RESEARCH SERIES
NUMBER 12
OCTOBER 2009

BUDGET PERSPECTIVES 2010

Tim Callan (ed.)

**Alan Barrett, Jean Goggin,
Paul K. Gorecki,
Claire Keane, Ide Kearney,
Alan Matthews,
John R. Walsh**

*Copies of this paper may be obtained from The Economic and Social Research Institute (Limited Company No. 18269).
Registered Office: Whitaker Square, Sir John Rogerson's Quay, Dublin 2.*
www.esri.ie

Tim Callan, Alan Barrett, Paul K. Gorecki are Research Professors, Ide Kearney is Associate Professor, John R. Walsh is Senior Research Analyst, Jean Goggin and Claire Keane are Research Assistants at the Economic and Social Research Institute (ESRI). Alan Matthews is Professor in the Department of Economics and Director of the Institute for International Integration Studies, Trinity College Dublin.

Research Series
Number 12
October 2009

Budget Perspectives 2010

Tim Callan (ed.)

**Alan Barrett, Jean Goggin,
Paul K. Gorecki,
Claire Keane, Ide Kearney,
Alan Matthews,
John R. Walsh**

ISBN 978 0 7070 0290 3

ACKNOWLEDGEMENTS

Thanks are due to the referees, from both inside and outside the ESRI, for comments which have helped to improve the papers included in this volume. Thanks are also due to Donal de Buitléir, Chair of the FFS Projects Committee, and to Frances Ruane, for their valuable inputs into the planning of the conference.

Conference organisation was handled with their customary skill and efficiency by Patricia Byrne and Mary Dowling. All authors, and particularly the editor, thank Mary Cleary, Regina Moore and Deirdre Whitaker for their excellent work in preparing the volume for publication under severe time constraints.

CONTENTS

INTRODUCTION

The 2010 Budget represents a futher step in the process of getting Irish fiscal policy back onto a sustainable path. This process started with the 2009 Budget published in October 2008, and continued, inter alia, with the Supplementary Budget in April this year. Over recent months, the global economy has begun to show some signs of recovery and there is growing evidence that the worst may be over in terms of the domestic downturn. The preparation of this year's budget has to take into account the downward trend in tax revenue during 2009, the potential for public expenditure changes that can yield savings in the shortrun, and the signal created by the Budget itself to international markets where Ireland is borrowing to fund the shortfall in revenue given current expenditure commitments. The Budgetary preparation can also be informed by the recently published report of the *Commission on Taxation*, the report of the *Special Group on Public Service Numbers and Expenditure Programmes* (also referred to as *An Bord Snip Nua* or the *McCarthy Report*). In addition, ESRI researchers have responded to the crisis by producing several research papers during 2009 of particular relevance to budgetary policy. This year's Budget Perspectives Conference, co-hosted by The Economic and Social Research Institute and the Foundation for Fiscal Studies, provides several inputs to inform macroeconomic decision making in these challenging times.

A key focus of this year's conference is the work of the *Commission on Taxation*, with a research paper on selected issues and overall responses from a distinguished panel comprising Donal de Buitleir (FFS), Philip Lane (TCD) and Richard Tol (ESRI). Two other papers extend the bounds of the usual discourse at Budget time: one deals with Ireland's approach to the EU budget, and the other with the pressures for protection via regulation, which become stronger during a downturn, and appear to have low or nil budgetary cost, but have high economic costs in the long term.

Outlook for Ireland

The short term issues facing the Irish economy are addressed in the opening presentation by **Alan Barrett**, **Ide Kearney**, and **Jean Goggin** based on the ESRI's Autumn *Quarterly Economic Commentary* which will be published on www.esri.ie. As this is to be published on the day of the conference, details are not available at the time of writing. The *Commentary* and the presentation will give particular attention to the state of the public finances, and the appropriate stance for fiscal policy in 2010 given developments in the international and domestic economy.

Tax Reform: Selected Issues

In their paper, ESRI researchers, **Tim Callan, Claire Keane** and **John Walsh** explore, using the ESRI tax-benefit model, *SWITCH*, two of the key issues covered in the *Report of the Commission on Taxation* which point to the need to restructure the Irish tax system. They begin by considering in some detail the introduction of a tax on residential property. In particular, they examine how a scheme of income-related waivers and reductions could link property tax liability to ability to pay. They find that it would be possible to devise such a scheme that would retain most of the revenue from a simple property tax, but would not require payment from those in the lowest one-fifth to one-quarter of the income distribution. In addition, they look at the impact of including Child Benefit in taxable income and compare this with a revenue neutral reduction in Child Benefit. They find that the taxation of child benefit is preferable in terms of its distributional impact on child income support.

Future of EU Budgets: Irish Perspectives

In the second paper, **Alan Matthews** (TCD) looks out to the medium term, exploring Ireland's possible negotiating position after 2013, when the current framework expires. This will be the first time that Ireland will enter these discussions in the certainty that it will be a net contributor. The paper looks at how expenditure has changed over time, noting how the relative importance of the CAP has reduced with increasing shares of expenditure coming under the structural and cohesion headings. It also looks at changes in the composition of revenue sources and at Ireland's net budgetary position. It provides a summary of the reform proposals in relation to both revenue and expenditure and possible options for dealing with what are seen as 'unacceptable net balances' across countries. It concludes with a discussion of Ireland's position in relation to EU budgetary reform in the context of the changed domestic fiscal stance.

Budgetary Challenges and the Pressures for Bespoke Protection

The final paper by **Paul Gorecki** (ESRI) explores the pressures for bespoke protectionism that arise in an economic downturn when the government faces difficult budgetary conditions. The emphasis on bespoke protectionism arises from the fact that it can appear to solve problems by helping those facing difficulties without any apparent fiscal cost. The reality is that bespoke protectionism is very costly in terms of its distortionary effects on the economy, which are large and likely to persist long after economic recovery. In the context of public choice and economic welfare analysis, the paper provides examples of the distortionary effects of regulation, specifically in the taxi licence and energy markets. It also reviews cases where exemptions from the Competition Act have been successfully sought, namely, medical practitioners and voice-over actors, and the potential danger for precedents that these examples set. Welfare economics points to the need for transparent fiscal interventions, which implies that regulatory impact assessment is applied robustly to all regulations under consideration.

TAX REFORM: SELECTED ISSUES

Tim Callan, Claire Keane and John R. Walsh[*]

1. Introduction

The report of the Commission on Taxation (2009) documents an agenda for the reform of taxation at a time when the public finances are under very severe pressure. It would undoubtedly be easier to reform taxation at a time when the overall tax take could be reduced, rather than when gains and losses must balance out in a revenue-neutral fashion. It is still more difficult if reforms have to be introduced at a time when, for macroeconomic reasons, the overall tax take must rise.[1] But even when facing the task of increasing revenues, there are choices to be made between increasing rates on the existing base, and broadening the base, without an increase in rates. As Poterba (2009) stated in this year's Geary Lecture, a touchstone result in public finance is that …*the distortionary cost of a tax system depends not on the level of tax rates but on the square of tax rates.*[2] This makes a strong argument for base-broadening rather than rate increases, which informs much of the report of the Commission on Taxation.

In this paper, we address a selection of issues linked by the theme of base-broadening; and we consider some aspects of the income tax rate structure which were addressed by the Commission. The two areas of base-broadening we consider are:

- Introduction of a tax on residential property (Section 2); and
- Inclusion of child benefit as part of taxable income (Section 3).

[*] The Economic and Social Research Institute, Whitaker Square, Sir John Rogerson's Quay, Dublin 2. *Email*: tim.callan@esri.ie
We are grateful to referees for helpful comments; the usual disclaimer applies.

[1] The February 2008 terms of reference for the Commission included keeping "the overall tax burden low" and implementation of a carbon tax on a revenue-neutral basis. The January 2009 Framework document agreed by the social partners included the following: *Additionally, given the urgency of the situation and the role that taxation will have to play in bringing stability back to the public finances, the Government is asking the Commission on Taxation to identify appropriate options to raise tax revenue and to complete its report by September 2009.*

[2] The basic result is due to Harberger (1964). There have been many further refinements and extensions, but Auerbach and Hines (2001) conclude that *Fundamentally, it remains true that departures from marginal cost pricing are associated with excess burden, that the magnitude of excess burden is roughly proportional to the square of any such departure.*

Each of these raises issues requiring close investigation, and we use *SWITCH,* the ESRI tax-benefit model to examine the first-round implications of policy changes in these areas.[3] The main findings are drawn together in the final section.

2. Property Tax

CONTEXT

A recent OECD study on taxes and economic growth (Johansson *et al.*, 2008) summarised the main advantages of property as a base for taxation:

- property is immobile,
- property taxes are hard to evade or avoid,
- property tax revenue can be used to reduce the burden of income taxation, and has fewer behavioural consequences than income taxes,
- property taxes can offset distortions caused by favourable tax treatments of owner occupation which tend to cause overinvestment in housing,
- property is a major component of wealth,
- property is suitable as a local tax base.[4]

The property tax heading includes recurrent taxes on immovable property (paid by both households and businesses), taxes on net wealth (paid by both households and corporations), taxes on gifts and inheritance and taxes on financial and capital transactions. Johansson *et al.* (2008) summarise empirical work, based on a panel regression covering 21 OECD countries over the period 1970 to 2005, suggesting that …*recurrent taxes on immovable property seem to have the least adverse effect on GDP per capita*… They found that within the OECD, recurrent taxes on immovable property accounted for about half of total property taxes, with taxes on transactions accounting for about another quarter.

The balance of taxes within the property tax heading is quite different for Ireland. The Commission on Taxation points to Ireland's heavy reliance on stamp duty and transactions taxes in the taxation of property. This imposes costs on mobility, including mobility between jobs requiring a change of residence. It distorts decisions as to whether to move to a more suitable property for changed needs (larger family, empty nest, or change in health status) or to adapt an existing property. It also means that stamp duties can be particularly sensitive to the state of the economic cycle. Stamp duties had been less than half of the "taxes on property" category in the 1990s, but rose to be over 70 per cent by 2006. However, the end of the housing boom has seen declines in property values and in transactions, which have greatly reduced revenue from this source in the recent past. Ireland has not had an annual tax based on domestic residential property values since the abolition of domestic rates in 1978. Both the Commission on Taxation and the OECD study point to a further advantage of an annual tax on immovable

[3] A third area where they may be scope for base-broadening reform, the tax treatment of pensions, was also considered by the Commission. This is the subject of a separate study (Callan *et al.*, 2009b).
[4] In this paper we examine the potential for a national property tax; we do not attempt to deal with issues of local taxation.

property: this tax base is more stable than one based on transactions. Indeed, Johansson *et al.* (2009) state that …*tax revenue generated from this tax is …. more predictable than for revenues obtained from labour and corporate taxes, partly due to less cyclical fluctuation in property values (e.g. Joumard and Kongsrud, 2003).*

RECOMMENDATIONS OF THE COMMISSION ON TAXATION

OECD (2006) has stated that *Ireland has some of the most generous tax provisions for owner-occupied housing, largely because it is the only OECD country that allows a tax deduction for mortgage interest payments at the same time as not taxing property values, capital gains or imputed rent.* In this context, the Commission on Taxation has recommended the introduction of an annual tax on residential housing units, with liability falling on the owner of the property (whether owner occupier or landlord). There would be exceptions for social housing (including local authority rented housing)[5] and some more limited exceptions such as nursing homes and boarding schools. Stamp duty for purchasers of a principal private residence would be zero-rated; and the tax would replace the €200 charge on second homes recently introduced. Key design features of the Commission's proposal for an annual property tax (APT) include:

- The tax liability be broadly proportionate to the value of the property, calculated as a fixed percentage of the midpoint of the valuation band into which the property falls.[6]
- The owner(s) of the property would be liable for the tax.
- The annual property tax should have regard to ability to pay. In particular, the Commission recommends that there should be a waiver scheme for those on low incomes, a 10 per cent reduction where the principal income earner has …*a substantial and permanent disability*; and a further provision that in some other cases the tax could be …*deferred and recovered when the property is subsequently sold or transferred.*

The link between property tax and ability to pay is a crucial one for the acceptability of such a tax. One of the main objections raised to an annual property tax is that it is "unfair" because it does not take account of the difficulties it would pose for low income individuals. The example often given is of a widow or pensioner living in a house with a value which would make for a large property tax bill and would be difficult or impossible to pay from a low income. The Commission makes a broad recommendation on this issue; we are able to explore what is involved in greater depth, as explained in the next sub-sections.

As regards the implementation of a property tax, the Commission recommended that the main valuation mechanism should be self-assessment, subject to appropriate monitoring and audit mechanisms. To this end, the development of an up-to-date and consistent valuation database is seen as critical, with this database being made available on-line to assist taxpayers in valuing their own property. In our view, self-assessment is a possible option for use as a valuation mechanism, but not the only one. Given that there are fewer transactions than usual in the current housing

[5] In the case of local authority housing, the owner/landlord would be the local authority.
[6] For houses in the highest valuation band, there is no midpoint, and actual market values are used – there is no "capping" of potential property tax liability.

market, and greater uncertainty over house values, it is possible that an alternative might be preferred. Modern methods of valuation, using statistical models explaining house price variation based on the characteristics of the dwelling,[7] and the portability of computing power, mean that the process of valuation can be completed much more quickly than in the past. Experience from the Northern Ireland (Northern Ireland Department of Finance and Personnel, 2009) and elsewhere (McCluskey and Adair, 1997) suggest that development of a valuation database could be achieved within a relatively short time frame. Thus, in our view, the Commission's recommendation of a property tax should not be seen as hinging on the use of self-assessment as a valuation mechanism; there are alternatives which could also be used to implement their design in a relatively short time frame.

ANNUAL PROPERTY TAX: ANALYTIC FRAMEWORK

In order to examine the potential impact of an annual property tax with an income-related full or partial waiver, we need a suitable database. This must contain a nationally representative sample of households, with information on the value of the house or apartment, and detailed information on the incomes and family relationships of those living in the dwelling. The Central Statistics Office Survey on Income and Living Conditions[8] provides such information, and our analysis is based on the data from that survey for the year 2005.[9] We have, however, made a number of adjustments to take account of developments in income and in the housing market since that time. We also need to be able to simulate the rules of the property tax system, and of a waiver scheme related to income and/or other characteristics of the owner of the property. This is provided by an extension of *SWITCH*, the ESRI tax-benefit model, to include options for a tax on owner-occupied property, and for a full or partial waiver of that tax depending on income.

The property tax we analyse is very similar in structure to that recommended by the Commission on Taxation, but there are some differences. Chief among these is the fact that the property tax we analyse does not apply to rental property, but only to owner occupied property. This is because data on house values are only gathered for owner-occupiers in the survey. There are also issues around the appropriate treatment of the rental sector,[10] but we are unable to explore these with the data currently available. However, given the high rate of owner-occupation, and the fact that the Commission excludes both local authority tenants and the social housing sector from the remit of its Annual Property Tax, the analysis here comes close to capturing the main effects of a tax as proposed by the Commission.

[7] These are know as "hedonic" pricing models, and are widely used. The permanent tsb/ESRI house price index is based on this approach.

[8] The survey is known as EU SILC, as it is conducted in all EU countries with a view to providing comparable statistics on income and living conditions.

[9] The estimated value of the housing stock is close to the product of the number of dwellings (Department of the Environment) and the standardised average house price (permanent tsb/ESRI series).

[10] It may be appropriate to have some form of property tax for the rental sector, as discussed in Callan *et al.* (2009a) but it should not be assumed that this would have exactly the same form – or the same goals – as a property tax on the owner-occupied sector.

A second difference is that the Commission proposes the use of banded house values, whereas our analysis looks at the use of discrete market values as reported by respondents to the survey. Compared with a discrete value system, the banded system can be seen as involving a higher payment for those with house values in the lower half of the band, and a lower payment for those in the top half of the house value band. The reason for adopting a banded system seems to be a practical one: that the introduction of a system based on discrete values would take longer to set up. Nevertheless, a banded system could be a stepping stone towards a discrete value system and the overall impact of the banded system proposed by the Commission can be expected to be broadly similar to that of the discrete system.

Full details of the methods and assumptions used in the analysis, and more detailed results on the potential impact of an annual property tax on households are available in a companion paper (Callan *et al.*, 2009a). Here we concentrate on three main aspects:

- The relationship between a property tax and ability pay, under different forms of a low income exemption scheme.
- The regional distribution of the revenue raised by a property tax.
- Transitional arrangements affecting those who have paid stamp duty during recent years.

The next three subsections deal with each of these issues in turn.

