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POLICY PAPER

A New Fiscal Strategy for Ireland

PHILIP R. LANE*
IIIS, Trinity College Dublin and CEPR

I INTRODUCTION

Around the world, fiscal policy has been accorded a prominent role in the debate on responding to the sharp economic slowdown. In large part, this reflects the limited effectiveness of monetary policy, once policy rates are close to zero and the persistent spread between inter-bank and policy rates renders ineffective the traditional monetary transmission mechanism through the bank lending channel. At a global level, the November 2008 and April 2009 summits of the G-20 group signalled the commitment of the world's largest economies to fiscal expansion. At the December 2008 European Council meeting, the member countries of the European Union have also agreed a fiscal expansion plan, amounting to 1.5 per cent of EU GDP. However, at both the global and European levels, there is widespread agreement that the appropriate fiscal stance varies across countries, according to the individual circumstances of each economy.

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Accordingly, the challenge for the Irish government has been to design and implement a fiscal response that recognises both the general importance of fiscal policy in dealing with a global financial and economic crisis and the set of constraints that limit the effectiveness of this tool for the Irish economy.

The successful execution of fiscal policy is especially important for members of the euro area, since these countries do not have the option to independently alter interest rates or the nominal exchange rate.[1] The primary focus of the research literature on fiscal policy and Economic and Monetary Union (EMU) has been on the importance of fiscal rules in order to avoid excessive debt accumulation, which are formalised in the Stability and Growth Pact (SGP). However, it is commonly accepted that the acute nature of the current crisis means that the normal implementation of the SGP is not appropriate, with temporary deviations from the SGP guidelines to be tolerated. Accordingly, attention has shifted to the potential effectiveness of fiscal policy in stabilising the euro area economy and the appropriate design of fiscal interventions. However, there is no consensus on the appropriate scale and composition of fiscal expansion programmes, with the German government especially sceptical as to the efficacy of Keynesian-style demand management.

The Irish case is especially interesting for several reasons. On the one side, there are some factors that may have enabled fiscal policy to play a stabilising role in the current Irish situation. First, the relatively low initial level of public debt at the onset of the crisis meant that Ireland was better placed than some other member countries in having room for some degree of fiscal expansion. Second, the severe and prolonged nature of housing-related slowdowns means that there may have been a useful role for discretionary fiscal policy in stabilising the Irish economy, since the traditional critique that business cycles are too shallow and temporary to be amenable to fiscal interventions may not apply with full force.

On the other side, there are important constraints that limit the potential effectiveness of Irish fiscal policy. Most obviously, the high trade openness of the Irish economy means that the impact on domestic demand of a given fiscal intervention is lower in Ireland than in more closed economies. In addition, the Irish economy currently suffers from a major structural imbalance, with export sectors having been squeezed in recent years by the expansion of activity in domestically-orientated sectors (construction, public services,

[1] Of course, the lack of policy autonomy over interest rates and exchange rates may be a blessing. At a collective level, independent choices over exchange rates have negative spillover effects, through the familiar beggar-thy-neighbour channel. In relation to interest rates, it is plausible that weaker members of the euro area would be compelled to raise interest rates during a crisis situation in order to stave off speculative attacks and capital flight.

consumption-related services). The long-term health of the Irish economy requires a rebalancing towards sectors that have a greater potential for delivering productivity growth. Accordingly, the appropriate fiscal policy for Ireland needs to incorporate the need for rebalancing.[2]

Most importantly, the effectiveness of fiscal interventions depends on the sustainability of a country's fiscal position. This is fully recognised in the recent IMF study on the role of fiscal policy in the current crisis (Spilimbergo *et al.,* 2008). While this study generally advocates the deployment of fiscal policy, it recognises that it will not be effective in all countries. In particular, the authors state: *However, it is also essential that fiscal stimulus not be seen by markets as seriously calling into question medium-term fiscal sustainability. This is key, not only for the medium run, but also for the short run, as questions about debt sustainability would undercut the near- term effectiveness of policy through adverse effects on financial markets, interest rates, and consumer spending* (paragraph 27 on page 8).

While Ireland had a low initial level of public debt at the onset of the crisis, the sustainability issue has been a substantive one due to a number of factors. First, the deterioration in the general government balance from a surplus in 2006 to a deficit of 7.5 per cent of GDP in 2008, plus very large projected deficits for 2009-2011 has raised a question mark about the dynamics of the public debt. Second, the sizeable projected losses for the banking sector has added to the negative outlook for the public finances.

Most directly, the re-capitalisation of the banking sector may involve a long-term fiscal cost to the taxpayer. In addition, the banking crisis has amplified the domestic recession, contributing to the loss of tax revenues and the increase in unemployment. Moreover, the re-financing of the banking system entails substantial funding risks, through an increase in the gross stock of government debt. Finally, the increase in spreads in the sovereign debt market contributes to negative debt dynamics by raising debt servicing costs.

