when the economy recovers, current spending must adjust to a more moderate rate of growth, in which spending cannot grow more quickly than GDP growth, unless the government commits to a substantial increase in traditional sources of tax revenue.

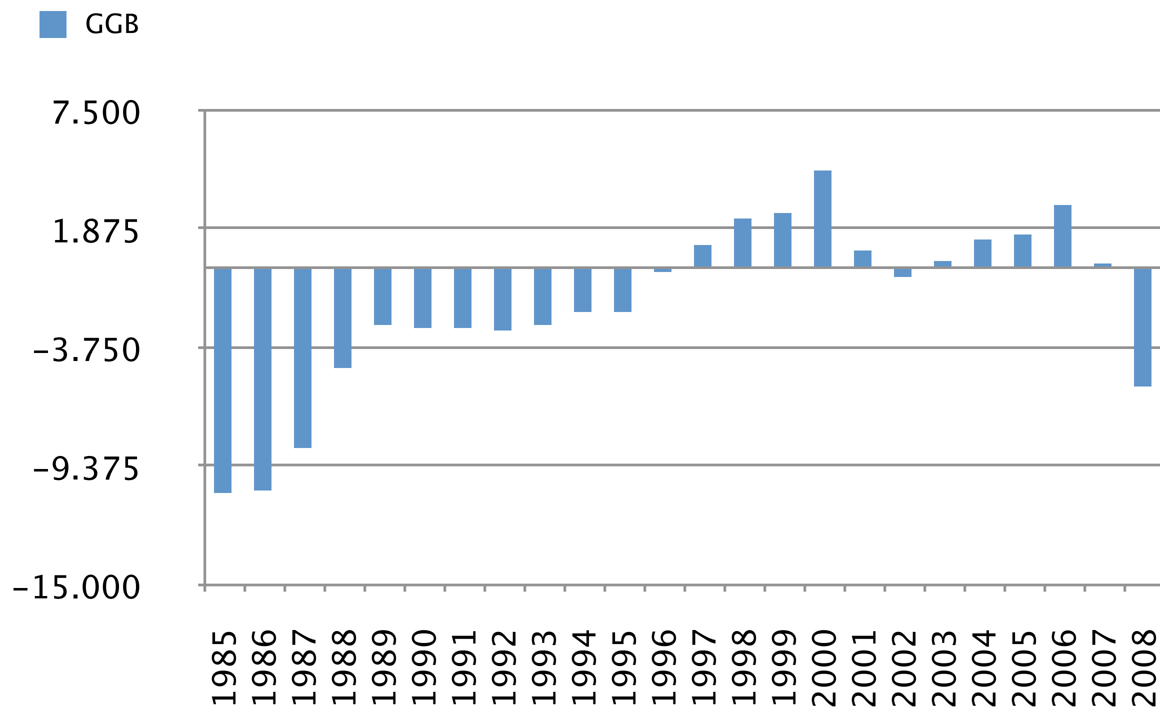

Figure 4. General Government Balance as a Ratio to GDP. Source: European Commission's AMECO database.

As is shown in Figure 4, the combination of plunging tax revenues and still-fast current spending has contributed to an extraordinary decline in the general government balance from surpluses of 2.98 percent and 0.5 percent of GDP in 2006 and 2007 to a projected deficit of 5.5 percent of GDP in 2008. A deterioration of this speed and scale is unprecedented in the context of European Monetary Union.

The current Irish predicament easily meets the set of criteria under which countries can exceed the normal Stability and Growth Pact deficit ceiling

of 3 percent: the scale of the decline in growth is very substantial, the level of government debt is low and the rate of public investment is high. However, further growth in the deficit combined with low or negative growth would see the debt to GDP ratio grow at an uncomfortable rate. Moreover, it is plausible that the appropriate level of public debt for Ireland has been reduced by the rapid accumulation of private debt in recent years, with substantial private borrowing incurred to finance housing-related tax payments.

Accordingly, it is important for the government to lay out a multi-year plan that will return the budget to inside the 3 percent limit within a reasonable time frame. While there is clearly some scope for re-calibrating public expenditure, it is not credible that the adjustment can fully land on spending, in view of the considerable demand for improved public services and the added burden of increased spending on unemployment-related welfare payments.

Beginning in Budget 2009, the fiscal correction requires a curb in many lines of current spending, the prioritisation of high-quality capital projects and a gradual increase in tax revenues. In view of the current low level of net direct taxes paid by typical middle- and low-income households (once account is taken of child benefit, mortgage interest relief and

other benefits), it is inevitable that the burden of higher taxation must fall on these groups, in addition to any extra

Income tax plus employee and employer contributions less cash benefits, by family-type and wage level (as % of labour costs), 2007

Family-type	Single	Single	Single	Single	Married	Married	Married	Married
children	no	no	no	2	2	2	2	no
Wage	67	100	167	67	100-0	100-33	100-67	100-33
France	44.4	49.2	53.1	35.8	41.9	39.4	43.7	43.9
Germany	47.4	52.2	53.1	34.5	36.4	41.5	45.3	47.3
Ireland	**15**	**22.3**	**33.1**	**-35.8**	**-1.1**	**7.4**	**12.8**	**15.6**
UK	30.8	34.1	37.9	15.5	28.3	26.4	29.9	30.8
US	27.8	30	35.3	7.6	18.1	22.2	24.5	27.8
OECD	33.8	37.7	42.1	18.2	27.3	29.5	32.4	34.5
EU-15	38	42.5	47.7	21.7	31.9	33.4	36.6	38.5

Table 1. Tax Burden on Average Households. Source: OECD Taxing Wages 2007.

revenues that are obtained from the highest income cohorts. The low level of net taxes paid by theses groups is clearly evident from Table 1, which is based on the OECD's **Taxing Wages 2007** report. In this regard, a key priority is to design the nature of tax increases to ensure that in–centives to participate in the labour market remain high for workers of all skill levels.

Since an excessive fiscal tightening runs the risk of deepening the recession, the fiscal adjustment should be conducted on a phased basis. In terms of the overall budget balance, the general government deficit should be gradually reduced from the projected 2008 out-turn of 5.5 percent of GDP, with a target of returning to below the normal 3 percent ceiling by Budget 2011.

Accordingly, a 2009 deficit in the 4-5 percent range would signal a move in the right direction in terms of fiscal sustainability, while still constituting an accomodative counter-cyclical fiscal stance that takes into account the downturn in the economy. It would be foolhardy to attempt to return to inside the 3 percent limit too quickly, in view of the negative impact on the economy of excessively large increases in taxation or cuts in spending. This is especially the case in the context of EMU membership, since a loose monetary policy cannot be relied upon to fight the recession and other countries such as Portugal have counted the cost of tightening too quickly during a downturn.

The government should also commit to establishing a new fiscal framework that minimises the risk of future procyclical episodes in fiscal policy. By reforming the fiscal process in this way, a period of temporarily

high deficits can be reconciled with long-term fiscal sustainability. Moreover, as part of its commitment to fiscal sustainability, the government should resist the temptation to deviate from its legal commitment to make an annual payment of one percent of GNP into the National Pensions Reserve Fund: a suspension of payments merely represents deferred taxation, in view of the predictability of the increase in ageing-related public expenditures in the coming years.

Finally, the tight fiscal situation re-inforces the urgency of pursuing reform across the public sector. Moreover, the loss of competitiveness in the private sector in recent years also requires the government to intensify its efforts to promote lower costs and prices across the economy through its anti-monopoly policies. Accordingly, even leaving to one side the government's newly-expanded role in the banking system, the current debate about economic policy should be much broader than the forthcoming Budget announcement.

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