PROPERTY TAX AND ABILITY TO PAY

We compare three forms of property tax. The first might be termed a simple property tax, with liability related only to the value of the property, and having no extra component related to ability to pay. This case is useful as a benchmark against which to measure the effectiveness of income exemption schemes in limiting the impact on lower income earners – it is not intended as a policy proposal. The other two variants have an income limit below which no property tax is paid (either €12,000 per annum, roughly the level of the State Contributory Pension, or €15,000 per annum), and a "rebate withdrawal rate"[11] which sees property tax liability rise by 20 cent for every euro of income above that limit. The income concept used in both of these variants is income adjusted to take account of the needs of families of different sizes and age compositions. The adjustment is done using an adult equivalence scale, with the first adult in the family counting as 1, and a second or subsequent adult as 0.66, to take account of economies of scale. Children are counted as having needs equivalent to 0.33 of those of the first adult. This is the national equivalence scale used by CSO in monitoring both the "at risk of poverty" measure and the "consistent poverty" target, and close to the scale implicit in the payment rates for social welfare schemes. In all cases, the rate of property tax assumed is 0.4 per cent of property value –

[11] This is equivalent to the marginal relief rate in the income tax code. Those with a full exemption can be thought of as getting a rebate equal to the full value of their property tax liability, with this rebate being reduced by 20 cent for each euro of income above the income exemption limit.

a figure chosen to arrive at a revenue of approximately €1,000 million per annum.[12]

Table 1: Revenue Impact of Alternative Waivers and Rebates for Property Tax

	Income Exemption Limit (Annual Disposable Income Per Adult Equivalent)	Rebate Withdrawal Rate (%)	Revenue €Million Per Annum
Simple property tax	0	n.a.	1,101
Property tax with income exemption limit and marginal relief	€12,000	20	973
Property tax with income exemption limit and marginal relief	€15,000	20	906

Note: A tax rate of 0.4 per cent is applied in all cases.

Table 1 summarises the main results in terms of the overall revenue that could be collected under each of these schemes. A simple property tax with no income exemption limit would raise about €1,100 million per annum. A tax with an income exemption limit of €12,000, and a rebate withdrawal rate of 20 per cent, would raise about €970 million. Extending the income limit further up the scale to €15,000 per annum would see the revenue fall to just over €900 million. Thus, the alternative schemes with income exemption limits would retain between 80 and 90 per cent of the maximum potential revenue.

How would the distributional impact of a property tax be affected by these different approaches? Table 2 summarises the impacts at different income levels, dividing the population into 10 equal sized groups from those with lowest to those with highest income ("deciles"). The income criterion used takes account of differences in family size and age composition in the manner described earlier (i.e., uses income per adult equivalent). A simple property tax with no income-related relief would see losses of between 1 and 2 per cent for those in the bottom 30 per cent of the income distribution. An income exemption limit of €12,000 per annum would eliminate losses for the bottom 10 per cent, limit them to 0.3 per cent for the next decile, and reduce them from almost 2 per cent to 1 per cent for the third decile. A higher income limit of €15,000 per annum could eliminate losses for the 20 per cent of households with lowest incomes, and limit losses to 0.2 per cent for the third decile.

Taken together, Tables 1 and 2 indicate that an income exemption limit, along with a gradual withdrawal of the full rebate, could be used to relate property tax liability to ability to pay, limiting the impact on those on the lowest incomes. At the same time, the property tax could raise between 80

[12] The total revenue is a product of the rate and the value of the owner-occupied housing stock. The rate required to generate €1,000 million depends on the value of the housing stock; the conservative assumption adopted on the path of house prices means that the rate required to generate this revenue may be less than 0.4 per cent. The Commission looked at rates of 0.25 and 0.30 per cent.

and 90 per cent of the maximum revenue. In part, this reflects the fact that those with low incomes tend also to have lower valued property on average. The existence of a low income rebate or full waiver would, of course, imply an increase in the effective marginal tax rate on income of those benefiting from a rebate. However, it seems that the proportion affected in this way would be not dissimilar to those in Great Britain and in Northern Ireland.

Table 2: Distributional Impact of a Property Tax With and Without Income Exemptions

Decile	Adjusted Net Income Per Week		% Change in Income for Income Group		
	More Than	*Less Than*	*Simple Property Tax*	*Income Exemption Limit of €12,000*	*Income Exemption Limit of €15,000*
Lowest		204	-1.0	0	0
2	204	263	-1.4	-0.3	0
3	263	325	-1.9	-1.0	-0.2
4	325	396	-1.2	-1.1	-1.0
5	396	449	-1.0	-1.0	-1.0
6	449	519	-1.3	-1.2	-1.2
7	519	605	-1.3	-1.2	-1.2
8	605	711	-1.6	-1.5	-1.5
9	711	889	-1.2	-1.2	-1.2
Highest	889		-1.1	-1.1	-1.1
Total			-1.3	-1.1	-1.0

Note: Each decile contains 10 per cent of all households, from those with lowest incomes up to those with the highest incomes. A property tax rate of 0.4 per cent of owner-occupied property is assumed throughout. Where an income exemption limit applies, the rebate withdrawal rate is 20 per cent.

REGIONAL DISTRIBUTION OF PROPERTY TAX

What about the regional distribution of revenue from property tax? A combination of factors led to the former Residential Property Tax raising close to three-quarters of its revenue from the Dublin area. How would a property tax of the type examined here compare? Table 3 shows how the share of revenue raised under a property tax (with a rate of 0.4 per cent and an income cut off of €12,000) varies across regions, and, for comparison, the shares of the regions in population and in disposable income.[13]

Dublin accounts for a higher share of the yield from property tax than its share in the population of households. However, Dublin also has a higher share of disposable income, indicating a higher than average income. Given the progressivity of the income tax code, the share of Dublin in the gross income would be higher than 44 per cent, and its share in the revenue from income tax would be higher again. Thus, while Dublin's share in the property tax is above its share in the population, it is not so far above its share in income or income tax – and a long way below the share it contributed in the narrower Residential Property tax.

[13] As the property tax revenue must come from *SWITCH* simulations, disposable income is also simulated in this framework.

Table 3: Regional Shares of Population, Income and Property Tax

Region	Households	Disposable Income	Property Tax Revenue
	%	%	%
Border	9	7	6
Midland	5	4	3
West	8	6	6
Dublin	36	44	52
Mid-East	9	9	10
Mid-West	7	7	5
South-East	10	7	6
South-West	16	14	12
Total	100	100	100

TRANSITIONAL RELIEF

The Commission recommends that, as a transitional arrangement, all those who have paid stamp duty should be exempt from property tax for a period of seven years from the year in which they paid stamp duty. This is to reflect the fact that …*many home owners paid considerable amounts of stamp duty*… particularly from 2000 up to 2008. In our view a transitional arrangement of this type is essential in making the transition from a system based on payment of taxes at the time of purchase to a system based on an annual tax. It may be, however, that a more refined system is needed. For example, the amount of stamp duty paid depends in part on the point of the house price cycle at which the purchase took place. A recent purchaser of a house may have paid much less in both stamp duty (and purchase price) than the buyer of a similar house at the peak of the cycle in late 2006/early 2007; but the system proposed by the Commission would give greater relief to the later purchaser. Similarly, the amount of stamp duty paid depends on the rates and rules of stamp duty in force at the time. Again, purchasers in recent years have benefited from a lowering of rates and the shift to a banded system, whereas earlier purchasers paid stamp duty at higher rates. Thus, in order to make the outcomes more equitable, a system may need to be devised which takes greater account of actual stamp duty paid, while discounting for the passage of time, possibly treating the stamp duty as a "prepayment" of property tax. In this event, the relief would use a formula which mimics the annual property tax which would have been payable if that tax had been introduced at the time of the house purchase.

3. Taxable Child Benefit

Child benefit is currently paid in respect of all children under 16 years of age, and those aged 16 or 17 years in full time education.[14] Currently child benefit is not included in the definition of income for taxation purposes. The Commission advised that Child Benefit should be included in taxable income,[15] but that this suggestion should be compared to the alternatives (such as means testing). The *Report of the Special Group on Public Service Numbers and Expenditure Programmes* also suggests either making Child Benefit taxable, making it a means-tested benefit or reducing rates to arrive at a 20 per cent cut in expenditure. The Report advises that savings of over €500 million could be achieved by creating a standard rate of €136 a month. Currently, if a family has three or more children they receive a rate of €166 for the first two children and a higher rate of €203 for the third or subsequent children. The rationale for this approach was that larger families were found to be at greater risk of poverty, so that a policy offering greater support to larger families could help to reduce poverty risk in a targeted way.[16]

There is extensive research on the structure of child income support which can be used to inform this choice. An increased, taxable child benefit was analysed by Callan (1991). Nolan (1993) reviewed the multiple objectives of child income support and proposed a reduction in child dependant additions, along with an increased, taxable child benefit. Callan *et al.* (2006) reviewed both taxable child benefit and a form of means-tested payment labelled "Child Benefit Supplement", designed to replace the child additions payable with social welfare payments, and, at least partially, the Family Income Supplement Scheme[17] Policy over the 1990s and the early years of this decade did not follow any of these paths. Instead, child benefit was increased without making it taxable. The options now being considered, in the face of the fiscal crisis, are:

- A cut in payment rates. This could maintain the current higher rate for large families, or, as proposed by The Report of the Special Group on Public Service Numbers and Expenditure Programmes, move to a standardised payment rate.
- Move to means-testing of the payment.
- Include child benefit in taxable income, so that those on the lowest incomes would be protected, and those on the highest incomes would see the greatest reduction in "net" child benefit payments.

A means test on Child Benefit would involve a new "benefit withdrawal rate" which acts to increase effective marginal tax rates. Thus it could lead to a disimprovement in the balance between income in work and income out of work, and would certainly lead to higher marginal tax rates facing some of those in work. Making the payment taxable would also lead to some impact on marginal tax rates, as some of those with children would move to a

[14] A half-rate payment is made in respect of 18 year olds at present, but Budget 2009 indicated that this would cease from January 2010.

[15] "Taxation of child benefit" is sometimes taken to mean that the payment would itself be reduced. The "inclusion of child benefit in taxable income" or "making child benefit taxable" are more precise descriptions of the policy change envisaged. Child benefit is usually paid to the mother, and the amount paid in this way would be unchanged.

[16] Akerlof (1978) shows how "tagging" based on income-related characteristics can provide a better outcome than directly relating payments to income.

[17] Initially known as "child dependant additions" and currently known as "qualified child increases".

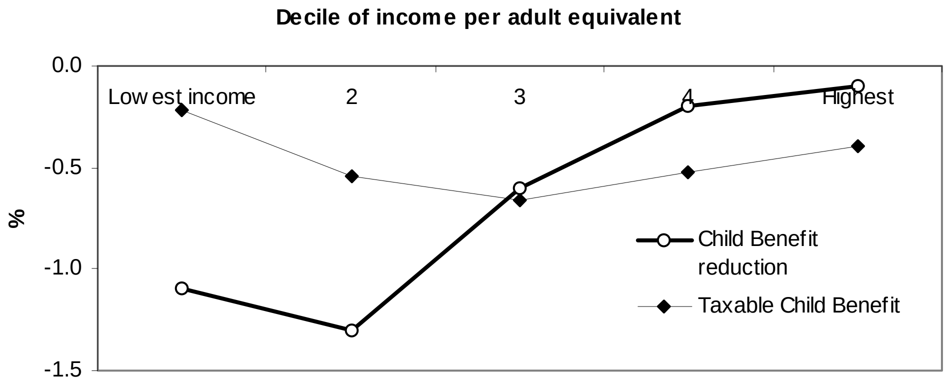
higher tax rate, or into the tax net – but the net impact on incentives would be lower. The least impact on financial work incentives would arise from the "rate-cutting" option, which would reduce income in work and in unemployment by the same amount, leaving the gap between the two unchanged.

What of the distributive effects of the alternatives? Here we focus on the taxable child benefit and rate cut options. The impact of the means-testing option depends crucially on the level of income at which withdrawal of benefit would begin, and on the rate of benefit withdrawal. There is no indication in official documents of how these parameters would be set.

Using the ESRI tax benefit model, *SWITCH*, it is possible to examine the overall impact of reducing Child Benefit rates or, alternatively, including Child Benefit in taxable income. *SWITCH* is based on a large scale, nationally representative sample of households and allows analysis to be carried out at tax unit level. Along with providing an estimate of savings that can be made for the exchequer it also allows us to examine the numbers affected by the policy change, the effects across the income distribution and the effect on poverty risk. Our survey-based estimate indicates a saving of about €450 million can be made by reducing the Child Benefit rate to €136 per month. This represents about 88 per cent of the impact as estimated by the Special Group; but a key advantage of the microsimulation approach is that we can identify how this impact differs across the income distribution. The inclusion of Child Benefit in taxable income could result in an increase in tax revenue in the region of €370 million per year. The Commission proposed a a tax credit to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale. It is not clear how this would be structured, but a tax credit which was only available to those in the lower half of the income distribution would have to be withdrawn gradually – making it more like a means-tested system. For both of these reasons, we do not attempt to simulate this here, and keep taxable child benefit, means-testing and rate-cutting as distinct options. The introduction of such a tax credit would reduce the Exchequer's tax revenue but would lessen the negative impact on the income of those in lower income deciles.

Reducing Child Benefit rates affects a larger number of tax units in the middle of the income distribution compared to the higher and lower end of the income distribution. As expected, making child benefit taxable affects a relatively small number of tax units in the bottom two income deciles as lower income deciles have a smaller tax liability due to low income levels. Figure 1 shows the average percentage loss in disposable income by income decile under the two approaches. Reducing the Child Benefit rates to a standard €140 per month results in an average loss in disposable income of 1 per cent for the lowest income quintile compared to a loss of 0.2 per cent for the highest income quintile. Making Child Benefit taxable results in a fall of disposable income of 0.2 percent for the lowest income decile compared to a 0.4 per cent reduction for the highest earners. A reduction in the Child Benefit rates, therefore, has a larger negative impact on disposable income for those on lower incomes compared to making Child Benefit taxable. It also results in a smaller loss for the upper income deciles compared to the inclusion of Child Benefit in taxable income.

Figure 1: Percentage Change in Disposable Income for Alternative Child Benefit Policy Changes: Making Child Benefit Taxable Versus Reduction in Child Benefit Payment Rates



Finally, we can examine the impact on child poverty rates of the two alternatives compared to the current 2009 budget. We focus on one of the key measures used by the EU Commission, the "at risk of poverty" measure, based on an income poverty line at 60 per cent of median income per adult equivalent. Reducing the rate of Child Benefit to €136 is associated with an increase of 1.2 percentage points in the head count version of the "at risk of poverty" measure for children. The inclusion of Child Benefit in taxable income would lead to a smaller increase of 0.6 percentage points. When a "poverty gap" measure is used, taking account of the depth as well as the extent of income poverty, the taxation option leads to a 3 per cent increase whereas the reduction to a new standard payment leads to a 17 per cent increase.

In our view, the inclusion of Child Benefit in taxable income provides a better structure for child income support. It allows for the possibility of effecting reductions in aggregate Child Benefit expenditure while affording protection to those on the lowest incomes. It has been indicated that there are serious technical difficulties in implementing such a change within a year. If it would take longer to implement such a policy, this should still be the medium term goal. In current circumstances, one could envisage, for example, a commitment to move to this structure, with temporary cuts in Child Benefit payment rates to be restored when Child Benefit is made taxable.

4. Conclusions

This paper has looked at two main areas for broadening of the tax base: an annual tax on property and Child Benefit.

Key findings from our analysis include the following:

- A property tax could raise substantial revenue, even when account is taken of an income exemption limit and marginal relief which ensure that there are few losses, if any, among those on the lowest incomes (the lowest 20 to 30 per cent of the income distribution).
- The share of property tax payable by those resident in the Dublin region would be similar to their share of income tax.

- We compared the inclusion of child benefit in the income tax base and a cut in child benefit rates to achieve the same net reduction in exchequer cost. This showed that the inclusion of Child Benefit in taxable income allows for the possibility of effecting reductions in aggregate Child Benefit expenditure while affording protection to those on the lowest incomes.

REFERENCES

AKERLOF, G., 1978. "The Economics of Tagging as Applied to the Optimal Income Tax and Other Things", *American Economic Review* (March).

AUERBACH, A. J. and J. Hines Jr., 2002. "Taxation and Economic Efficiency", in A. J. Auerbach and M. Feldstein (eds.), *Handbook of Public Economics*, Edition 1, Volume 3, Chapter 21, pps. 1347-1421, Amsterdam: Elsevier.

CALLAN, T., 1991. *Principles and Policy Options*, Policy Research Series Paper No. 12, Dublin: The Economic and Social Research Institute,.

CALLAN, T., C. KEANE and J.R. WALSH, 2009a. "What Role for Property Taxes in Ireland?", ESRI Working Paper No. 322, October. www.esri.ie.

CALLAN, T., C. KEANE and J.R. WALSH, 2009b, forthcoming. *Pension Policy: New Evidence on Key Issues,* Research Series, Dublin: The Economic and Social Research Institute.

CALLAN, T., K. COLEMAN, B. NOLAN, J.R. WALSH, 2006. "Child Poverty and Child Income Supports: Ireland in Comparative Perspective" in T. Callan and A. Doris (eds.), *Budget Perspectives 2007*, Dublin: The Economic and Social Research Institute.