While some of these factors are temporary in nature, concerns about sustainability have been augmented by the lack of a sufficiently strong long-term anchor for Irish fiscal policy. A period of even high deficits may be quite sustainable, so long as taxpayers and investors believe that the fiscal position will recover within a reasonable time frame. Unfortunately, several factors

[2] The importance of switching the sectoral composition of activity is also a concern for other countries. In general, most other deficit countries (US, UK, Spain, Central and Eastern Europe) are looking to reduce domestic spending and increase exports, while the resolution of global imbalances is best achieved if the major surplus countries (China, Japan, Germany, oil exporters) take steps to raise domestic spending and reduce their reliance on export-driven growth.

contribute to substantial uncertainty concerning the long-term fiscal prospects for Ireland. These include Ireland's own fiscal history, which showed a capacity to allow the public debt to chronically expand to a very high level before a fiscal correction was eventually accomplished. Next, the current tax shortfall has a major structural component, such that economic recovery on its own will not lead to a restoration of pre-crisis levels of tax revenue, while the level of government spending has been quite unstable relative to GDP. While the government has made significant moves to stabilise the public finances in the last several months, there remains much uncertainty about the medium-term levels of revenue and public expenditure.

In view of these competing forces, the identification of the optimal fiscal strategy in response to the crisis is unusually difficult. In the rest of this paper, I analyse in more detail the factors that are relevant in designing the fiscal response. In Section II, I turn to the potential effectiveness of fiscal policy as a stabilisation tool. Section III considers the fiscal sustainability constraint. Based on the foregoing analysis, Section IV outlines the main features of a credible fiscal plan for Ireland. I then turn to an analysis of the government's fiscal adjustment efforts to date in Section V. Section VI discusses the next phase of fiscal adjustment. Finally, concluding remarks are offered in Section VII.

II THE EFFECTIVENESS OF FISCAL POLICY

As is reviewed by Spilimbergo *et al.* (2008), there is surprisingly little solid empirical evidence as to the effectiveness of fiscal policy, with the estimated magnitudes of fiscal multipliers showing considerable variation across across countries and time periods. This should not be too surprising in view of differences in economic structures: textbook analysis suggests that fiscal effectiveness should indeed vary across different environments and across different types of fiscal packages.[3] An important factor that has been identified is that the short-term effectiveness of fiscal policy critically depends on long-term fiscal sustainability: if an increase in spending today signals a long-term increase in the tax burden, its positive demand effects will be negated (Favero and Giavazzi, 2007, Corsetti *et al.,* 2008).

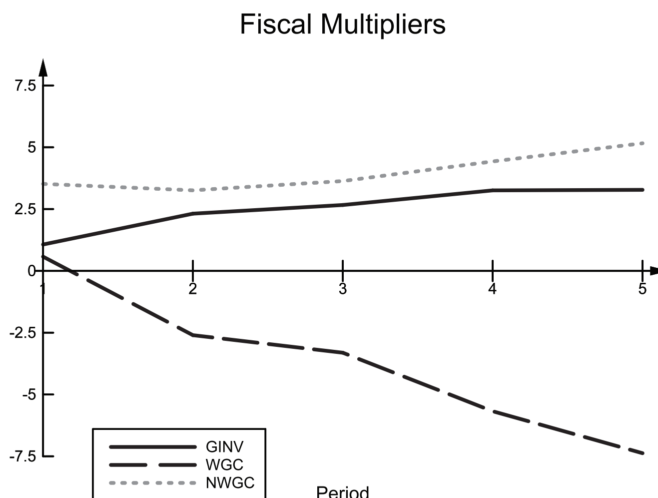
The empirical evidence concerning the effectiveness of fiscal policy for Ireland is scarce. However, Benetrix and Lane (2009) provide some clues. These authors estimate a vector autoregression model of the Irish economy

[3] The textbook effectiveness of fiscal policy depends on the textbook also, in view of the dispersion of views concerning the appropriate model for business cycle analysis.

that permits identification of the impact of government spending shocks on the level of output. An important feature of this study is that it allows the impact to vary across different types of government spending (public investment and different components of public consumption). As is illustrated in Figure 1, it finds that government investment has a positive fiscal multiplier that is above unity: a given boost to public capital spending raises output by more than the size of the injection. Government purchases of consumption goods and services from the private sector (non-wage government consumption) have a similar effect. In contrast, an increase in the government payroll (wage government consumption) has a negative fiscal multiplier on average: an expansion in this category is associated with a contraction in output. Moreover, Benetrix and Lane show that the variation in the fiscal multipliers can be linked to the labour market impact of these different policies: an increase in wage government consumption tends to increase the economy-wide level of real wages, whereas the wage effect is not significantly different from zero for the other categories.

These results come with important caveats. First, the model is estimated over the 1970-2006 period, such that the fiscal multipliers are average effects across the range of economic conditions faced by Ireland over that interval. In particular, the size of the fiscal multiplier surely varies with the level of slack in the labour market and, as indicated above, the perceived sustainability of

Figure 1: *Fiscal Multipliers*



Note: Multipliers calculated based on the impulse-response F=functions generated by Benetrix and Lane (2009).

the fiscal position. However, the main message of the Benetrix-Lane empirical analysis is that the fiscal multiplier varies across expenditure categories, with public investment boosting the level of output whereas an expansion in the public sector payroll is associated with output contraction.

The composition of government spending also matters for external competitiveness. Figure 2 shows the rapid increase in the real exchange rate in recent years. While external factors (movements in the euro-dollar and euro-sterling rates) are important contributors to these dynamics, the appropriate domestic response is to engineer a reduction in domestic costs.[4] In the short run, increases in public spending (whether investment or consumption) tend to be associated with real exchange rate appreciation. However, Galstyan and Lane (2008, 2009) find an important long-run difference between government investment and government consumption. An increase in the former is associated with long-run real exchange rate depreciation, while an expansion in the latter is associated with long-run real appreciation. As is shown in the model developed by Galstyan and Lane (2008, 2009), this

Figure 2: *Harmonised Competitiveness Indicator*

Source: Central Bank and Financial Services Authority of Ireland. Real HCI (deflated by consumer prices).

[4] In what follows, I focus on labour costs. However, the effort should also extend to tackling monopoly power in various sheltered sectors in the economy, since high local input costs are also an important factor in determining international competitiveness. See also Lane (2004).

difference can be intuitively explained in a generalised Balassa-Samuelson framework: public investment boosts productivity and thereby drives down the relative price level, whereas government consumption squeezes the export sector by reducing the availability of labour to the private sector.

III FISCAL SUSTAINABILITY

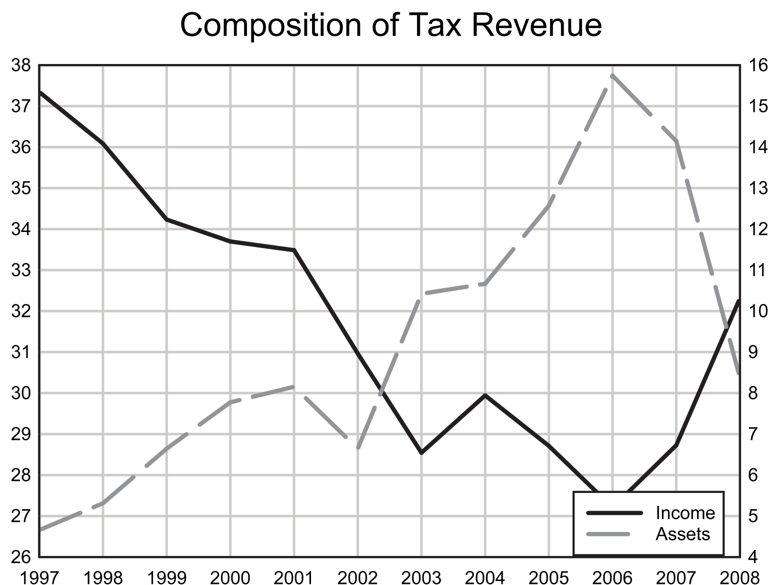
A non-sustainable fiscal position is destabilising for the economy. Taxpayers and investors find it difficult to make commitments if there is excessive uncertainty about the future level of taxation; the situation is even worse if a non-trivial probability is assigned to default-type events.[5] Despite the low initial level of public debt, there are several reasons to be concerned about the sustainability of the Irish public finances. First, the rate of deterioration in the general government balance has been dramatic, from a surplus in 2006 to a projected 2009 deficit of 10.75 per cent of GDP.

The decline in the budgetary position is in part attributable to the collapse in tax revenues. While a decline in tax revenues can be expected when GDP falls, it is clear that a significant part of the revenue contraction is structural in nature. In particular, the evolution of the tax base over 1997-2006 became increasingly skewed towards asset-related taxes (stamp duties, capital gains tax, capital acquisition tax), which facilitated a decline in the income tax burden. This is sharply illustrated by Figure 3, which shows that the income tax share in core tax revenues declined by 10.1 percentage points between 1997 and 2006 that was offset by a 11 percentage point increase in the share of asset-related taxes. Since the asset-related taxes will not recover for the foreseeable future, this left a structural hole in the tax base. Accordingly, the securing of fiscal sustainability necessarily involves clarity on how the tax base will be restored.

Moreover, fiscal uncertainty also relates to the level of public sector spending. The total level of government spending has undergone tremendous oscillations over the 1995-2008 period (for most advanced economies, the ratio of public spending to GDP tends to be much more stable). At one level, this is understandable in view of the unexpected shifts in the GDP growth rate over

[5] Historically, the returns on sovereign debt could be compromised through the indirect mechanism of inflating away the burden of debt denominated in the domestic currency. This option is not available to a member government of the euro area. There remain two main default risks. First, outright default by a sovereign government can be envisaged as the least bad of all available choices in a truly dire state of the world. Second, effective default could be accomplished by leaving the euro area and redenominating debt in the new domestic currency at a more depreciated exchange rate. Both default options would carry heavy costs and I take it that these scenarios are not relevant for Ireland.