CLARK, T., C. GILES and J. HALL, 1999. *Does Council Tax Benefit Work?*, London: Institute for Fiscal Studies.

COMMISSION ON TAXATION, 2009. *Commission on Taxation Report 2009*, Dublin: Stationery Office.

CONNIFFE, D. and D. DUFFY, 1999. "Irish House Price Indices: Methodological Issues", *The Economic and Social Review,* Vol. 30, No. 4, October.

CENTRAL STATISTICS OFFICE, 2008. *Survey on Income and Living Conditions (SILC) in Ireland*, Cork: Central Statistics Office.

DEPARTMENT OF SOCIAL AND FAMILY AFFAIRS, 2007. *Green Paper on Pensions*, Dublin: Stationery Office.

DUFFY, D., 2009. "Measuring House Prices in Ireland" in A. Barrett, I. Kearney and J. Goggin, *Quarterly Economic Commentary*, Spring 2009, pp. 18-21.

FOSTER, J., J. GREER, E. THORBECKE, 1984. "A Class of Decomposable Poverty Measures", *Econmetrica,* Vol. 52, No. 3, May, pp. 761-766.

HARBERGER, A.C., 1964. "The Measurement of Waste". *American Economic Review*, Papers and Proceedings, Vol. 54, May, pp. 58-76 (a).

HEADY, C., 2009. "Review of International Experience", paper presented to Foundation for Fiscal Studies Annual Conference on 'The Fiscal Treatment of Property', May.

HUGHES, G., 2005. "Pension Tax Reliefs and Equity" in J. Stewart (ed.), *For Richer, For Poorer: An Investigation of the Irish Pension System*, Dublin: tasc/New Island Press.

HUGHES, G. and A. SINFIELD, 2004. "Financing Pensions by Stealth: The Anglo-American Model and the Cost and Distribution of Tax Benefits for Private Pensions" in G. Hughes and J. Stewart (eds.), *Reforming Pensions in Europe: Evolution of Pension Funding and Sources of Retirement Income,* Cheltenham: Edward Elgar.

JOHANSSON, A., C. HEADY, J. ARNOLD, B. BRYS, L. VARTIA, 2008. "Taxation and Economic Growth", OECD Economics Department Working Papers, No. 620, OECD publishing © OECD. doi: 10.1787/241216205486

JOUMARD, I. and. P.M. KONGSRUD, 2003. "Fiscal Relations Across Government Levels", OECD Economics Department, Working Paper No. 375.

McCLUSKEY, W.J. (ed.), 1999. *Property Tax: An International Comparative Review*, Aldershot: Ashgate Publishing Limited, pp. 1-458.

McCLUSKEY, W.J. and A. ADAIR, 1997. *Computer Assisted Mass Appraisal Systems*, Avebury, London: Gower.

McCLUSKEY, W.J., P. DAVIS and L.C. LIM, 2007. "Domestic Rate Reform in Northern Ireland: A Critical Review of Policy Options", *Environment and Planning: Government and Policy*, Vol. 25, pp. 131-149.

McCLUSKEY, W.J., F. PLIMMER and O. CONNELLAN, 1998. "Ad Valorem Property Tax: Issues of Fairness and Equity", *Assessment Journal*, May, pp. 47-55.

NOLAN, B., 1993. *Reforming Child Income Support*, Dublin: Combat Poverty Agency.

NORTHERN IRELAND DEPARTMENT OF FINANCE AND PERSONNEL, 2002. *Review of Rating Policy: A Consultation Paper,* Bangor: Department of Finance and Personnel Rating Division.

NORTHERN IRELAND DEPARTMENT OF FINANCE AND PERSONNEL, 2004. *Reform of the Domestic Rating System in Northern Ireland: Policy Paper – A Fairer Share,* Bangor: Department of Finance and Personnel Rating Division.

NORTHERN IRELAND DEPARTMENT OF FINANCE AND PERSONNEL, 2007. *Reform of the Domestic Rating System in Northern Ireland: A Consultation Report,* Bangor: Department of Finance and Personnel Rating Division.

NORTHERN IRELAND DEPARTMENT OF FINANCE AND PERSONNEL, 2009. *Review of Domestic Rating: A Consultation Report*, Bangor: Department of Finance and Personnel Rating Division.

OECD, 2009. *Pensions at a Glance*, Paris: OECD.

OECD, 2006. *OECD Economic Surveys: Ireland*, Paris: OECD.

PENSIONS BOARD, 2005. *National Pensions Review*, Dublin: The Pensions Board.

PENSIONS POLICY INSTITUTE, 2005. *A Commentary on the Pension Reform Debate*, London: Pensions Policy Institute.

POTERBA, J., 2009, forthcoming. "The Challenge of Tax Reform and Expanding the Tax Base", ESRI Geary Lecture, Dublin: The Economic and Social Research Institute.

SPECIAL GROUP ON PUBLIC SERVICE NUMBERS AND EXPENDITURE PROGRAMMES, 2009. *Report of the Special Group on Public Service Numbers and Expenditure Programmes 2009*, Dublin: Stationery Office.

APPENDIX: SIMULATING WELFARE AND INCOME TAX CHANGES (*SWITCH*)

When considering the potential impact of tax changes, calculations are often undertaken for just a small number of illustrative families. This approach has severe limitations. For example, less than one family in 20 falls into the category of "one-earner couple with 2 children" which attracts so much attention at budget time. Furthermore families within this category differ in terms of income, housing tenure, and other characteristics that affect their tax-benefit position. More fundamentally, analysis of hypothetical families - no matter how well chosen - simply cannot give an overall picture of the impact of a policy change on incomes and work incentives. For this reason, in many countries policy changes are assessed using tax-benefit models which are based on large-scale nationally representative samples of households. This ensures that the models represent as fully as possible the great diversity of household circumstances relevant to tax and social welfare. Several countries including the UK and the US have models which are maintained and used by official departments or agencies, as well as models developed and used in the academic sector (e.g., the Institute for Fiscal Studies, the Tax Policy Center in Washington and the Microsimulation Unit at the University of Essex). In Ireland, the ESRI has developed a microsimulation model of the Irish tax and benefit systems, *SWITCH* (*S*imulating *W*elfare and *I*ncome *T*ax *CH*anges).

The current *SWITCH* database uses data from the EU's Survey on Income and Living Conditions (EU SILC) for the year 2005. The survey contains detailed information on more than 6,000 households including about 15,000 individuals. These data include detailed information on household size and composition, labour market participation, incomes from work and occupational pensions, and from receipts of social welfare payments. The *SWITCH* database is adjusted from year to year to allow for key changes in incomes and population structure as forecast for the next budgetary year. Changes in social welfare rates, income tax rates, bands and allowances, and the structure of employee PRSI are taken into account within the model. Using these data the model has been developed to simulate the rules of the welfare and tax systems so as to allow it to predict the tax liabilities and welfare entitlements of respondents under the existing tax/welfare rules and under alternative reforms.

The capabilities of the model include:

- Estimation of the net budgetary cost of packages of tax and welfare changes. Alternative reform packages with the same budgetary cost can therefore be constructed.
- Estimation of the pattern of gains and losses from a policy change. The numbers of families gaining and losing and the size of their gains and losses can be estimated, and the distribution of gains and losses across family types and income levels can be explored.
- Estimation of the impact of policy changes on effective marginal tax rates.

The model has now been extended to allow for the modelling of various property tax options. This required the use of data contained in the survey on house values, and the establishment of a set of rules for modelling property tax liability. Full details can be found in Callan *et al.* (2009a). While the permanent tsb/ESRI House Price Index has fallen just under 25 per cent from its peak in early 2007, we allow for a greater fall in order to arrive at a somewhat conservative estimate of potential revenue from a property tax. The discount factor applied to the values reported by respondents in 2005 is one-third, implying an even greater fall from the peak values in late 2006/early 2007. This assumption is not a forecast, and it differs somewhat from the assumption used by the Commission itself in its analysis. However, as the revenue potential depends not only on the value of the housing stock, but on the product of this value and the rate applied, this does not affect the relevance of the analysis of the distributional impact under alternative waiver schemes.

THE RECESSION, BUDGETS, COMPETITION, AND REGULATION: SHOULD THE STATE SUPPLY BESPOKE PROTECTION?

Paul K. Gorecki[*]

1. Introduction

Recessions are harsh. Demand declines. Firms shed labour, reduce output or file for bankruptcy. Pressure mounts to reduce prices and increase productivity. Returns decline; margins are squeezed; dividends are suspended. Unemployment increases. Firms seek to delay payments to suppliers, while simultaneously demanding suppliers reduce input prices and extend credit. Carefully assembled workforce teams are broken up. New products and innovations are put on hold. Competition is characterised as cut-throat, destructive and excessive. Faith in markets begins to be questioned.

As a result some producers, often with the support of organised labour, demand protection or shelter from market forces in a recession. The demand for what will be referred to as bespoke protection takes many forms from legislative to budgetary. The state is asked to provide free insurance against the impact of the recession, usually to well organised and articulate groups. Of course, the state already provides protection against the effects of the recession through universal programmes: for individuals, unemployment benefits, medical cards and, in exceptional cases, mortgage

[*] This paper has benefited from comments and suggestions made by ESRI colleagues at a lunchtime seminar on 27 May 2009. I should like to thank Seán Lyons, Noreen Mackey and Fran O'Toole for commenting and discussing an earlier version of the paper as well as two anonymous referees for their helpful suggestions. The paper reflects events as of 26 August 2009. The usual disclaimer applies.

assistance; and, for firms, bankruptcy and limited liability laws. This paper focuses on bespoke protection, rather than universal programmes.

A superficially plausible case can be made for responding to these demands by providing bespoke protection. Unprecedented times demand, it is argued, radical solutions. Government, many believe, should preserve jobs to the maximum extent possible. The banking crisis and light touch regulation demonstrates liberal capitalism has failed. There is a need to tame the market. Too much competition, or what has been referred to as 'overcompetition,' leads to destructive and cut-throat competition driving firms, employees and their families into penury. The intervention need only be temporary. Thus, there will be no long-term adverse impact on growth and productivity. This paper considers the validity of such arguments.

There are three inter-related issues that need to be addressed by the state in considering the demand for bespoke protection:

- On what criteria or grounds should the state supply such free insurance to particular groups in recessionary times? In other words, why should the state intervene?

- How and in what form should the state provide the protection? The state has a number of instruments that it can use to supply the protection demanded, from budgetary to regulatory; and

- What are the consequences of providing bespoke protection, in terms, for example, of productivity and growth? What can be learnt from previous examples of protection provided in similar circumstances? Will bespoke protection impede the rapid recovery scenario from the current recession as set out in Bergin *et al.* (2009, Figure 2, p. 11)?

In answering these three questions two alternative approaches are used: public choice and welfare economics. Public choice is about explaining the actions of public representatives based on the assumption that politicians make choices that they think will get them re-elected. In contrast, welfare economics focuses on the overall welfare of society. It is more about what politicians *should* do and about working out the consequences of sub-optimal decisions by politicians.

The paper is divided into five sections including the Introduction. Section 2 considers the alternative instruments that governments can employ to provide bespoke protection and the merits, from a public choice perspective, in a tight budgetary situation of favouring off-budget instruments such as regulation and competition. Section 3 presents some actual or proposed recent examples of the provision of bespoke protection – restrictive regulatory and competition interventions. In each case a public choice and welfare economics approach is considered. Attention turns in Section 4 to the costs and benefits of providing bespoke protection, drawing both on the Irish and international experience. A bleak picture emerges of the economic costs of acceding to the demand for bespoke protection, while some of the benefits are transitory. Section 5 compares the answers to the three questions set out above using the public choice and welfare economics frameworks. The answers are not the same. The public choice model results in granting bespoke protection which is not justified using welfare economics criteria. This suggests that welfare can be improved if mechanisms can be put in place that result in political decisions closer to those favoured by welfare economics.

2. Some Preliminary Observations: Instrument and Public Choice

INTRODUCTION

The purpose of this section is to provide a thumbnail sketch of how the public choice mechanism can influence government intervention. Attention is also devoted to how the predictions derived from public choice with respect to instrument choice are reinforced by the current recession. A particular Irish twist that solves two of the problems inherent in public choice is discussed next. The section concludes with a brief discussion of whether or not welfare economics and public choice are likely to respond to demands for bespoke protection in a similar manner.

INSTRUMENT CHOICE

Governments can intervene to supply relief from market forces. Governments have a rich menu of instruments of intervention from which to choose. These can be divided into three broad categories:[1]

- Budgetary, such as subsidies (e.g. overpayment for goods and services, award contracts on non-competitive basis, modernisation and R&D grants and so on) and tax expenditures (e.g. tax relief for investing in selected activities such as multi-storey car parks and holiday camps);

- Regulatory, such as restricting entry by placing a cap on the number of participants in a regulated activity and/or mandating price reductions in a regulated activity; and

- Competition, such as partial or complete exemption of certain markets or professions or other groups from competition law and/or budget reductions/reorganisations of the competition agency that lessen operational effectiveness.

These instruments are substitutes in many policy contexts in that each can be used to achieve the same policy objective.

An example illustrates the point. After the decline in the value of sterling at the end of 2008 due to the UK recession, Irish shoppers increasingly turned to Northern Ireland for their groceries.[2] Retailers in Ireland eventually reacted by reducing some prices, evidenced by Tesco's announcement on 5 May 2009 (Tesco, 2009). This in turn put pressure on food processor margins and farm gate prices. Demands for bespoke protection from the impact of these pressures could be met in various ways:

[1] There are, of course, other instruments that the state could employ. For example, Trebilcock *et al.* (1982) consider public inquiries and public enterprise, but do not consider competition policy. In part this reflects the different contexts within which choice of instrument is considered. In this paper the context is the recession, while for Trebilcock *et al.* (1982) the context was part of a larger study of regulation.

[2] For further discussion of these developments see Revenue Commissioners/Central Statistics Office (2009).

- Budgetary assistance through a tax on food which would be redistributed to food processors and farmers, and/or grants to enhance productivity of processors and farmers and/or provision of an export credit scheme with a state-backed guarantee;[3]

- Regulatory assistance through the creation of a Retail Ombudsman to make sure that processors and farmers are paid sufficiently to ensure "equity and fairness in the food supply chain" and/or government instructions to the independent regulator, the Commission for Energy Regulation (CER), to reduce electricity prices,[4] and,

- Competition assistance through the exemption of food processors and farmers in dealing with retailers from the Competition Act 2002 (the Competition Act), so that producers can combine to offset the alleged buyer power of the supermarkets.

Of course, it is possible that these instruments can be used in a complementary manner, with one reinforcing the other.

If the state is to intervene to provide bespoke protection, the issue arises of what form the intervention might take. In other words, which of the three instruments are likely to be selected? In an era of budgetary restraint in Ireland consequent on the worldwide recession, exacerbated considerably by domestic policy failures, there are severe constraints on the extent to which these demands for protection can be met through *increased* budgetary measures.[5] Instead the relative attractiveness of the two off-budget balance sheet instruments identified above – regulation and competition policy – is likely to increase. These off-budget instruments have minimal public expenditure implications, while delivering the desired benefits to the group demanding protection. Vigorous competition policy and independent regulation designed to promote entry and competition for the benefit of consumers thus may be seen as unaffordable luxuries in a period of economic crisis, if the state decides to supply protection demanded by particular groups.

It should be noted that budgetary measures may be used to complement restrictive regulation and competition policies in times of recession if they involve a *reduction*, rather than an increase, in public expenditure. For example, the effectiveness of regulatory and competition agencies can be weakened through budgetary reductions and/or reorganisations. This weakening will lead to less vigorous enforcement of competition law, with the result that private arrangements to mitigate the impact of the recession,

[3] Apart from the tax on food, this response was favoured by food processors. For details see FDII (2009a; 2009b). In this connection it might be noted that the government announced in 2006 a €50 million investment grant package to beef and sheepmeat processors. For details see Department of Agriculture and Food (2006).

[4] The Retail Ombudsman is favoured by the farmers (IFA, 2009a) and FDII (2009a; 2009b), while the FDII also called for lower electricity prices in meeting the challenge posed by Tesco's price cuts. The quotation in the text is from IFA (2009a).

[5] For details of the budgetary situation see Barrett *et al.* (2009). The General Government Deficit is forecast to be 12 per cent of GDP in 2009, 11.5 per cent in 2010. While public net current expenditure will decline in nominal terms, in volume terms it will remain essentially constant over this period.

such as a cartel, are less likely to be detected and prosecuted. This, therefore, facilitates private, albeit illegal, market restrictions.[6]

PUBLIC CHOICE

Public choice is about explaining choices made by politicians.[7] A number of different assumptions have been made as to what politicians are maximising, what they are trying to achieve, what motivates and guides their selection of policies or other actions as public representatives. Trebilcock *et al.* (1982, p.11), for example, assume that proximate aim of politicians is …*maximizing the likelihood of their election or re-election.* In this respect politicians are competing for the marginal voters, since these voters are most likely to switch compared to infra-marginal voters. Friedman (1990, p. 546), in contrast, assumes that the …*politician is seeking to maximize his long-run income (plus non pecuniary benefits, one of which maybe 'national welfare')*… subject only to the constraint that they need to get re-elected.