Figure 3: *Composition of Tax Revenue*



Note: Author's calculations based on data from Department of Finance.

the period, which has typically led to lagged adjustment in government spending. However, it is not clear what represents the trend path for government spending and so it is difficult to make projections about the long-term tax burden that is required to match the trend level of public spending.[6] The system of annual budgeting does not help in this regard, to the extent that governments have not sought to target the spending to GDP ratio over a multi-year horizon. Finally, the banking crisis constitutes a further source of fiscal uncertainty, since the ultimate net fiscal cost to the government remains unknown.

Finally, the prospective fiscal costs of the banking crisis also bear on fiscal sustainability. Reinhart and Rogoff (2009) have highlighted that financial crises typically carry a high fiscal cost, both directly through the subsidy component of public re-financing of the banking system and indirectly via the depressive impact of financial crises on the level of economic activity and tax revenues. If the cross-country evidence proves relevant, the severe banking crisis in Ireland may ultimately impose a significant fiscal cost.

[6] See also Honohan (2008), who suggests that the average level during the pre-boom 1994-1998 period may be taken as a rough-and-ready target for the ratio of public spending to national income.

IV ELEMENTS OF AN OPTIMAL FISCAL STRATEGY

The analysis in the preceding sections provides some indications as to the optimal design of a fiscal plan for Ireland. First and foremost, it is important to establish a credible multi-year strategy that ensures the sustainability of the Irish fiscal position. In particular, this should include a clear target range for the trend level of government spending relative to GDP and a tax schedule that can finance this level of spending over the medium term. If such a strategy is adopted and perceived as credible by taxpayers and investors, then a temporary period of high deficits during the transition to the new trend path is more feasible and more likely to help stabilise the economy. The implementation of such a plan will also enable the government to meet the terms of the SGP by demonstrating to the European Commission and the other EU member countries that Ireland will respect the SGP's fiscal rules over the medium term.

In relation to the composition of government spending, the evidence suggests that a high level of productive government investment is both stabilising in the short run and helps to improve external competitiveness over the long run. At the same time, it is important to ensure that public investment is focused on high-quality projects that deliver lasting gains: proposals that fail to pass rigorous and transparent benefit-cost tests should not be pursued. It is also the case that the downward revision in the growth projections for Ireland means that the optimal public capital stock is not as large was previously projected during the fast-growth period.

The evidence is that high wage government consumption harms external competitiveness, by placing upward pressure on economy-wide pay levels. Accordingly, the fiscal trade-off is to balance the desire for public services against the macroeconomic impact of a large government wage bill. Moreover, a high level of unemployment is no excuse for the postponement of productivity-enhancing reforms in the public sector or the effective redeployment of staff across categories within the public sector. If these reforms (plus the impact of a shrinking economy and outward migration on the demand for public services) result in aggregate over-staffing in the public sector, a decline in public sector employment may be appropriate. However, while part of the adjustment may take the form of skilfully-crafted and targeted redundancy programmes, a major proportion of the adjustment should take the form of a sizeable reduction in public sector pay rates.[7]

[7] The level of public sector pay should be broadly interpreted to include the value of implicit pension contributions. In addition, the same logic applies to sectors in which the government is the primary purchaser of effective labour services through the imposition of lower procurement rates.

The case for a generalised reduction in public sector pay levels is reinforced by the key analytical point that the structure of the economy became distorted during the latter boom years. In addition to the over-expansion of the construction sector, the domestic consumption boom fed rapid growth in retail and domestic services. Moreover, the surge in windfall tax revenues allowed a major expansion in those sectors in which the government is the major customer and/or employer. Looking forward, the composition of economic activity in the post-crisis economy needs to shift towards a stronger platform in traded-sector activities. Although international competitiveness is a far broader concept than just relative pay levels, there is no escaping the reality that the level of wages that can sustain full employment in Ireland has declined. To this end, nominal reductions in public sector pay can play a central role in achieving the restoration of competitiveness.

The contribution of public sector pay cuts in fostering a generalised reduction in wage levels is appropriate in view of the need to restore external competitiveness and re-balance the composition of activity in the economy towards the tradables sector. A cut in public sector wages helps to promote wage adjustment in the private sector, both through the direct competition for labour and indirectly via a demonstration effect. This factor is potentially quite relevant for Ireland, even if recent events show that the Irish private-sector labour market displays considerable flexibility in some dimensions. In particular, the negotiation of nominal wage cuts at a firm level encounters the asymmetric information problem mentioned above in relation to the true state of the employer's finances. Accordingly, the temptation is to delay adjustment until the firm is in dire straits. The empirical evidence of Honohan and Leddin (2006) suggests that the speed of labour market adjustment is quite gradual in Ireland, such that market forces by themselves may not be enough to prevent a sizeable and persistent increase in unemployment. By setting a lower pay norm, pay reductions in the public sector could facilitate a smoother form of adjustment in the private sector.