Public choice theory sees politicians as operating in a market in which they supply (say) bespoke protection during a recession, in return for actions which contribute positively towards their aim or objective such as re-election. These actions might, for example, include campaign and other contributions to party coffers. Certain propositions have been developed using this framework which can assist in predicting the conditions under which politicians supply bespoke protection and the likely characteristics of the instrument selected.

A number of propositions have been developed in the public choice literature, which are particularly relevant in respect of instrument choice. Two are considered here, following the terminology adopted in Friedman (1990, pp. 545-548): [8]

- protection will favour concentrated not dispersed groups; and

- politicians will prefer transfers for which the information cost of determining what is going on is as high as possible for the victims –

[6] There is some evidence that cartels are more likely to occur in a recession. For example, Stephan (2009) finds, contrary to expectations, that many of the cartel infringements in the past 10 years …*indicate that many collusive agreements may be formed as a consequence of an economic downturn*. (p. 5). In Ireland the formation of a beef cartel was encouraged by the government in order to reduce overcapacity. The Competition Authority took a case under the Competition Act. Although the Competition Authority lost at the High Court, the case was appealed and aspects of the case were referred to the European Court of Justice ("ECJ") by the Supreme Court. The ECJ ruled that the beef capacity reduction arrangements were an infringement of competition law. The Supreme Court has still to decide whether despite being an illegal agreement there are offsetting advantages, which would mean that on balance the arrangements were consistent with competition law. The Supreme Court held the hearing on 25-26 May 2009. Judgment is awaited.

[7] It is, of course, the case that the discussion could be extended, as the literature shows, to include other important actors such as public servants. However, it could be argued in a country such as Ireland with a much smaller public sector – in absolute size – and thus a smaller span of control within a government department, compared to many other larger countries, that politicians are able to exert an unusually high degree of influence over decisions and hence it is appropriate to concentrate attention on politicians in this paper. See Trebilcock *et al.* (1982) for consideration of other actors besides politicians.

[8] A third is that more efficient transfers will be preferred to less efficient transfers. For a discussion see Friedman (1990).

> consumers and taxpayers – and as low as possible for the beneficiaries – small well organised groups.

The prediction that protection will typically be awarded to small concentrated groups rather than larger dispersed groups reflects a number of factors. *First*, there is a greater incentive to belong to a concentrated group than a dispersed group. This reflects the differing pay-offs or benefits. Let us assume that the bespoke protection is equivalent to €20 million that benefits 20 firms €1 million each per year, while the cost is borne by consumers through a small increase in price, equivalent €10 per household per year. The firm has a much greater incentive to belong to a group since the pay-off is substantial whereas for the household the cost is trivial. *Second*, there is an information problem. Members of a concentrated group are much more likely to be aware of the value of the benefit afforded by the protection and have an incentive – given its expected size – to estimate its magnitude. In contrast, a dispersed group is much less likely to be aware of the cost to them of the restriction and may not be in a position to estimate its magnitude. Furthermore, even if they were, given that the likely magnitude is small they may decide to remain what Friedman (1990, p. 547) and others call "rationally ignorant."[9]

Third, it is easier to overcome the free-rider problem for a concentrated than a dispersed group. Each group – whether it is the concentrated or dispersed – is providing a benefit that takes on the characteristics of a public good.[10] In other words, if the concentrated group is successful in securing protection (or the dispersed group successful in preventing the protection), then a firm (or member of the dispersed group) is likely to benefit irrespective of whether or not it contributed to funding, organising and participating in the group. Hence, if the firm (or member of a dispersed group) does not contribute to the group it still benefits and thus is referred to as a free rider. If there are too many free riders the group will not be formed, since insufficient subscriptions will be collected to fund the lobbying effort. Overcoming the free rider problem is much easier for the concentrated group since moral persuasion and social sanctions can be applied, which are much more difficult to apply to a dispersed group. There is, of course, the added problem of identifying members of the group, which is likely to be more difficult for the dispersed group. Thus, it is easier to free ride in the dispersed than the concentrated group. *Fourth*, the transaction costs of running a concentrated group are much more likely to be small compared to a dispersed group, especially given the above factors.

The second prediction is that politicians will prefer transfers for which the information cost of figuring out what is going on is as high as possible for the victims – consumers and taxpayers – and as low as possible for the beneficiaries – small well organised groups. This point is fairly obvious. Politicians have no desire for consumers and taxpayers to become aware that each of them is paying a small increase in price in order that income can be

[9] See Peltzman (1989, p.6).

[10] These are a very special class of goods which cannot practically be withheld from one individual consumer without withholding them from all (the *non excludability criterion*) and for which the marginal cost of an additional person consuming them, once they have been produced, is zero (the *non rivalrous consumption criterion*). Paul M. Johnson, "A Glossary of Political Economy Terms," http://www.auburn.edu/~johnspm/gloss/public_goods. (Accessed on 15 May 2009).

transferred to a concentrated group, particularly if that group is perceived to be well off and in some sense privileged. Hence, the provision of bespoke regulation is likely to be justified on grounds other than a transfer or quasi tax on a large group to benefit a small group. In the example cited above concerning assistance to food processors and farmers the bespoke regulation could be justified, for example, on grounds of ensuring equity and fairness in the food chain.[11]

It might, of course, be argued in some sense that the various special interest groups would cancel each other out. In other words, there would be some sort of balance that would neutralise the impact of these special interest groups.[12] However, there can be no assurance that this will occur in the context of this paper, in examining whether or not bespoke protection should be offered in a recession. Indeed, it is unlikely to be the case. It is often the case that these special interest groups combine to argue for protection, rather than oppose one another.[13]

There are a number of criticisms that could be made of the public choice explanation of when bespoke protection will be provided.[14] These criticisms are not so much that the discussion above is incorrect, but rather that it needs to be extended. It is not clear, from a public choice perspective, when the state will say 'yes' and when it will say 'no' to demands for bespoke protection.[15] There appear to be no bright lines that can be used to exclude demands from certain groups or activities, but not others. Equally, there are

[11] On 11 August 2009, the Minister for Enterprise, Trade and Employment issued a consultation document on proposals to establish an Ombudsman to enforce a code of practice for grocery good undertakings (Department of Enterprise, Trade and Employment, 2009). The consultation document referred to …*the need to achieve balance in the relationships between grocery undertakings, taking into account the need for a fair return to both suppliers and retailers, the need to enhance consumer welfare*…(p. 2). The proposals were welcomed by food processors (IBEC, 2009c) and farmers (IFA, 2009b), while retailers have, as yet, to take a position. In their initial reaction retailers talked about the necessity of ensuring, …*that no obstacles are put in the way of retailers securing the best value from their suppliers and, in turn, delivering the most competitive price to consumers* (IBEC, 2009b).

[12] There are instances where the interests of differing groups might to some extent offset each other. For example, in international trade negotiations there may be groups opposed to further liberalisation such as farmers and other groups such as exporters that are in favour of greater liberalisation and openness.

[13] A good example is the Voluntary Restraint Agreements ("VRAs") that between 1981 and 1985 artificially restrained the volume of car exports from Japan to the US. These were in reaction to the file jointly submitted by the Ford Motor Company and the United Auto Workers to the US International Trade Commission for relief from imports. Although it was unsuccessful it led to the VRAs. It has been estimated that in 1984-1985 the VRAs imposed the equivalent of an 11 per cent tariff on cars, with a benefit to producers of $2.6 billion, about a quarter of industry profits, but of course, there was also a positive impact on employment and wages. For details see Hufbauer (1991, pp. 121-125).

[14] There are, of course, more fundamental criticisms of the public choice approach. Trebilcock (2005, pp. 436-438), for example, points out how the move towards deregulation and vigorous competition policy are examples of policies that by and large benefit dispersed rather than concentrated groups. However, in Ireland these policies have not been followed with the same degree of vigour as in other countries. Attempts to reform the regulation in urban buses was a failure, while several of the examples of deregulation in Ireland – taxis and pharmacies – have come about because of judicial intervention, rather than public policy. Furthermore, as reported below, recent policy action by the state appears to signal a downgrading of competition policy.

[15] Becker (1983) presents a model where interest groups compete for rents that tries to resolve this issue.

many well informed groups demanding bespoke protection. Hence, while there may be information asymmetries between the concentrated group that receives such protection and the dispersed group that pays the cost, such asymmetries may not obtain with other concentrated groups, particularly in adjacent areas of economic activity. This poses a problem for the politician in that in giving bespoke protection to one concentrated group but not another it may alienate the latter group. In the discussion of social partnership below one possible method of resolving this is presented.

IMPLICATIONS FOR INSTRUMENT CHOICE

The second prediction has an implication for instrument choice. Restrictive regulation and relaxing competition policy are much more opaque methods of providing bespoke regulation than budgetary measures such as a tax increase. In the example cited earlier concerning the impact of price reductions on food processors and farmers, the government could impose a tax on groceries and then redistribute the revenue to the processors and farmers or it could set up a Retail Ombudsman to make sure that processors and farmers are paid sufficient to ensure "equity and fairness in the food supply chain." Both instruments of intervention have the same outcome in terms of redistributing income to farmers and processors, but in the latter case the transfer is cloaked in language designed to justify higher consumer prices that may well be acceptable, while a tax on food would probably result in howls of outrage, especially given that poor consumers spend a disproportionate percentage of their income on food. Perhaps it is for this reason that an ombudsman has recently been proposed by government.[16]

AN IRISH TWIST: SOCIAL PARTNERSHIP[17]

While these predictions are general, in the case of Ireland, a specific institutional structure, social partnership, has been put in place that is conducive to facilitating the introduction of bespoke protection. Although partnership is primarily concerned with pay bargaining, since its inception in 1987 its remit has gradually been extended so that now it …*is difficult to think of a policy issue that is not now the subject of some social partnership working group or another*… (Hardiman, 2006, p. 362). Social partnership is a corporatist arrangement whereby, primarily, representatives of organised labour and business, together with the government taking the role of chairman, reach multi-year agreements on important aspects of economic and social policy. For example, the partnership framework for 2006 to 2015 is 140 pages in length – not including a separate 11 page document on agriculture – and covers everything from the Irish abroad to better regulation.[18]

Partnership is essentially an interest or pressure group model of decision making. As noted above, it is typically the well organised groups representing labour and business which do a deal, with the blessing of

[16] See footnote 11 above for details.

[17] For a further discussion of partnership see for example, Boyle *et al.* (2004), Hardiman (2000, 2006), Roche (2009) and references cited below.

[18] For details see Department of the Taoiseach (2006). At the present time there are ongoing discussions to reach a new a partnership agreement between the social partners in view of the changed economic circumstances. It appears that reaching an agreement is proving challenging.

government.[19] There are no groups representing consumers. The advantages of any partnership agreement reached, even if it contains bespoke protection, is likely to be stressed by the parties to the agreement. It is very difficult for the outsider to unpick the deal, as the negotiating process and the various trade-offs reached are conducted in secret, with very little involvement of the legislature.

Social partnership helps resolve the co-ordination problems identified above with respect to the public choice approach as to when bespoke protection will be provided. The partnership process involves many if not all of the concentrated groups that are likely to demand bespoke protection. It thus provides a forum in which these groups can reach an accommodation as to which demands should be met.

This is not to deny that there may be benefits flowing from social partnership (Hardiman, 2000; 2006). The process may lead, for example, to a shared understanding of the problems facing the Irish economy and thus make resolution easier to formulate and implement. However, these benefits should not be exaggerated. For example, the OECD (2001, p. 26), based on Fitz Gerald (1999), questions whether partnership led to an outcome for wages that was any different from what market forces would have led to. As Fitz Gerald (1999, p. 162) states, *While helping to bring about a more orderly labour market, with fewer industrial disputes than in the 1970s, the partnership approach served more to validate the results which market forces had made inevitable.*

In view of subsequent developments in social partnership this conclusion arguably needs to be modified, perhaps even rejected. In particular, public sector pay rises awarded in 2003 and thereafter were based on a comparison of *equivalent positions in the private sector* (Kelly *et al.*, 2009, p. 342). The outcome of this benchmarking process was that the public sector pay differential with the private sector …*increased from less than 10 per cent in 2003 to almost 22 per cent in 2006, controlling for human capital and other relevant pay determining characteristics*… (Kelly *et al.*, 2009, p. 364).[20] In other words, it does not appear that there were any objective economic grounds for the increase in public sector pay compared to the private sector.[21,22] Such significant widening of the public/private sector pay differential is likely to have adverse macro-economic effects: competitiveness will suffer due to wage inflation in the private sector, the tax burden is increased and any downward adjustment in public sector wages in the current recession is likely to be difficult, raising the possibility of strikes and other forms of industrial action.

[19] While it is true that a third pillar, the community and voluntary sector, was added in 1997 (Hardiman, 2000, p. 293), …*the core economic actors – unions and employers – inevitably have a privileged status over the community and voluntary sector* (Hardiman, 2006, p. 348).
[20] This is likely to understate the differential since no account is taken of the fact that public servants have defined benefit, rather than defined contribution, pension schemes, that there is greater pension coverage in the public sector and there is much greater job security in the public compared to the private sector. Kelly *et al* (2009, p. 365) estimate that the impact of the greater pension coverage in the public sector is to raise the pay differentail in 2003 from 9.7 per cent to 12.9 per cent.
[21] The result is consistent with the hypothesis put forward by Boyle *et al.* (2004, p. 22) that partnership *conferred greater bargaining power than they [public sector unions] would otherwise have had.*
[22] The basis on which the increased differential was recommended was not made public and appears inconsistent with other evidence such as that on vacancies. For further details see O'Leary (2002).

ECONOMIC EFFICIENCY, INSTRUMENT CHOICE AND INTERVENTION

The rationale for intervention and the instrument selected using the public choice approach is unlikely to coincide with that provided by welfare economics, as illustrated in Table 1. Typically in the welfare economics approach the first question to be asked is: What is the rationale for intervention? In terms of the grounds for intervention, the relevant question is whether or not there is a market failure that merits intervention. The market failure might be a misallocation of resources due to the existence of a monopoly, the presence of negative externalities due to environmental pollution and so on. Given that there is a sound rationale for intervention, the next question is: What is the most appropriate instrument? The instrument selected is designed to be the most cost effective, with a preference for transparent instruments that increase accountability. There can be no guarantee that it will be off-budget rather than budgetary. Furthermore, before deciding whether to actually intervene there is a need to compare the cost of intervention with the benefits. The third set of issues is the economic and other consequences of intervention guided by welfare economics and public choice considerations. A priori it seems likely that interventions guided by welfare economics will improve the welfare of society whereas it is not at all clear that this will hold for interventions based on public choice. In the next two sections this latter issue will be discussed in more detail.

Table 1: Public Choice and Welfare Economics Models: Answers to Three Questions

Public Choice Model	Welfare Economics Model
Q1 Why? Political benefits> political costs	**Q1 Why?** Market failure
Q2 Which instrument? Regulation/competition; not budgetary	**Q2 Which instrument?** Preference for more transparent
Q3 Consequences? Concentrated groups will benefit at the expense of widely dispersed groups	**Q3 Consequences?** Increase in societal welfare

Source: See text.

3. Demand and Supply of Bespoke Protection: Some Recent Illustrative Examples

INTRODUCTION

There are already signs that the recession has resulted in increased demands for bespoke protection. In some cases the protection has been granted, in others the outcome is not yet certain as events unfold on a daily basis. The purpose of this section is to provide illustrative examples of the way in which regulation and competition may be used to provide bespoke protection in the current economic climate. In each case reference is made to whether or not from a welfare economics point of view there is a market failure that merits bespoke protection. The list is not exhaustive; it is meant to be illustrative only.[23]

REGULATION

There are a number of ways in which regulation can provide protection to those adversely affected by the recession. As noted above these ways include restrictive regulation and influencing regulatory decisions.

Restrictive Regulation:[24] *Proposed Cap on Taxi Licences*

Prior to 2000 entry into the taxi market had been restricted dating back to 1978.[25] Taxi licences acquired a substantial value.[26] Liberalisation occurred in 2000 as a result of a High Court ruling which found that the Minister of Transport could not impose limits on the number of taxi licences.[27] The number of taxi licences more than tripled between 2000 and 2004 (Goodbody, 2009, Table 4.3, p. 32). In the latter year a Taxi Regulator was established which presaged reforms such as a national fare structure and other changes. The number of taxi licences continued to climb, so that by 2008 the level was 50 per cent above 2004 and five times the level in 2000. Demand also increased. In Dublin, for example, there were 22 million trips in 1997, 27 million just after liberalisation and in 2008, 40 million (Goodbody, 2009, Figure 3.3, p. 18). Waiting times were reduced drastically: in Dublin, for example, 58.3 per cent of taxi users waited 10 minutes or less in 1997, by 2008 the corresponding percentage was 85.7 per cent (Goodbody, 2009, Table 6.3, p. 49).