Moreover, other factors also support the case for a reduction in public sector pay. First, the evidence indicates that there is a considerable premium in public sector pay. Moreover, Kelly *et al.* (2008) show that the premium has grown from 7.7 to 23.5 per cent between 2003 and 2006. A striking feature of this study is that these authors shows that the premium is largest in lower-level grades (a premium in the 24-32 per cent range), while the premium at the senior level is around 10 per cent. Moreover, these authors argue that it is plausible that the pay differential has expanded since 2006, due to the payment of the two latest installments of the national pay agreements, the awards under the second benchmarking exercise and those implemented in the wake of the two most recent reports of the Review Body on Higher

Remuneration. Finally, the estimated premia in this paper are likely a lower bound, since it takes no account of the superior pension arrangements in the public sector.

Second, the typical arguments against nominal wage reductions do not have much force in the current environment. The most influential recent study on nominal wage rigidity was conducted by Bewley (1999). His main message is that firms avoid nominal wage reductions, due to the adverse impact on morale. However, much of the morale effect relates to the relative status of workers: if there is a general wage reduction across the public sector, the relative positions of different groups of workers would be unchanged. Since the public sector pay reductions would take place against a backdrop of tough private-sector labour market conditions, the relative status of public sector workers vis-a-vis private sector counterparts would also not be egregiously affected (beyond the potential elimination of the aforementioned public sector pay premium).

Third, a major difficulty in achieving nominal wage reductions in the private sector relates to the difficulties encountered by workers in assessing the true financial state of their employers (Bruno and Sachs, 1985). However, the state of the public finances is common knowledge and the scale of the financing gap is clearly evident to public sector workers.

Fourth, nominal wage reductions may actually be helpful in boosting aggregate demand in the economy. If pay cuts help to stabilise the public finances, a major deterrent to spending plans is removed in that decision makers can better forecast the future tax burden. In addition, the improvement in external competitiveness will give confidence that economic recovery will be based on a sustainable foundation of expansion in the tradables sector.

Fifth, membership of EMU means that there is no link between domestic wage behaviour and the ability of the European Central Bank (ECB) to implement an effective monetary policy. In particular, the deflation scenario in its true meaning is a function of aggregate price dynamics at the area-wide level, which are unaffected by domestic wage behaviour. While Irish inflation in the next few years may fall below the area-wide average (and may well be negative for a sustained period), this is a purely temporary (albeit persistent) phenomenon and is just a by-product of engineering a depreciation in the real effective exchange rate. Rather, long-term inflation expectations for Ireland will be driven by ECB monetary policy, which is committed to delivering a long-term annual average positive inflation rate of 2 per cent.

To this end, it is better to front load the nominal wage reduction. In particular, aggregate demand is better supported by a sufficiently large initial cut in wages that can be followed by a rising path for wages in subsequent

periods. Such a positively-sloped wage profile promotes current consumption, in the same way that expected exchange rate appreciation effectively reduces the consumption-based real interest rate. By contrast, Blanchard (2007) shows that slow wage adjustment in Portugal amplified the economic slowdown there, since expectations of further wage cuts in the future acted to increase the effective real interest rate there.[8]

In implementing public sector pay cuts, it is desirable if this can be achieved within the context of social partnership. A core strength of the social partnership infrastructure is that it is broader than a pay agreement (O'Donnell 2001, Sweeney 2008). Accordingly, a union movement that cares about the quality and level of public services in addition to the pay and conditions of its members may not oppose public sector pay reductions (plus efficiency-enhancing reforms of public sector service provision) that contribute to the preservation of a given level of public service provision. The linkage between pay levels and service levels would be weaker in a non-coordinated setting in which the government must deal with individual public sector unions in a decentralised fashion, such that pay settlements cannot be linked to the overall provision of public services.

Moreover, the social partnership should facilitate the linkage between public sector pay and employment growth in the private sector. The evidence suggests that a coordinated approach to pay determination enables wage adjustment in response to macroeconomic shocks, since a centralised mechanism helps to clarify the distinction between the appropriate levels of economy-wide and sector-specific wage adjustment.[9] This is especially important for member countries of the euro area, since the alternative approach to reducing economy-wide real wages (nominal exchange rate devaluation) is not possible.

The design of the pay deal could also provide some upside potential to workers by specifying the possibility of faster wage growth if economic recovery takes hold more quickly than is currently expected. This can be achieved by agreeing a formula by which wage growth (after the inital cut) is expressed as a function of macroeconomic indicators, such as the rate of (appropriately-measured) productivity growth. Looking to the future, this type of state-contingent wage bargain should be incorporated into future versions

[8] See also Lane (2008a).