In more recent times the gross earnings of taxi drivers has fallen – by 5 per cent between 2005 and 2008 in Dublin (Goodbody, 2009, p. 43) – and hours of work increased – by 8 per cent between 2005 and 2008 in Dublin (Goodbody, 2009, Table 5.8, p. 45). There are indications that as national unemployment grows and overall economic activity declines that the number of new taxi licences issued is declining, while the exit rate has increased.[28] Furthermore, it appears that there is some discounting of taxi fares, since the Taxi Regulator only sets maximum fares.[29] Terenure Taxis, which operates in south Dublin, for example, offers a 10 per cent discount off metered fares.[30] In other words, there is nothing unusual in the way in which the taxi market is functioning that might merit government intervention.

[23] It could, of course, be argued that the selection may be biased in that the most successful examples of bespoke protection will pass with little comment in the media. However, the author was a member of the Competition Authority between 2000 and 2008 and so would have been aware of attempts to supply bespoke protection through competition and regulation, since in both cases the Competition Authority would have been involved either directly or indirectly in making comments and presentations.

[24] Other examples include the Retail Ombudsman mentioned earlier in the paper.

[25] For details see Barrett (2006).

[26] See Table 2 below for details.

[27] Humphrey v. Minister for Environment and Local Government [2000] IEHC 149; [2001] 1 ILRM 241 (13 October, 2000). The judgment may be accessed at: http://www.bailii.org/ie/cases/IEHC/2000/149.html. Accessed on 19 May 2009.

[28] Goodbody (2009, Table 9.1, p. 78; Figure 9.1, p. 78).

[29] Goodbody (2009, p. 77).

[30] Based on an advertisement by Terenure Taxis in the free sheet *Town & Village* June 2009 issue on the front page. The free sheet is distributed to various places in south Dublin and claims a circulation of 20,000.

Under these conditions it is not surprising that taxi owners have organised to seek protection from the impact of the recession that has exacerbated a decline in income, a lengthening of the working week and pressure on prices. These demands continue despite the March 2009 report by Goodbody for the Taxi Regulator. The report rejected the call for a moratorium on the issuing of new licences, for which taxi organisations had called. Goodbody (2009, pp. 83-84) could identify no market failure which would justify such a policy move. Indeed, it pointed out the adverse effects on consumer welfare of such a moratorium. This has not stopped the clamour for government to provide bespoke protection to taxi owners.

SIPTU, which represents a number of taxi drivers,[31] for example, states:

> *We totally reject the notion that people should be expected to work longer, harder and for less pay ad infinitum.*
>
> *There is also an important question for us of having an appeals system in place to protect our members' rights, not to mention the health and safety implications of the Goodbody approach, for the travelling public and our members* (SIPTU, 2009).

Protests by taxi drivers have continued in support of these demands. Traffic is disrupted; consumers and others are inconvenienced.

Some elected representatives have lent more than a sympathetic ear to the plight of the taxi owners. The Chairman of the Joint Oireachtas Committee on Transport, Frank Fahey, criticised the methodology in Goodbody by stating that:

> *… it is like reading the front of* ***The Beano****. Mr Feeney [from Goodbody] has no idea about drivers' incomes. The driver of any cab into which one gets will tell you that he or she is earning below the minimum wage. They cannot all be fooling us. I have been in five or six cabs in recent weeks, the drivers of which tell me that they earned €50 over eight or nine hours. The report's finding is ludicrous and every cab driver in this city [Dublin] and throughout the country is hopping mad about it.* (Joint Oireachtas Committee on Transport, 25 March 2009, p. 8).

In the latter respect the Deputy preferred to rely on the information gleaned from taking five or six cabs as opposed to the representative sample included in Goodbody.

The Labour Party wants to introduce not only a moratorium on new licences, which it argues is consistent with Deputy Fahey's proposals in a new bill the Taxi Regulator Amendment Bill 2009, but also that before issuing new licences the regulator would be required to consider…*taking capacity and the demand-supply balance into account…* (Labour Party, 2009, p. 22). It is not clear why administrative intervention, rather than the market, is needed to make such decisions. Thus although the Minister has up until now

[31] The vast majority of drivers own and operate their cabs. …. Only a small minority of drivers are renting as opposed to owning a licenced vehicle. (Goodbody, 2009, p. 23). Thus SIPTU in this context is representing the self-employed rather than the employed.

rejected calls for a cap on the number of licences, the pressure continues for a moratorium on issuing new licences.

There seem to be three different concerns expressed with the regulatory regime. *First*, there is a concern that standards are not appropriate and that there are insufficient resources to enforce the existing rules. The solution to these problems is setting the correct standards and ensuring that there are adequate resources so that they can be enforced. *Second*, there is a concern that taxi drivers' earnings are in some sense too low. Restricting entry is the answer of the taxi organisations supported by some elected representatives. However, it is not clear what market failure would be addressed by a putting a cap on numbers. If the return is too low in this market then taxi drivers will exit and/or not enter in as large numbers. Indeed, as noted above this is the record of recent developments in the taxi market. Furthermore as Goodbody (2009, p. 84) points out there is no guarantee that a cap will raise incomes of existing taxi owners unless other restrictive rules are also introduced. *Third*, it is sometimes argued that it is necessary to restrict entry in order to ensure that proper standards are adhered to by the taxis. However, it is not at all clear why if enforcement of existing standards is adequate, that there is any linkage between the two. Indeed, in pharmacy where entry restrictions were introduced in 1996 in part on the grounds of improving quality, there is no evidence of any improvement, but pharmacy incomes increased substantially (Gorecki, 2009b). Finally, there is no evidence that when entry controls on the number of taxis were in place prior to 2000 that there were not problems with the quality of taxi services; on the contrary there was widespread dissatisfaction because of a shortage of taxis at certain times (Barrett, 2006, p. 4).

Influencing Regulatory Decisions: Electricity Prices

The Commission for Energy Regulation (CER) is an independent regulator of the energy sector, including electricity prices. It has processes and procedures concerning the conduct of its affairs and cycles for the review of key issues such as price and investment reviews. Adhering to those processes and procedures is important in terms of creating regulatory certainty and predictability. The greater the uncertainty and unpredictability the greater the regulatory risk, which translates into, for example, higher cost of capital with consequent adverse effects on price and investment for consumers.

Ireland's industrial electricity prices are high by EU standards. The National Competitiveness Council (NCC) regularly draws attention to this situation. (NCC, 2009, Figure 3.37, p. 65). IBEC (2009a) raised the question of high energy costs during the 2009 partnership talks, including at several meetings with the Minister for Communications, Energy and Natural Resources and the CER. It appears that in part as a result of these exchanges the Minister asked the CER to undertake a review of electricity prices to determine if prices could be reduced. More specifically the Minister stated:

> *We have a robust regulatory energy framework in Ireland which is transparent and encourages competition. It is right that we maintain the role of the CER as the decision-maker in terms of pricing. To this end, I am asking the energy regulator to undertake an immediate review of options to bring forward a reduction in electricity prices. Based on current trends I expect a double-digit decrease in electricity and gas prices this year.* (DCENR, 2009a, p. 1).

In response to the Minister's request the CER issued a proposed decision paper (CER, 2009a) and subsequently issued the decision (CER, 2009b). The CER complied with the Minister's request by:

> *…re-profiling network charges, bringing forward reductions now and repaying them next year, there can be a reduction in the short term. The advantages of this approach are that it is non-distortionary and benefits all electricity users regardless of their supplier.* (CER, 2009a, p. 21).

In other words, prices will be a little lower in the short term and a little higher in the medium term, compared to what they otherwise would be.

The action of the Minister clearly undercuts the perceived independence of a major regulator and thus increases regulatory risk for a very short term gain. The CER (2009a, p. 4) drew attention to this in its proposed decision: *[T]he re-profiling is not without risk, as it deviates from established regulatory process creating market uncertainty and introducing unpredictability into regulatory decisions.* In the CER's final decision, which summarised the various submissions received, several firms expressed concerns as to the impact of the re-profiling on regulatory risk and predictability.[32]

A number of observations can be made on the Minister's actions. *First*, if the aim of policy is to reduce energy prices, then there are a number of regulatory alternatives that can be considered. Some of these, for example, envisage reform in market structure. One change which has attracted considerable support is that Eirgrid, the transmission system operator, should own the transmission network, rather than the former vertically integrated monopolist in the electricity market, ESB.[33] However, the Minister decided to defer in March 2008 decision on this issue pending yet another report (DCENR, 2008). The promised senior independent chairman responsible for overseeing the process leading to the report was not appointed until 15 months later at the end of June 2009.[34] *Second*, it is not clear that any analysis was carried out concerning the economic rationale for the Minister's intervention. Is there a market failure? What are the benefits and costs of a small reduction today in prices compared to a slightly higher offsetting price later in 2009? Surely, if there are systematic problems with the regulatory regime they should be addressed directly rather than through ad hoc policy interventions. In other words, is it a sufficient rationale for

[32] For example, CER (2009b, p. 23) report that: *ESB Networks raised their concern that the re-profiling option significantly distorts the whole framework of unbundling and price regulation that has been developed over the last decade. Further to this it introduces significant additional risk and is likely to increase the perceived Regulatory risk in Irish network infrastructure assets and consequentially increase the cost of capital.*

[33] See, for example, Fitz Gerald *et al.* (2005), Competition Authority (2004a), OECD (2001), and Prasifka (2009).

[34] For details of the statement by the Minister see DCENR (2008) in which reference is made to appointing shortly a senior independent chair who in turn would *…appoint independent consultants to carry out the technical and economic analysis.* However, the Chair was not appointed until 29 June 2009. In the news release making the announcement, reference is made to an assessment of the costs and benefits and the regulatory impacts, for which input will be sought from *…all the direct key stakeholders: ESB and EirGrid managements, ESB and EirGrid unions and ESB Employee Share Ownership Trust* (DCENR, 2009b). No reference is made to consumers or other agencies such as the CER, the Competition Authority or others with a broader consumer/economic welfare perspective.

public intervention that one of the social partners is concerned enough that it raises the matter with the Minister?

COMPETITION

Competition policy has been strengthened considerably in terms of legislation and resources since 2000. The Competition Act 2002 (the Competition Act) modernised competition law in Ireland. Mergers were assigned to the Competition Authority and were to be assessed on a competition test, instead of a broad public interest test. Sanctions against criminal cartels were raised and the Competition Authority was given better and more effective investigative tools. The restrictive Groceries Order 1987, which criminalised reducing price below the invoice cost for certain grocery products, was abolished in 2006. The budget of the Competition Authority was raised substantially during the early part of the decade. However, with the onset of the recession the future for competition policy is not as favourable, as a number of measures have been proposed or implemented which have the effect either directly or indirectly of weakening competition law and enforcement in furtherance of the supply of bespoke protection.

In terms of the administration of competition policy a decision was made in October 2008 to merge the Competition Authority with the National Consumer Agency (NCA).[35] Ongoing discussions are taking place to implement this merger with legislation expected in late 2009/early 2010. Subsequently, it was announced on 18 June 2009 that the Consumer Directorate in the Financial Regulator will incorporated into the NCA.[36] Finally, the Special Group on Public Service Numbers and Expenditure Programmes (2009), headed by Colm McCarthy, recommended in its July 2009 report that the Irish Takeover Panel be merged with the Competition Authority.[37] These organisational changes are likely, in the short run at least, to reduce enforcement efforts of competition law.[38]

Two sets of activities have or are scheduled to be made partially exempt from the Competition Act:

[35] See Department of Enterprise, Trade and Employment (2008a; 2008b). For an analysis of the merger see Gorecki (2009a) which suggests little consideration was given to the problems and mechanics of the merger prior to the decision being made.

[36] See Department of Finance (2009).

[37] It is not clear on what basis this merger is being proposed. No cost savings are expected. It is not at all clear how the duties of the Irish Takeover Panel dovetail with the consumer and competition remit of the new Competition/NCA/Consumer Directorate in the Financial Regulator. A reading of *Special Group on Public Service Numbers and Expenditure Programmes* (2009, Volume 1, pp. 18-19; p. 27) does not fill this gap.

[38] This reflects: *first*, resources will have to be diverted from enforcement to address issues surrounding the merger of the Competition Authority and the NCA; *second,* there appear to be some differences in the way that the NCA and the Competition Authority view price fixing agreements. The two representative organisations of the publicans, the Vintners Federation of Ireland ("VFI") and the Licensed Vintners Association (LVA), announced a price freeze on behalf of their over 5,500 members from 1 December 2008 (VFI/LVA, 2008). The NCA broadly welcomed the announcement, but would have preferred that the emphasis was on reducing prices (Michael and Cullen, 2008). In contrast, the Competition Authority, which sees its role as promoting consumer welfare, saw the behaviour as a breach of competition law and successfully instituted legal proceedings against the two representative organisations, after unsuccessfully asking them to cease and desist (Competition Authority, 2009a; 2009b).

- trade associations representing medical professions in negotiating with the Minister for Health and Children are able under the Financial Emergency Measures in the Public Interest Act, 2009, to consult on the outcome of any such negotiation without contravening section 4 of the Competition Act;[39] and,

- voice-over actors, freelance journalists and session musicians are to be made exempt from section 4 of the Competition Act when engaging in collective negotiations.

In addition, under the Credit Institutions (Financial Support) Act 2008 the application of merger control is removed from the Competition Authority and transferred to the Department of Finance for certain classes of credit institution mergers. It should be noted, however, that the state cannot exempt firms in Ireland from EU competition law. Thus trade associations will still be subject to Articles 81 and 82 of the Treaty, while if mergers reach the European Union merger control financial and other thresholds they will be subject to assessment by the European Commission, not the Member State.[40]

Exemptions: Voice-over Actors, Freelance Journalists and Session Musicians[41]

As a result of an Competition Authority investigation into possible price-fixing between self-employed actors and advertising agencies for voice-over services, the union representing the actors, Irish Actors' Equity SIPTU, and the trade association representing the advertising agencies, Institute of Advertising Practioners in Ireland, agreed in 2004 not to enter into or implement any agreement that fixes fees for voice-overs (Competition Authority, 2004b). Subsequently, Equity tried unsuccessfully to persuade the Competition Authority that the former impugned agreements between it and the advertising agencies benefited from the exemptions set out in section 4(5) of the Competition Act and/or Article 81(3) of the Treaty.[42]

Broadly speaking section 4(5) of the Competition Act sets up a series of criteria whereby an agreement that would otherwise damage consumer

[39] For further discussion on this exemption see Gorecki (2009a) and *Competition* (2009). There is some question as to whether or not this is an exemption. It could be argued that consultation is not prohibited under the Competition Act, based on Judge Findlay-Geoghegan's recent decision in the pharmacists case (*Hickey and others vs HSE* (2007) 180 COM, and that all this amendment does is clarifies the position based on this judgment. It should be noted that in the past that some medical groups have employed boycotts to gain higher fees and/or preserve the status quo that resulted in the Competition Authority commencing proceedings under the Competition Act.

[40] It is, of course, the case that under certain conditions parts of a merger relevant to a particular Member State can be referred by the Commission to a Member State to assess. This occurred in 2008 when Heineken's proposed acquisition of Beamish and Crawford was referred back to Ireland to be dealt with the under the relevant section of the Competition Act.

[41] This discussion draws heavily on Gorecki (2009a).

[42] The author was the member of the Competition Authority responsible for reviewing the arguments put forward by the representatives of voice-over actors and with other members of the Competition Authority deciding that, in its view, the section 4(5) criteria were not met.

welfare is permitted.[43] These criteria, which include that the agreement promotes technical or economic progress, improves the production or distribution of goods, while allowing consumers a fair share of the benefits, are cumulative. Thus, the legislation strikes a balance whereby the damage caused by the price fixing is compared to the benefits and a judgment made. In other words, this is very much like a cost-benefit analysis that would be undertaken as part of the welfare economics approach used to award bespoke protection.

However, despite the fact that the Competition Authority considered that the agreement did not pass the tests set out in section 4(5), part of the text of the partnership agreement of September 17, 2008 reads as follows:

> *The Government is committed to introducing amending legislation in 2009 to exclude voice-over actors, freelance journalists and session musicians, being categories of workers formerly or currently covered by collective agreements, when engaged in collective bargaining, from the provisions of Section 4 of the Competition Act, 2002 taking into account, inter alia, that there would be negligible negative impacts on the economy or on the level of competition, and having regard to the specific attributes and nature of the work involved subject to consistency with EU competition rules.* (Dobbins, 2008).

It is well established that the Competition Act does apply to workers when they are self-employed, but not when they are employees. While agreements among voice-over actors etc. as to price may have only a negligible impact on the economy, it is nevertheless likely to raise prices in the affected markets. Indeed, in a recent recruiting drive, trade unions claimed that they raise the price of labour.[44]

Trading Places: Credit Crisis, Banks, Takeovers, and Mergers[45]

Since 1 January 2003, under the Competition Act, the Competition Authority has had responsibility for merger control in Ireland. All mergers above a certain turnover threshold have to be notified to the Competition Authority. This requires a thorough investigation to see whether the merger leads to a substantial lessening of competition (SLC) and if it does whether there are any remedies that might fix the competitive problems created by the merger. The Competition Authority is a specialist body with expertise in applying the SLC test to several hundred mergers since 2003.