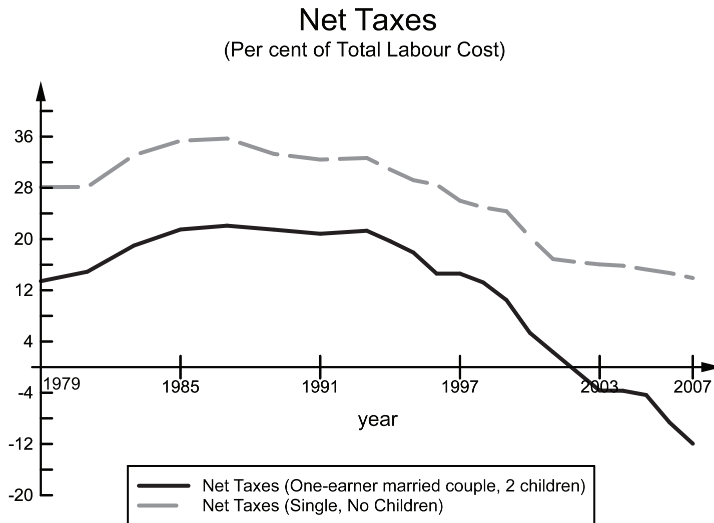
[9] The seminal empirical contribution is Calmfors and Driffill (1988). While the Irish private-sector labour market displays considerable flexibility in some dimensions, the negotiation of nominal wage cuts at a firm level encounters the asymmetric information problem mentioned above in relation to the true state of the employer's finances. Accordingly, the temptation is to delay adjustment until the firm is in dire straits. By setting a lower pay norm, the social partnership agreement could facilitate a smoother form of adjustment in the private sector.

of the social partnership agreements. Variants of this idea have been explored in detail by Geary and Honohan (1997) and De Buitleir and Thornhill (2001) amongst others.

In relation to the restoration of the tax base, the sitting Commission on Taxation may well underpin support for new sources of taxes (carbon tax, property tax) and a widening of the tax base is highly desirable. However, a major part of the adjustment will surely include the re-entry of lower-paid workers into the tax net and adapting the tax treatment of cash transfers such as child benefit. The scope for such measures is well illustrated by Figure 4 which shows the sharp decline in the net tax burden (income taxes paid minus cash transfers received) in recent years, especially for families with children.

Furthermore, Table 1 shows the net tax burden for different types of typical households in a sample of advanced economies.[10] While the generosity of Ireland to lower-income households with children may deliver important social benefits, it is atypical. Finally, reform of the tax treatment of lower-paid workers must be closely integrated with adjustments to the social welfare system and the promotion of active labour market policies, to avoid the well-known difficulties with high replacement rates.

Figure 4: *Net Taxes, 1979 to 2007*



Note: Net taxes at average wage level.
Source: OECD Taxing Wages Database.

[10] See also Lane (2007, 2008b).

Table 1: *Net Taxes*

Family-type S *Children*	*S* *no*	*S* *no*	*S* *no*	*M* *2*	*M* *2*	*M* *2*	*M* *2*	*no* *Wage*
	67	100	167	67	100 0	100 33	100 67	100 0
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

Note: Taxes Minus Cash Transfers as a per cent of total labour costs.
Source: OECD Taxing Wages database.

V FIRST STEPS TOWARDS FISCAL ADJUSTMENT

The scale of the decline in the fiscal situation is astounding. In December 2007, the projection was that the general government budget deficit in 2009 would be 1.1 per cent of GDP. Even with the sizeable adjustment measures that have been announced and the inclusion of some one-off items, the projected general government budget deficit for 2009 now stands at 10.75 per cent of GDP. A central factor behind this decline is a major collapse in tax revenues. In December 2007, the projection for 2009 was that tax revenues would be €51.8 billion; the current projection stands at €34.4 billion. While voted capital spending has been cut back from a projected level of €9.1 billion to €7.3 billion (a cut of 20 per cent), voted current spending has expanded from a projected €53.3 billion to €56.6 billion. While the sharp increase in unemployment in part accounts for this increase, non-welfare spending has only slightly declined from a projected €36.3 billion to €35.3 billion. Since nominal GDP in 2009 will be much lower than was projected at the end of 2007, the result is that the ratio of public spending to GDP has jumped from a projected 37 per cent to the region of 45 per cent.

The fiscal situation would have been far worse again if the government had not taken steps to achieve some level of fiscal correction. Taken together, the correction of about 5 per cent of GDP, which represents a very large shock relative to previous expectations concerning the paths for expenditure and taxation. There have been four stages to the government's efforts to make a start on fiscal adjustment. In Summer 2008, a mid-year correction for 2008

was implemented by which enhanced spending controls for 2008 were put in place. The October 2008 announcement of the 2009 budget went further by imposing tax hikes in the form of income levys and a range of minor expenditure cuts. However that budget was based on expectations of a minor recession of minus 0.8 per cent of GDP in 2009, whereas the April 2009 projection is for minus 7.7 per cent of GDP growth in 2009. The associated deterioration in the public finances in the final quarter of 2008 and first months of 2009 subsequently led to the imposition in January 2009 of a public sector pension levy (plus the cancellation of further scheduled pay increases for public sector workers under the national pay agreement and a package of other expenditure control measures) and the introduction of a supplementary budget in April 2009.

On the spending side, the most remarkable feature has been the imposition of the public sector pension levy, which amounts to a de facto average nominal pay cut in the region of 7.5 per cent. While such a nominal pay reduction has few precedents in advanced economies, it helps to protect the provision of public services in a tighter fiscal environment and facilitates the required adjustment in wage levels across the economy, as was discussed in the previous section. Moreover, the pension levy should be interpreted in the context of steep pay increases over the previous decade and the estimated premium between pay levels in the public and private sectors. In addition, the impact on living standards has been mitigated by the decline in the consumer price level. In terms of the political economy of fiscal adjustment, it demonstrates a commitment that public sector workers will share the pain in a setting in which many in the private sector must deal with unemployment or declines in pay levels.