This changed in 2008 with respect to banking where under certain conditions the Department of Finance administers the SLC test. To maintain the stability of the financial system guarantee arrangements to safeguard all deposits with respect to six Irish banks was introduced effective on midnight on September 29 2008 for two years. Coverage was subsequently extended to five banking subsidiaries with significant

[43] For further discussion see Whish (2009, pp. 148-164). Section 4(5) provides a legal exception to the prohibition in section 4(1) concerning agreements that prevent, restrict or distort competition, by, for example, price fixing, sharing/allocating markets and/or limiting production, by providing that it may be declared that section 4(1) is inapplicable if certain conditions – specified in section 4(5) – are satisfied.

[44] *See* http://www.ictu.ie/joinaunion/.

[45] This discussion draws heavily on Gorecki (2009a).

operations in Ireland.[46] However, the emergency legislation also amends the Competition Act to give the Minister for Finance control of merger review involving financial institutions.

For such mergers, if the Minister for Finance considers that the proposed one is necessary to maintain the stability of the financial system, then the Minister may approve the merger even if it will result in SLC. Under the legislation, the responsibility for determining whether the merger will lead to an SLC lies with the Minister for Finance, not the Competition Authority. Furthermore, although the Minister for Finance may as he/she sees fit consult the Competition Authority, the Minister may appoint a competition advisor other than the Competition Authority to assist in arriving at a view about SLC.

It is readily acknowledged that maintaining the stability of the financial system is vital for the functioning of markets. In an emergency, mergers may have to be approved rapidly. However, other jurisdictions have combined the flexibility of quick approval but still allowed a key role for the national competition authority in analysing the competitive effects of the merger.

The United Kingdom has one such system. Although the Secretary of State makes the final decision as does the Minister for Finance in Ireland, nevertheless the Office of Fair Trading (OFT) provides an analysis of the competition effects of the proposed merger. This has occurred with the anticipated takeover of Lloyds TSB plc of HBOS plc in which the OFT had from September 25 to October 24, 2008 to make a report to the Secretary of State.[47]

The Competition Authority could have been given a bigger role, especially as the Competition Authority's merger control function generally gets good marks in surveys.[48] There is ample evidence that competition problems are likely to arise in any merger situation involving banking in Ireland. In 2003, for example, the two leading banks accounted for between 65-75 per cent of the value of personal current accounts. Although there has been some entry since then, the market share of these two banks is unlikely to have declined significantly. As the Competition Authority has conducted an extensive analysis of the banking sector, it has expertise in the area.[49]

CONCLUSIONS

Two conclusions can be drawn from this discussion of recent examples of bespoke protection. *First,* the public choice model of awarding bespoke protection is unlikely to deliver outcomes consistent with welfare economics unless new or revised rules and/or policies are introduced, a subject dealt with in Section 5 below. While from a welfare economics viewpoint there are no grounds for either exempting voice-over actors from the Competition Act or imposing a moratorium on the issuance of new taxi licences, the public choice model would predict that both are candidates for bespoke

[46] More details may be found at the Department of Finance website, http://www.finance.gov.ie/.
[47] More details may be found on the Office of Fair Trading's website at: http://www.oft.gov.uk/advice_and_resources/resource_base/Mergers_home/comment/.
[48] Based on a survey of stakeholders undertaken independently in preparation for the three-year strategy of the Competition Authority, covering 2009-2011.
[49] Competition Authority (2005).

protection. *Second*, promoting competition as a policy objective – judged by government policy – has been accorded less weight since the onset of the recession.

4. The Costs and Benefits of Restrictive Regulatory and Competition Policy

INTRODUCTION

Just because these regulatory and competition interventions are off budget and relatively costless to implement in budgetary terms does not necessarily mean that such intervention is not costless. Indeed, the precise opposite is the case. Arguably restrictive regulation and competition costs are higher than budgetary measures designed to achieve the same objective. The latter are more transparent, easier to understand and quantify and thus more difficult to hide from the public. They are thus more likely to be subject to critical scrutiny. Furthermore, in recessionary times budgetary expenditure is less likely to be used to supply bespoke protection through, for example, subsidies. In this section the costs of bespoke protection are presented, together with the benefits.

THE COSTS

There are a number of costs associated with the granting of bespoke protection. These can be divided into four main categories:

- Lower consumer welfare as a result of higher prices and reduced quality of service;
- Misallocation of resources due to dissipation of resources in rent seeking behaviour and X-inefficiency;
- A less flexible economy that will underperform when the world economy recovers ; and,
- Dynamic losses that increase over time.

In each case the nature of the cost will be specified and evidence of the costs will be presented. In general the evidence refers to Ireland. However, the adverse impact of bespoke protection on the ability of Ireland to take advantage of the recovery in the world economy is based on evidence drawn from the US for the 1930s and Japan for the 1990s.

Lower Consumer Welfare: Higher Prices and Reduced Quality of Service

Bespoke protection of the sort discussed above reduces the scope for market forces to allocate resources. Typically in well functioning markets if prices are raised then entry takes place and/or existing firms expand output, thus moderating any price increase. However, with bespoke protection there is much less opportunity for these mechanisms to operate. Entry, for example, may be prohibited. The market becomes less competitive; prices are higher then they otherwise would be and the quality of service may decline. Consumers are worst off and the beneficiaries of bespoke protection are – initially at least – better off, an issue that will be discussed further below.

In many instances the future stream of benefits from bespoke protection are capitalised in the value of the right to engage in the economic activity that has been restricted. In the case of taxis, for example, it is the taxi licence, in the case of a pub it is also the licence. Table 2 presents estimates of the value of these licences for specific years expressed in 1999/2000 €. In some cases, as noted in the 'Comments' column, the bespoke protection has subsequently been abolished, an issue discussed further below. These licence values suggest a non-trivial transfer of resources from a dispersed group – consumers – to the concentrated group receiving the protection. In the case of taxis the evidence suggests that these licence values are high by international standards (Barret, 2006, p. 5).

Table 2: Impact of Restrictive Entry Regulation, Licence Value, Selected Activities, Various Years, Ireland

Regulated Activity	Year Licence Value Estimated	Value of Licence (€1999/2000)	Comment
Pharmacy	2002	Increased value of pharmacy by circa 40%	The restrictive regulations were revoked by the Minister due to a case brought in the High Court.
Pubs	2000	140,000	Geographical mobility of licence, 2000
Road freight	1980	40,000	Dail deregulated, 1986
Taxis	1999	101,000	High Court abolished controls, 2000

Source: OECD (2001, pps. 31, 32, 36) and Purcell (2004, pp. 51-52).

There is less evidence available on the impact of restrictive regulation on prices in Ireland, but the impact of restrictive regulation on airline routes was to raise prices by 18-33 per cent.[50] Weakening competition policy by exemptions and various administrative measures means that anti-competitive activity, such as cartels, is less likely to be investigated and prosecuted. A large worldwide survey of the impact of cartels on prices concluded that the median impact of a cartel was to raise prices by 25 per cent (Werden, 2008, p. 10).

With competitive pressure being less onerous the quality of service may decline. As noted above, waiting times for taxis decreased once entry controls were abolished. Similarly, with the liberalisation of entry into the airlines the number of destinations served from Dublin increased dramatically and consumers were given a choice of types of service – full service compared to no frills. Although referring to the UK, evidence suggested that where there was more competition among pharmacists service quality improved. For example, *…when a pharmacy faced no other pharmacy within 5km, it was less likely to offer home delivery…* (OFT, 2003, p. 44).

In some cases entry control is geographical thus leading to under-served populations. For example, the people of Knock, Co. Mayo were denied a pharmacy – until the relevant regulations were revoked by the Minister in 2002 due to a case brought in the High Court – despite the fact that Knock had 1.5 million tourists and pilgrims a year because the local health board determined that there was not a market for such a facility despite two

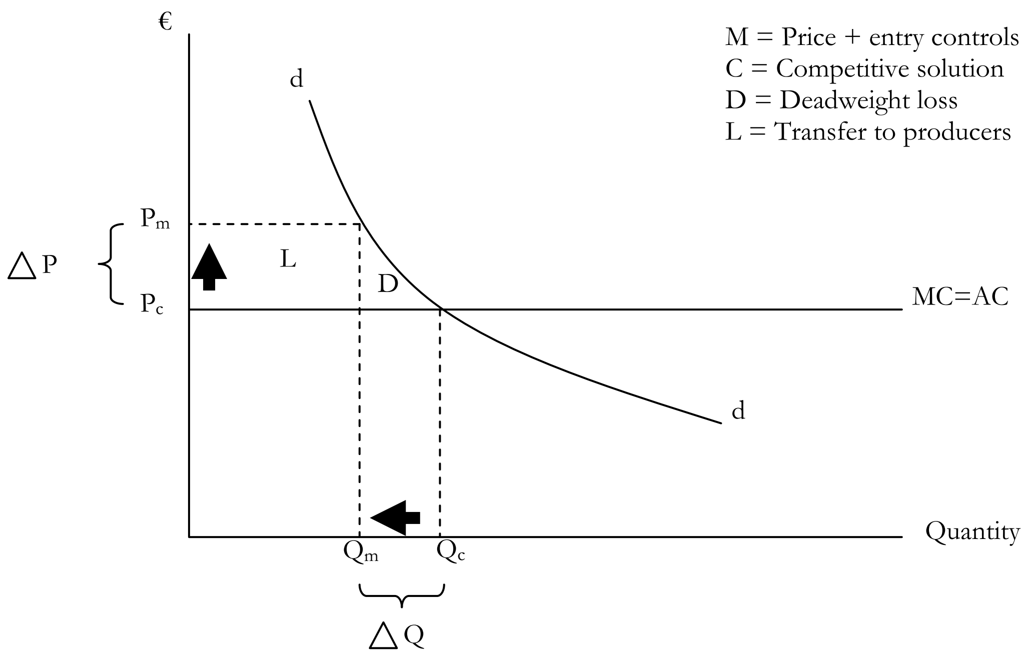
[50] Real decline in Dublin-London price 1985-1995 was 25 per cent; US airline deregulation 15 per cent price decline. In 1985 the Irish government announced that it had decided to deregulate air transport. For details see OECD (2001, p. 33).

applications to set up a pharmacy in Knock (Competition Authority, 2001b, pp. 12-13). A similar situation existed with respect to pubs where Dublin was considerably 'under-pubbed.' (Competition Authority, 1998, pp. 36-50).

Rent Seeking: Rectangles and Triangles

It could, of course, be argued that the above discussion has overestimated the costs of bespoke regulation, since what is being measured is the rectangle L in Figure 1 which represents a transfer from dispersed groups such as consumers to concentrated groups such as producers. Economists should be neutral on distributional issues. Instead attention should be confined to the deadweight loss of consumer welfare, represented by the triangle D. This is the so-called Harberger (1954) triangle, named after the economist that was among the first to estimate its magnitude due to monopoly, concluding that it was quite small, slightly more than 0.01 per cent of national income. However, this argument does not stand up to critical scrutiny.

Figure 1: Bespoke Protection, Prices and Output



Source: See text.

First, the redistribution of income has not been achieved in an open and transparent manner, compared to a tax increase. Considerable concern has been expressed about so-called stealth taxes; bespoke protection is only one remove from such stealth taxes.[51] *Second*, rent seeking behaviour in the form of lobbying for bespoke protection consumes resources. Such activities are concerned with wealth redistribution rather than wealth creation. Not all requests for protection can be granted. In the political marketplace it is difficult to set out criteria for accepting the demands of group A as opposed

[51] For example, restrictions on entry into taxi services not only redistributes income from consumers to producers, but also prevents the unemployed, for example, from supplying such services.

to group B. Firms and other organised groups will thus lobby for protection. Equally, in some cases, those who oppose bespoke protection will also organise and lobby. The use of resources for these purposes is considered unproductive and therefore a waste. Tullock (1967), Krueger (1974), and Posner (1975) have argued that resources devoted to demanding bespoke protection will be equal to the rectangle L. *Third*, once bespoke protection is awarded then the group that is in receipt of such protection may have to devote resources to retaining that protection as entrants may wish to share in the rents that are being generated. *Fourth*, the rents represented by L in Figure 1 may be dissipated by those in receipt of these rents in a variety of ways. Production may become less efficient as competitive pressure eases; X-inefficiency will become important. As a result cost curves will tend to drift upwards, with the result that the observed L and D based on actual cost data will understate the magnitude of both L and D. In sum, some or all of the rectangle L as well as the triangle D should be considered as the cost of supplying bespoke protection.

Thwarting the Road to Recovery

A recent ESRI recovery scenario for Ireland from the current recession envisages the possibility of a rapid recovery once the world economy starts to pick up (Bergin, 2009, Figure 2, p. 11). A critical implicit assumption is that resources will be able to flow from activities where demand is unlikely to expand such as construction to those where demand is likely to be more buoyant such as electronics and financial services. This in turn implies that there will be no artificial barriers that impede the flow of resources between markets. However, bespoke protection, by raising returns in the protected sector is likely to not only impede the flow resources but also slow adjustment and adaptation.

A number of recent papers have examined the impact of granting bespoke protection to markets in economies suffering a recession. In the US under Roosevelt's New Deal policies certain sectors were made exempt from antitrust laws and cartels were allowed to be formed provided that wages were raised. Cole and Ohanian (2004) in a careful study of the effects of these policies conclude that *New Deal cartelization policies are an important factor in accounting for the failure of the economy to recover back to trend* (p. 779). Equally, in Japan certain sectors were shielded from competition using a variety of instruments including *…weak antitrust enforcement, legalized cartels, subsidies, protection and cooperative R&D* (Porter *et al.,* 2000, p. 117). The evidence suggests that these sectors did not fare well in, for example, export markets. As a result Porter and Sakakibara (2004, p. 47) conclude that unless the *…serious impediments and distortions…* that developed in the 1990s are addressed then *…the period of Japanese economic stagnation will be unnecessarily protracted.*

Dynamic Losses: Bespoke Protection is Not Just for Christmas

The discussion above is largely in terms of static welfare losses. However, as the discussion of how bespoke protection can thwart the recovery from the current recession makes clear, there are ongoing losses which may increase over time. Hence, the dynamic effects of bespoke protection also need to be considered.

Dynamic effects can be divided into two broad groups. *First*, dynamic competition usually refers to innovation through new products and processes. Entrants are often the source of such competition, as they apply a technology from another market or a person leaves an existing firm to establish a new firm. Bespoke protection frequently restricts entry which removes this source of competition. Furthermore, this leads to less competitive pressure on incumbents who as a result are less likely to innovate. Thus bespoke regulation is likely to harm dynamic competition. As such it is inconsistent with the recently announced government policy of the promotion of the smart economy, which is based on innovation (Department of the Taoiseach, 2008).

Second, dynamic effects occur through the impact of the bespoke protection increasing as the constraints become more binding. The number of licences might be fixed or expand at a rate well below the increase in demand. The result is that each licence holder will experience an increase in demand. Since entry is restricted price is likely to increase and the value of the licence increase. This is clearly observable in the case of taxis where the licence value increased by almost 26 (in nominal terms) and almost 10 (in real terms) fold between 1980, two years after the introduction of bespoke protection to 2000, when it was terminated due to a High Court judgment. (See Table 3 for details).

Table 3: Taxi Licence Value, Dublin, Selected Years, 1980-2000

Year	Value (€) Nominal	Value (€) Real*
1980	4,400	4,400
1985	9,100	5,100
1990	54,600	26,000
1995	89,000	37,400
2000	114,000	42,300

* Deflated using CPI.
Source: Barrett (2006, Table 3, p. 6).

Dynamic costs associated with bespoke regulation will, other things being equal, increase with time. In this respect there are good grounds for arguing that once granted bespoke protection is difficult to reverse. Indeed, there is an inbuilt mechanism to ensure that the regulation becomes more restrictive and binding. The beneficiaries of bespoke protection will defend their turf and their lifestyle. They will adjust to their newfound wealth. In this context it is important to distinguish between the initial and subsequent beneficiaries of bespoke protection. While the initial beneficiary of bespoke regulation earns a rent represented by the capitalised value of the future returns in the licence, the new owner will only earn a normal rate of return and will have an incentive to realise unanticipated further gains. On the other hand, if the bespoke protection is withdrawn then the firms subject to the protection will experience large losses and hence are likely to vigorously resist change and reform.[52] Tullock (1975) has referred to this as the transitional gains trap. Thus bespoke regulation is likely to be long lived, not temporary.

The evidence presented in Table 4 is broadly consistent with this view, with protection lasting almost a century in the case of pubs. However, it is

[52] Of course, expectations about the stability of the regulatory regime will be incorporated into the price of a licence. If liberalisation is anticipated then a high discount rate will be used to evaluate future benefits. However, if no liberalisation is anticipated a lower discount rate will be used.

also true that in some cases that the bespoke protection was much shorter – six years in the case of pharmacies. In this case it was revoked by the Minister due to a case brought in the High Court. Efforts were made by both the government and the pharmacists' representative body to find a way of reintroducing the restrictive entry regulation but to no avail (Purcell, 2004, pp. 48-49).