In relation to taxation, the implementation of income levies means that all those earning more than €15,000 now face a higher tax burden. Moreover, the distribution of tax increases has been heavily focused on higher income earners. Relative to 2008 tax rates, the all-in marginal tax rate now faced by a higher income earner has increased from 43.5 per cent to 52 per cent, once the various levies are factored in. The increase in the marginal tax rate for middle-income earners is also substantial, from 22 per cent in 2008 to 26-28 per cent in 2009. As is highlighted by Callan *et al.* (2009), the combined impact of the tax and welfare changes has been heavily redistributionist, since the average incomes of the poorest one fifth of the population are set to increase this year, while the average losses for the middle and upper income groups range from 2.5 per cent to 9 per cent. The political economy attractiveness of initially focusing fiscal adjustment on higher earners is clear and indeed the UK government had made a similar move in relation to very high income earners in its April budget.

VI THE NEXT PHASE OF FISCAL ADJUSTMENT

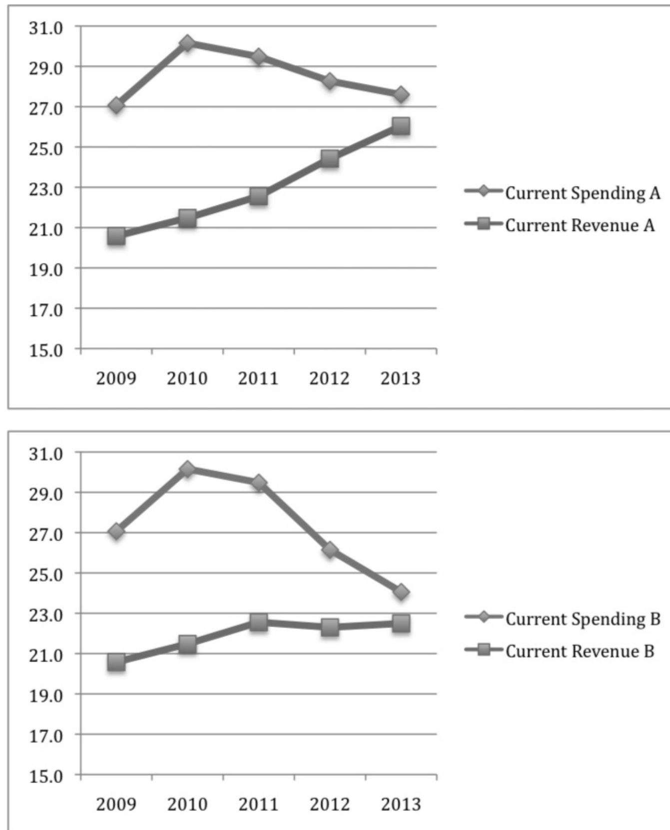
In addition to the 2009 measures, the announcement of the April budget also included the publication of a new medium-term fiscal framework for 2009-2013. A credible medium-term framework is essential for several reasons. Domestically, decisions on investment and labour supply are facilitated by more information on the future path for taxes and public spending. In turn, these influence the medium-term level of potential output for the economy. At the international level, the government's commitment to the Stability and Growth Pact is evaluated in relation to its medium-term plan, while bond investors also look towards a medium-term horizon.

The fiscal framework for 2009-2013 envisages the stabilisation of the general government deficit at 10.7/10.8 per cent in 2009/2010, with subsequent sharp reductions in the deficits to 8.6 per cent, 5.6 per cent and 3.0 per cent during 2011-2013. There are two important features in this projection. First, it is assumed that economic growth will be quite rapid during this period, with growth rates of 2.7 per cent in 2011, 4.2 per cent in 2012 and 4.0 per cent in 2013. These projected growth rates are far in excess of the potential output growth rates estimated by the European Commission (1.1 per cent, 1.4 per cent and 1.7 per cent for 2011, 2012 and 2013 respectively). It would be more conservative to adopt a more sombre path for output, in line with the potential output growth rates. In turn, it is easier to correct excessively-pessimistic budgets than to row back from excessively-optimistic ones.

Second, the balance between spending and taxation has not been fully specified for 2012-2013, with savings of €4 billion in 2012 and €7 billion in 2013 yet to be allocated. In Figure 5, I show two polar cases in which these savings are either fully allocated to a reduction in current spending or an increase in current revenue. These figures illustrate that the medium-term path for the economy will be critically determined by the nature of the adjustment over this period. While political preferences differ in terms of the appropriate level of public services and redistribution, it should be recognised that a large and permanent increase in the level of distortionary taxes will have a negative impact on the path for potential output. In turn, a lower rate of potential output growth will make it more difficult to tackle the projected high rates of unemployment.