Table 4: Restrictive Entry Regulation, Duration, Selected Activities, Ireland

Regulated Activity	Start	Reformed/ Abolished	Duration	Comment
Airlines	1932	1986	54 yrs	Abolished. Administrative act
Bus – Dublin	1932	No Reform	77 yrs +	Very restrictive licensing regime
Bus – Inter City	1932	No Reform	77 yrs +	Restrictive licensing regime
Cement	1933	2000	67 yrs	1 licence issued
Supermarkets	2001	No reform	8 yrs +	Restriction on store size of supermarkets, with a lower cap for discounters such as Aldi & Lidl
Pharmacies	1996	2002	6 yrs	Revoked by the Minister due to a case brought in the High Court
Pubs	1902	Partial reform, 2000	98 yrs+	Partial reform; geographical mobility of licence between country and Dublin
Road freight	1932	1986	54 yrs	Dail deregulated
Taxis	1978	2000	22 yrs	High Court abolished entry controls

Source: Barrett (2006); Competition Authority (1998, 2001a, 2008); Massey (2007); OECD (2001, pps. 31, 32, 33, 36).

CONCLUSION

None of the four sets of costs is likely to be readily apparent to the victims – consumers. The costs in terms of lower productivity are in the future and may take sometime to emerge. Linking bespoke protection to slowing the recovery from the current recession may be a difficult stretch for people to accept. Quantification of the impact of bespoke protection requires careful measurement and quantification. This can take considerable time and effort, thus delaying the necessary debate as to the appropriateness of bespoke protection. Nevertheless, in some cases consumers can make the connection between bespoke protection and low quality service, such as the long waiting times for a taxi because of restriction on numbers.

BENEFITS

The benefits and beneficiaries of bespoke protection appear, at first glance, a mirror image of the costs outlined above. The concentrated group, whether it is taxi drivers or pharmacists, receive rents, while the politicians receive support, in return for supplying bespoke protection, in various forms. However, this is somewhat misleading as has already been alluded to earlier in the paper. While it is the case that the firms engaged in the activity granted bespoke protection are in receipt of rents when the protection is first introduced, when the right is subsequently sold then some or all of the stream of future rents are capitalised in the value of the licence and subsequent participants are likely to earn a normal rate of return – with little or zero rent.

THE BANK GUARANTEE: A COUNTER-EXAMPLE?

It could be argued that one of the largest recent examples of bespoke protection, the two year bank guarantee provided in September 2008, referred to in Section 3 above, is an exception to the picture presented in this and earlier sections, that bespoke protection has little if any merit. It is not clear whether such protection was actively sought by bankers. Intervention to protect the banking system from collapsing is likely to be welfare enhancing, given the undoubted negative externalities in terms of the seizing up of credit markets and loss of faith in this vital sector of the economy. Hence, supplying bespoke protection in the form of the guarantee would, it could be argued, improve welfare and cure a market failure. However, is such a conclusion warranted?

There is an alternative version of events that is consistent with the view that the guarantee is an example of bespoke protection that is needlessly costly to consumers and taxpayers. It appears that the guarantee was supplied in response to the difficulties of one bank – supposedly Anglo-Irish – that was *…unable to roll-over its foreign borrowings and had effectively run out of collateral to refinance at the European Central Bank* (Honohan, 2009, p. 220). Other banks did not face a comparable situation. Hence an alternative course of action to the guarantee, given the insolvency of one bank, would have been to nationalise it and effect an orderly wind down, while at the same time introducing measures to provide more limited assistance to other banks should there be a risk of contagion.[53] Such measures might have included *…specific state guarantees for new borrowings or injections of preference shares* (Honohan, 2009, p. 220). Such intervention would not have provided protection to the shareholders of the bank at risk – unless the government overpaid – while the assistance to the other banks would have been limited and appropriately priced. This, of course, did not happen. Hence the fact that the protection provided through the bank guarantee was far more than necessary, suggests that the awarding of the guarantee is indeed an example of bespoke protection consistent with the thrust of the paper.[54]

It should be remembered, however, that the events surrounding the introduction of the bank guarantee and the information available is not all in the public domain so that any conclusion must, of necessity, be tentative.

CONCLUSION

Bespoke protection inflicts large enduring costs on both consumers and the wider economy, while the benefits are ephemeral. As such bespoke protection should be avoided.

[53] See Honohan (2009) and Fitz Gerald (2008). The latter suggests that this was the position of the Department of Finance.
[54] Honohan (2009) and Fitz Gerald (2008) list some of the negative economic consequences of the guarantee.

5. Towards a Solution

INTRODUCTION

In this section of the paper the threads of the discussion are brought together and the policy implications developed. The three questions raised in Section 1 are answered with respect to the demand and supply of bespoke protection. Next, attention turns to policies that should enhance welfare in deciding whether or not to grant bespoke protection. These policies include: the provision of better information; a regulatory budget; and, screens that should be applied before granting such protection.

TWO MODELS AND THREE QUESTIONS

Section 1 of the paper posed three questions with respect to bespoke protection: 'Why?'; 'Which Instrument?'; and, 'What are the Consequences?' These questions were answered within a public choice and welfare economics framework in Section 2, with the results summarised in Table 1. Sections 3 and 4 of the paper examined the record of bespoke protection in Ireland, enabling Table 1 to be amended to take into account the consequences of bespoke protection, with the results presented in Table 5. The burden of the paper is that the welfare economics model compared to the public choice model is based on a different rationale for supplying bespoke protection, favours using different instruments to provide the protection and has quite different consequences. The public choice model damages consumer welfare; the welfare economics model enhances consumer welfare.

Table 5: Public Choice and Welfare Economics Models: Answers to Three Questions: A Reprise

Public Choice Model	Welfare Economics Model
Q1 Why? Political benefits> political costs	**Q1 Why?** Market failure
Q2 Which instrument? Regulation/competition; not budgetary	**Q2 Which instrument?** Preference for more transparency
Q3 Consequences? Stalled recovery, lower consumer welfare, ephemeral benefits	**Q3 Consequences?** No slowdown in recovery, no long term consumer harm

Source: See text.

This naturally leads to the policy question of can policies or mechanisms be developed that will move policy outcomes closer to the welfare economics model than the public choice model. It may be objected that this is not feasible; that politicians would not agree to such a change. However, this is incorrect. Politicians often make commitments or tie their hands so as to limit their discretion in such a way that welfare is enhanced. For example, Ireland and other countries through GATT and then the WTO have committed through successive international rounds of cutting tariffs and reducing non-tariff barriers where the major beneficiaries are consumers and narrow concentrated groups often are the losers.[55] A similar argument could be made with respect to Ireland's membership of the European Union, where the state aid rules have, for example, limited the ability of the Irish

[55] This is not to deny that concentrated groups of exporters gain from such free trade agreements.

government to provide financial assistance to Aer Lingus after 9/11 as well as to Waterford Crystal. Finally, many countries have assigned control of monetary policy to an independent central bank such as the Bank of England or the European Central Bank.

REDUCING INFORMATION ASYMMETRIES: THE EMPEROR HAS NO CLOTHES

As noted in Section 2 it is much easier to supply bespoke protection where there is information asymmetry. In other words, the concentrated group is well aware of the impact of the bespoke protection, but the dispersed group, usually consumers, is unaware of the cost and may even be under the mistaken impression that the bespoke regulation improves their welfare. Furthermore, for reasons set out above it is rational for the members of a dispersed group not to invest in determining the impact of the bespoke regulation on their welfare – they remain rationally ignorant.

One solution is thus to remove the information asymmetry by supplying an evaluation of the impact of a proposed bespoke protection so that members of dispersed groups are in a position to evaluate the impact of the protection. One of the case studies discussed in Section 3 above concerned whether or not there should be a moratorium on the issuance of new taxi licences. In this case the Taxi Regulator commissioned and issued a report that addressed the question of a moratorium on issuing new taxi licences, firmly rejecting the idea. The availability of such information makes it more difficult for concentrated groups to argue successfully in favour of bespoke protection since there is more likely to be a perception that such protection is likely to have an adverse effect on consumer welfare.

Nevertheless, the provision of additional information is only the first step. As noted above concentrated groups can overcome the free rider problem, whereas dispersed groups find it harder if not impossible to overcome this problem. Thus, some thought needs to be given to how the voice of the dispersed groups can be articulated and thus command attention in the policymaking process. There are already a number of agencies that fulfil this role at the moment. Such bodies are also responsible for the generation of information to make dispersed groups aware of the issues.

The Competition Authority has a specific role under the Competition Act to comment on the …*implications for competition in the market for goods and services of proposals for legislation (including any instruments to be made under any enactment)*. It has taken this role with respect to, for example, taxis. Similarly, the National Consumer Agency has also made representations concerning bespoke protection in the taxi market. Individual regulatory agencies, to the extent that they are mandated to promote consumer welfare, may also play a similar role, albeit confined to a single sector. The role of the Taxi Regulator and the CER has already been alluded to in this respect. The regulatory impact analysis procedure discussed below is another mechanism with respect to new regulatory legislation. Finally, the Department of Finance might play a stronger role.[56] It is concerned with the overall efficiency and growth of the economy and research cited above shows how damaging bespoke protection can be to the economy and it would seem that this Department would have

[56] See, for example, Cowen (2007).

a major interest in promoting mechanisms and policies that limit such protection. Without such effective mechanisms and policies ongoing structural change will be more difficult to achieve.

REGULATORY BUDGET: A TAX IS A TAX IS A TAX ………

Bespoke protection is essentially taxation by regulation and relaxing competition policy. By supplying such protection the concentrated group is able to impose a small per unit quasi tax on purchasers of the group's good or service. However, as discussed above the cost is more than just the initial price hike; there is also likely to be a reduction in quality, while, over time, dynamic costs such as lower levels of innovation, will occur. Since all of these quasi tax increases are off-budget the result is that there is likely to be little if any discussion concerning the burdens imposed by the bespoke protection.

One option to redress this imbalance is the introduction of a regulatory budget.[57] Such a budget would quantify the quasi taxes imposed by any bespoke protection that is being proposed. Furthermore, the revenue generated by these quasi taxes would be allocated to the relevant government department; the Department of Transport in the case of a cap on taxis; the Department of Communications, Energy and Natural Resources for the increased regulatory risk because of the Minister's intervention in the determination of electricity prices.

It is, of course, recognised that estimation of the quasi tax imposed by bespoke protection will not always be easy. There can be genuine differences about the magnitude of the quasi tax. There may be considerable administrative costs in the provision of the budget in terms of collecting the necessary information. It is perhaps for reasons such as these that although the idea of a regulatory budget has been discussed for around 30 years, it is only recently been introduced in the UK: a trial run in 2009 before full implementation in 2010.

However, to a considerable degree, while discussions over the practicality of a regulatory budget are of obvious importance, such objections miss the point of introducing a regulatory budget. The purpose is not to present precise estimates and generate large volumes of consultants' reports. Rather the purpose is to get policymakers to realise that bespoke protection imposes costs which should be explicitly taken into account in any decision making process.[58]

[57] For a discussion of the concept of a regulatory budget see, for example, DeMuth (1980), Doern (2009) and Thompson (1998). Doern reviews the developments in the UK referred to below in the text.

[58] It could be argued that tax expenditures are similar to bespoke protection in that they are less than transparent. In this respect it should be noted that the Department of Finance does publish estimates of such tax breaks and has undertaken a major review of said tax breaks. (For details see the Department of Finance's website: http://www.finance.gov.ie/ViewDoc.asp?fn=/home.asp). There seems no reason in principle this could not be extended to bespoke protection.

EXEMPTIONS AND REGULATORY IMPACT ANALYSIS

An important part of policymaking is necessarily evaluation. Policies should be adopted where the benefits outweigh the costs and thus society as a whole is better off. To inform such decisions analysis and study are required. However, this can be a time consuming exercise and as a result screening devices are introduced so that only the most important instances of government intervention are analysed. For example, policy interventions that are likely to impose costs above a certain minimum threshold or the likelihood that significant competition problems will occur would be subject to extensive analysis. These issues are considered first with respect to exemptions from competition law and then the introduction of restrictive regulation.

Exemptions from the Competition Act

The Competition Act is a law of general application that covers all sectors of the economy. It does not prohibit all forms of cooperation between businesses. An agreement that does not have as its object or effect the restriction of competition is not an offence under the Competition Act; equally a merger that does not substantially lessen competition would not be prohibited. The Competition Act only applies to undertakings – persons or organisations – involved in the sale of goods or the supply of services for gain. Hence, certain thresholds need to be met before the Competition Act comes into play. Even when the Competition Act is breached, in the first instance, there are mechanisms within the Competition Act that may mean an otherwise anti-competitive conduct is still permitted. A dominant firm that is apparently abusing its dominant position may have an objective justification; an anti-competitive agreement that apparently raises prices may improve economic progress, reduce costs and benefit consumers; and, a merger that apparently leads to SLC may be permitted if it leads to efficiencies that result in lower overall prices to consumers. Thus competition law contains within it a system of checks and balances designed to improve consumer welfare even for otherwise anti-competitive conduct. Thus if government is going to exempt the activity of a certain group from the Competition Act, it should first determine whether or not it can satisfy the relevant conditions as set out above. If it does not – as appears to be the case in voice-over actors, discussed above – then the government should be required to provide compelling public interest reasons for such a policy move. In the case of voice-over actors this has not been forthcoming, setting an unsettling precedent.

Screens and Full Regulatory Impact Analysis

Ireland has recently developed a system of reviewing proposals for regulation.[59] It is a two-part regulatory impact analysis ("RIA") procedure: first, a Screening RIA for selecting those regulations that should be subject to further analysis;[60] and second, a Full RIA, an evaluation of the proposed regulation that may lead to a full cost-benefit framework. This is clearly a

[59] For details of the programme see the better regulation website at: http://www.betterregulation.ie/eng/. Accessed 17 June 2009.

[60] On screening filters see, for example, Lyons (2005/6); and Lyons and O'Toole (2006). A Screening RIA results in significant regulations being selected for a Full RIA. Significant means initial costs of at least €10 million or cumulative costs over 10 years of at least €50 million. For further details see Department of the Taoiseach (n.d.).

move in the right direction. In order to ensure that a healthy debate occurs it is important that RIAs are published which is the intention of government. RIA is clearly a promising development in ensuring that the costs and benefits of bespoke protection are taken into account in decision making. However, it is too early to come to a judgment as to its effectiveness.

It may seem a bit odd, perhaps even out of place, to present a paper on the supply and demand for bespoke protection at a conference on budgetary perspectives. However, that would be too narrow a perspective. A little like the drunk who, on losing his keys at night, only looks under the street lamp where the light shines. The rigor and transparency of the budget process leads to a substitution effect as organised groups use alternative instruments to achieve effects comparable to a tax increase. It is, therefore, important to examine these effects and to the extent possible ensure that the use of these alternative instruments is subject to the same rigor and transparency as taxes are subject to through the budgetary process.

REFERENCES

BARRETT, A., I. KEARNEY and J. GOGGIN. 2009. *ESRI Quarterly Economic Commentary,* Spring, pp. 1-45, Dublin: Economic and Social Research Institute.

BARRETT, S., 2006. *Regulatory Capture, Property Rights and Taxi Deregulation – A Case Study*. Dublin: Trinity College. This can be accessed at: http://www.tcd.ie/Economics/staff/sbarrett/Producer%20Pressures%20in%202002%20and%202003%20%20to%20Reverse%20High%20Court%20%20Taxi%20Deregulation%20Decisions.doc

BECKER, G., 1983. "A Theory of Competition Among Pressure Groups for Political Influence", *Quarterly Journal of Economics,* Volume 98, No. 3, August, pp. 371-400.

BERGIN, A., T. CONEFREY, J. FITZ GERALD and I. KEARNEY, 2009. *Recovery Scenarios for Ireland,* Research Series No. 7, Dublin: Economic and Social Research Institute.

BOYLE, G., R. McELLIGOTT and J. O'LEARY, 2004. "Public-Private Wage Differentials in Ireland", *ESRI Quarterly Economic Commentary.* Summer, pp. 1-23, Dublin: Economic and Social Research Institute.

CER, 2009a. "Proposed Decision on ESB PES Tariffs to apply from 1st May 2009 to 30th September 2009". CER/09/038. Dublin: CER.

CER, 2009b. "Decision on ESB PES (Public Electricity Supplier) Tariffs and Use of System Charges for the period 1st May 2009 to 30th September 2009". CER/09/053. Dublin: CER.

COLE, H.L., and L.E. OHANIAN, 2004. "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis", *Journal of Political Economy*, Vol. 112, No. 4, May, pp. 779-816.

COMPETITION, 2009. "Financial Emergency Act Abolishes Competition Act Limit on Trade Talks", *Competition,* Vol. 16, Edition 5, pp. 112-115.