Accordingly, the quality of fiscal decisions over the next five years is critically important in determining not only the speed of recovery from the current crisis but also longer-term economic performance. Since the tax burden is set to further increase under any plausible scenario, this reinforces the urgency of widening the tax base and ensuring that the distortionary impact of taxes are mitigated as far as is practicable. As was outlined in

Figure 5: *Fiscal Scenarios for 2010-2013*



Note: Top panel assumes all of unallocated adjustment in 2011-2013 is through extra taxation; bottom panel assumes all of unallocated adjustment is via cuts in current spending.

Section III, it is inevitable that the widening of the tax base will involve a greater contribution from lower-income cohorts.

However, the scale of tax increases can be moderated by seeking improvements in productivity in public services and focusing on those public capital projects that will deliver the highest social returns. In an environment of projected high unemployment, the paths for public sector pay and welfare benefits must be determined in the context of a labour market strategy that seeks to maximise sustainable employment growth over this period.

To this end, further reductions in the level of public sector pay must be envisaged. While the government has announced a review of pay for senior

grades in the public sector, the scale of the fiscal challenge means that the scope for further pay reductions should be broader than this group. Moreover, the macroeconomic logic outlined in Section III suggests that this should be tackled in the earlier phase of the adjustment process, rather than deferring this component. In particular, the shadow of future pay reductions will induce a high level of precautionary savings, whereas the combination of an early round of pay reductions with future pay growth is more supportive of domestic aggregate demand.

Going beyond the fiscal framework document, the cross-country empirical evidence is that the implementation of fiscal plans can be enhanced by procedural reforms (Beetsma *et al.,* 2009). One element can be to enhance the level of commitment to multi-year expenditure plans, which specify detailed allocations for a multi-year horizon. While such a multi-year plan may be more difficult to design, it may be useful in terms of disciplining potential drift in lines of public expenditure.

In addition, the credibility of the overall budgetary plan can be enhanced by relying on independent forecasts for GDP growth. Moreover, there may be a case for a greater involvement of independent experts in evaluating the sustainability of tax and spending plans, while still recognising the primacy of political accountability in making ultimate fiscal decisions. For instance, Calmfors (2003) recommends the establishment of an independent fiscal council that can play this role.

In related fashion, the ideal fiscal strategy should also include a range of measures to ensure that the current fiscal situation does not recur in the future. One core element should be to develop institutional mechanisms that permit the accumulation of much greater fiscal reserves during boom periods. While the National Pension Reserve Fund has acted as a de facto rainy day fund during the current banking crisis, it was not established with that intention. Rather, as was proposed by Lane (1998), the fiscal framework should make explicit provision for a liquid reserve fund that may be deployed in the event of severe shocks and financial-sector problems. In the context of general institutional reform in Ireland, the merits of a new institutional approach to the setting of fiscal policy should be part of the current debate.

Finally, going beyond the narrow confines of the public finances, public policy has a much wider role to play in engineering recovery from the current slump and setting a new course for the economy. Most importantly, the successful re-structuring of the bank sector is a prerequisite for the resumption of normal credit operations in the economy. At a broader level, there is a widespread consensus across the social partners in terms of what is required to improve competitiveness. This is reflected in the analysis presented in the series of publications from the National Competitiveness

Council and other bodies such as the National Economic and Social Council. It is also well recognised in the government's long-term strategic vision, as laid out in the Smart Economy document launched in December 2008.

Many of the policy reforms recommended by these agencies have not been fully implemented. During the boom years, the case for tackling structural problems such as monopoly power in key economic sectors was perhaps not viewed with great urgency. Indeed, the current crisis may provide the opportunity to robustly tackle structural barriers to greater efficiency, through the appropriate mix of pro-competition policies and tougher regulation (where it is warranted). As is widely recognised, there is also much to be done in terms of improving the skill levels in the workforce and retraining individuals to shift across occupations, with the current slack in economic activity providing an opportunity to release workers and those unemployed to undertake such programmes.

VII CONCLUSIONS

Getting fiscal policy right is especially important for Ireland, since it is the main macroeconomic policy instrument available to a national government within the euro area. Moreover, the close linkage between fiscal sustainability and the re-financing of the domestic banking system reinforces the imperative to demonstrate commitment to a sustainable medium-term fiscal position. While the government has taken a large initial step towards fiscal adjustment and has published the broad framework for its ongoing efforts, many details have not been specified and its implementation faces severe challenges.

The political economy challenges in securing fiscal sustainability are significant. While the 2009 adjustments to taxes and spending have largely protected lower-income groups, the widening of the tax base and extra controls on current spending in the coming years mean that the pain of fiscal adjustment is bound to be yet more extensive across the population. Income levels for many groups of public sector workers are set to be placed under further pressure but the trade-off between pay levels and service levels is centrally important in view of the scale of the required fiscal tightening.

While the elevated spreads in the sovereign debt market and the risk of an international funding crisis means that there is now considerable external pressure for reform, it remains the case that the nature and timing of fiscal adjustment remains largely under the control of the domestic socio-political system. The capacity of the domestic system to deliver a fiscal correction that ensures a bright medium-term future for the Irish economy will be revealed over the coming months.

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