COMPETITION AUTHORITY, 1998. Interim Study on the Liquor Licensing Laws and Other Barriers to Entry and their Impact on Competition in the Retail Drinks Market. Dublin: Competition Authority.

COMPETITION AUTHORITY, 2001a. *Report on Bus and Rail Passenger Transport Sector*. Dublin: Competititon Authority.

COMPETITION AUTHORITY, 2001b. S*ubmission of the Competition Authority to the Pharmacy Review Group*, Dublin: Competition Authority.

COMPETITION AUTHORITY, 2004a. "Submission to the Commission for Energy Regulation – Strategy for the Management of ESB Dominance under MAE". No. S/04/002. Dublin: Competition Authority.

COMPETITION AUTHORITY, 2004b. "Agreements between Irish Actors' Equity SIPTU and the Institute of Advertising Practioners in Ireland Concerning the Terms and Conditions under which Advertising Agencies Will Hire Actors". Enforcement Decision No. E/04/002. Dublin: Competition Authority.

COMPETITION AUTHORITY, 2005. "Competition in the (Non-Investment) Banking Sector in Ireland," Dublin: Competition Authority.

COMPETITION AUTHORITY, 2008. *The Retail Planning System as Applied to the Grocery Sector: 2001 to 2007*. Grocery Monitor Report No. 3, Dublin: Competition Authority.

COMPETITION AUTHORITY, 2009a. "Publicans told of competition concerns about price freeze." Press Release. 5 March.

COMPETITION AUTHORITY, 2009b. "Consumers win in Publican's price case." Press Release. 29 July.

COWEN, B., 2007. Achieving the Fastest Rate of Productivity Growth of Any EU Country. Dublin: Indecon.

DEMUTH, C., 1980. "Constraining Regulatory Costs: the Regulatory Budget", *Regulation,* Volume 4, No. 2, March/April, pp. 29-43.

DEPARTMENT OF AGRICULTURE AND FOOD, 2006. "Coughlan Announces Major Capital Investment Programme for Beef and Sheepmeat Processing Sectors." Press Release. 8 November.

DEPARTMENT OF COMMUNICATIONS, ENERGY AND NATURAL RESOURCES (DCENR) 2008. "Statement by the Minister Eamon Ryan on the future of Ireland's electricity sector." Press Release. 13 March.

DEPARTMENT OF COMMUNICATIONS, ENERGY AND NATURAL RESOURCES (DCENR) 2009a. "Double-digit decrease in electricity prices on the way. Immediate review of pricing by Commission for Energy Regulation." Press Release. 3 February.

DEPARTMENT OF COMMUNICATIONS, ENERGY AND NATURAL RESOURCES (DCENR). 2009b. "Minister Ryan appoints Chair for Transmission Transfer Process". Press Release. 29 June.

DEPARTMENT OF ENTERPRISE, TRADE AND EMPLOYMENT. 2008a. "Tanaiste Endorses Confidence-Building Budget and Announces Increased Spending for Science, Technology and Innovation Programmes", Press Release October 14.

DEPARTMENT OF ENTERPRISE, TRADE AND EMPLOYMENT. 2008b. "Address by the Tánaiste to Dáil Eireann on the 2009 Budget and Estimates." Press Release. October 15.

DEPARTMENT OF ENTERPRISE, TRADE AND EMPLOYMENT. 2009. *Code of Practice for Grocery Goods Undertakings*. Consultation Paper. Dublin: Department of Enterprise, Trade and Employment.

DEPARTMENT OF FINANCE, 2009. "Minister for Finance Brian Lenihan TD announces major reforms of the institutional structures for regulation of financial services in Ireland". Press Release. 18 June.

DEPARTMENT OF THE TAOISEACH, 2006. Towards 2016. Ten-Year Framework Social Partnership Agreement 2006-2015, Dublin: Stationery Office.

DEPARTMENT OF THE TAOISEACH, 2008. Building Ireland's Smart Economy. A Framework for Sustainable Economic Renewal. Dublin: Stationery Office.

DEPARTMENT OF THE TAOISEACH. n.d. *RIA Guidelines. How to Conduct a Regulatory Impact Analysis*. Dublin: Department of the Taoiseach.

DOBBINS, T., 2008. "Journalists union welcomes new freelance bargaining rights". *Industrial Relations News*, 25 September, p. 4.

DOERN, G.B., 2009. "An Idea Whose Time Has Come: A Regulatory Budget and Strategic Regulatory Agenda." Ottawa: Policy Research Initiative. This may be accessed at: http://www.policyresearch.gc.ca/page.asp?pagenm=2009-0014_06.

FITZ GERALD, J., 1999. "Wage Formation and the Labour Market" in F. Barry (ed.), *Understanding Ireland's Economic Growth*, Basingstoke: Macmillan Press, pp. 137-165.

FITZ GERALD, J., M. KENNY, N. McCARTHY, E. O'MALLEY and S. SCOTT, 2005. *Aspects of Irish Energy Policy*. Policy Research Series Number 57. Dublin: Economic and Social Research Institute.

FITZ GERALD, G., 2008. "Guaranteeing all deposits was not Government's only option", *Irish Times,* 4 October.

FOOD & DRINK INDUSTRY IRELAND (FDII), 2009a. "Food and Drink Industry Ireland (FDII) comments on Tesco move". Press Release. 5 May.

FOOD & DRINK INDUSTRY IRELAND (FDII), 2009b. The Food and Drink Industry in Ireland. Closing the Gap. Competitiveness Indicators, Dublin: IBEC.

FRIEDMAN, D., 1990. *Price Theory: An Intermediate Text*. 2nd Edition. Cincinnati: South-Western.

GOODBODY ECONOMIC CONSULTANTS, 2009. *Economic Review of the Small Public Service Vehicle Industry*. Dublin: the Taxi Regulator/Commission for Taxi Regulation.

GORECKI, P., 2009a. "Future Challenges for Competition Policy in Ireland: A Personal Perspective" in D. Evans and F. Jenny (eds.), *Trustbusters*. Cambridge, MA; Competition Policy International, pp. 207-232.

GORECKI, P., 2009b. *Rent, Regulatory Reform and R_x.* Working Paper. Dublin: Economic and Social Research Institute. Forthcoming.

HARBERGER, A., 1954. "Monopoly and Resource Allocation". *American Economic Review,* Papers and Proceedings, Vol. 44, No. 2, May, pp.77-87.

HONOHAN, P., 2009. "Resolving Ireland's Banking Crisis", *The Economic and Social Review,* Vol. 40, No. 2, Summer, pp. 207-231.

HUFBAUER, G., 1991. "United States: Adjustment Through Import Restriction" in *Pacific Basin Industries in Distress. Structural Adjustment and Trade Policy in the Nine Industrialised Economies*. New York: Columbia University Press. pp. 88-128.

HARDIMAN, N., 2000. "Social Partnership, Wage Bargaining, and Growth" in B. Nolan, P. O'Connell and C. Whelan (eds.), *Bust to Boom? The Irish Experience of Growth and Inequality*, Dublin: Institute of Public Administration, pp. 286-309.

HARDIMAN, N., 2006. "Politics and Social Partnership: Flexible Network Governance", *The Economic and Social Review*, Vol. 37, No. 3, Winter, pp.343-374.

IBEC, 2009a. "Energy Costs", Press Release. 3 March.

IBEC, 2009b. "Retail Ireland comment on draft code of practice". Press Release. 11 August.

IBEC, 2009c. "FDII statement on draft code of practice for grocery sector". Press Release, 11 August.

IFA, 2009a. "Populist 'Consumer Good' Argument by Retailers is Flawed." Press Release. May.

IFA, 2009b. "Code of Practice must be statutory and enforced by an ombudsman". Press Release. 11 August.

KELLY, E., S. McGUINNESS and P. O'CONNELL, 2009. "Benchmarking, Social Partnership and Higher Remuneration: Wage Settling Institutions and the Public-Private Sector Wage Gap in Ireland", *The Economic and Social Review*, Vol. 40, No. 3, pp. 339-370.

KRUEGER, A. O., 1974. "The Political Economy of the Rent-Seeking Society", *American Economic Review*, Volume 64, No. 3, June, pp. 291-303.

LABOUR PARTY, 2009. *Proposals on Reforming the Taxi Industry*, Dublin: Labour Party.

LYONS, S., 2005/6. "Testing which Proposed Regulations Need 'Competition-Proofing.'" *Journal of the Statistical and Social Inquiry Society of Ireland*, Volume 25, pp. 89-109.

LYONS, S. and F. O'TOOLE, 2006. "Conceptual and Applied Problems with the UK Competition Filter", *Journal of Competition Law and Economics,* Volume 2, No. 2, December, pp. 683-696.

MASSEY, P., 2007. "Delayed Indefinitely: Regulatory Reform of the Irish Bus Industry", *ESRI Quarterly Economic Commentary*, Spring, pp., 38-61.

MICHAEL, J. and P. CULLEN, 2008. "Publicans announce year-long price freeze on drink". *Irish Times*, 1 December.

NATIONAL COMPETITIVENESS COUNCIL (NCC), 2009. *Annual Competitiveness Report 2008*. Volume 1: *Benchmarking Ireland's Performance*, Dublin: NCC.

OECD, 2001. *Regulatory Reform in Ireland*, Paris: OECD.

OFFICE OF FAIR TRADING (OFT), 2003. The Control of Entry Regulations and Retail Pharmacy Services in the UK. London: OFT.

O'LEARY, J., 2002. "Benchmarking the Benchmarkers", *ESRI Quarterly Economic Commentary,* Winter, pp. 1-13.

PELTZMAN, S., 1989. "The Economic Theory of Regulation after a Decade of Deregulation", *Brookings Papers on Economic Activity*, pp. 1-59.

PORTER, M. E., H. TAKEUCHI and M. SAKAIBARA, 2000. *Can Japan Compete?* Basingstoke: Macmillan Press.

PORTER, M. E. and M. SAKAKIBARA, 2004. "Competition in Japan", *Journal of Economic Perspectives,* Vol. 18, No. 1, Winter, pp. 37-50.

POSNER, R. A., 1975. "The Social Costs of Monopoly and Regulation", *Journal of Political Economy*, Volume 83, No. 4, August, pp. 807-828.

PRASIFKA, B., 2009. "ESB's power over a vital national interest is bad for the country", *Irish Times,* 2 February.

PURCELL, D., 2004. *Competition and Regulation in the Retail Pharmacy Market.* Studies in Public Policy: 14. Dublin: the Policy Institute at Trinity College.

REVENUE COMMISSIONERS/CENTRAL STATISTICS OFFICE, 2009. *The Implications of Cross Border Shopping for the Irish Exchequer,* Dublin: Revenue Commissioners/CSO.

ROCHE, W.K., 2009. "Social Partnership: Lessons from Lemass to Cowen", *The Economic and Social Review*, Volume 40, No. 2, Summer, pp. 183-205.

SIPTU, 2009. "SIPTU taxi drivers to resume protests", Press Release, 19 March.

STEPHAN, A., 2009. "Will the Recession Make Cartels More Likely and Cartel Enforcement More Difficult?" *Centre for Competition Policy Newsletter*, Volume 16, February, p. 5.

SPECIAL GROUP ON PUBLIC SERVICE NUMBERS AND EXPENDITURE PROGRAMMES, 2009. *Report.* Dublin: Government Publications.

TESCO, 2009. "Tesco in Major Price Changes in Border Areas", Press Release, 5 May.

THOMPSON, F., 1998. "Towards a Regulatory Budget", *Policy Sciences.* Volume 31, Issue 4, pp. 89-98.

TREBILCOCK, M. J., D. J. HARTLE, J.R.S. PRICHARD and D. N. DEWEES, 1982. *The Choice of Governing Instrument.* A study prepared for the Economic Council of Canada. Ottawa: Supply & Services Canada.

TREBILCOCK, M. J., 2005. "Journeys across the Divides" in F. Parisi and C. K Rowley. (eds.), *The Origins of Law and Economics. Essays by Founding Fathers*. Cheltenham, UK: Edward Elgar. pp. 422-457.

TULLOCK, G., 1967. "The Welfare Costs of Tariffs, Monopolies, and Theft", *Western Economic Journal*, Volume 5, June, pp. 224-232.

TULLOCK, G., 1975. "The Transitional Gains Trap". *Bell Journal of Economics,* Volume 6, No. 2, Autumn, pp. 671-678.

VFI & LVA. 2008. "Good News for Consumers as Year Long Price Freeze Announced for Irish Pubs". Press Release. 1 December.

WERDEN, G., 2008. "Sanctioning Cartel Activity: Let the Punishment Fit the Crime", Paper presented at Competition Authority sponsored conference, 'Sanctions, Fines and Settlements in Cartel Cases: Developments and Deterrence in the EU and Ireland', 22 November, Dublin.

WHISH, R., 2009. *Competition Law,* 6th Edition, Oxford: Oxford University Press.

THE FUTURE OF THE EU BUDGET: IRISH PERSPECTIVES

Alan Matthews[*]

1. Introduction

In this paper, we discuss the Irish position in the negotiations on the next EU medium-term financial framework (MFF, previously known as the financial perspective) covering the period after the expiry of the current framework in 2013. These negotiations will begin in earnest when the new Commission takes office at the beginning of next year. The Commission's deliberations will take account of the outcome of the extensive review of EU budget priorities and financing conducted over the past two years. This budget review was mandated as part of the agreement between the European Parliament, the Council and the Commission in relation to the 2007-13 financial framework in May 2006.[1] The Commission was invited

> …to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008/9. On the basis of such a review, the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspective.

The budget review was intended as an opportunity for a thorough assessment of the EU budget and its financing, free from the constraints of a negotiation on a financial framework. It was not intended to propose a new MFF for the period from 2014 – this will be the responsibility of the next Commission. The Commission contracted a number of substantial studies on both the financing and expenditure sides of the EU budget as part of the review process, and a wide range of proposals were put on the

[*] Department of Economics and Institute for International Integration Studies, Trinity College Dublin. *Email*: alan.matthews@tcd.ie

[1] Declaration n° 3 annexed to the Inter-institutional Agreement between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management - OJ C 139, 14.6.2006.

table.[2] Despite the completion of the consultation phase of the review last year, the Commission has not yet presented its own assessment. At this stage it is not yet clear whether it will still present a report before the end of this year, as had been originally planned.

For the first time, Ireland will enter these negotiations as a net contributor to the EU budget, and the implications of this change in status for the position we will take in these negotiations remains an unexplored topic. EU budgetary policy has been bedevilled by the fixation of Member States on their net budgetary balances. This has both distorted debate on EU budgetary priorities and introduced a major status quo bias into budgetary policy. In the negotiations leading to the approval of the last two multi-annual EU financial frameworks there was widespread agreement on the need to devote additional resources to areas of common European interest in order to respond to the economic and political challenges posed by a changing international environment. Yet the required money could not be found because net contributors blocked any increase in the overall budget ceiling for fear of seeing their deficits increased, and the main beneficiaries of existing expenditure programmes or financing privileges strongly resisted any attempt to curtail their funding.

The Commission now regularly publishes net budgetary balances in its annual Financial Reports. However, both the concept and its measurement have been severely criticised as meaningless and misleading (Le Cacheux, 2007). It is argued that the net balances of Member States do not reflect the true benefits and/or costs associated with EU membership,[3] and that they wrongly characterise EU membership as a zero-sum rather than a positive-sum game. Apparently, small changes to the accounting conventions used to assign revenues and expenditures to Member States can make a large difference to the resulting net balances.[4] Despite these criticisms, it is clear that Member States do look at their net budgetary positions, and the question is whether and how this should be addressed in the budget framework itself.

Ireland has been a significant net beneficiary from the operation of the EU budget since its accession to the EU in 1973. Inflows from both the Common Agricultural Policy (CAP) and Structural Funds have exceeded payments to the EU budget by significant amounts. Our position as a net beneficiary of the EU budget has helped to shape our attitude to successive re-negotiations of the EU MFFs. But this status of net beneficiary is coming to an end. By 2007, the start of the most recent EU MFF covering the period 2007-13, Irish GNI per capita had risen to one of the highest within the EU-27. As a result, we are no longer eligible to receive Cohesion Funds and our eligibility for Structural Funds has been greatly reduced. Although

[2] The contributions to this consultation can be found on the European Commission website http://ec.europa.eu/budget/reform/index_en.htm. A summary of the submissions is presented in Commission of the European Communities (2008a).

[3] The benefits of the single market are clearly worth money, as is shown by the willingness of both Norway and Switzerland to contribute to the EU budget although receiving no budgetary benefit in return. Norway currently contributes €47 per capita to the EU budget, which is higher than the net per capita financial contribution to the EU budget of Austria, Finland, Italy and the UK (Richter, 2008).

[4] For example, the treatment of administrative expenses makes a big difference to the net budgetary balances of Belgium and Luxembourg given the location of the EU administration in these countries.

we continue to receive generous funding under the CAP, a ceiling on the growth of overall CAP expenditure means that CAP receipts now grow more slowly than overall EU budget expenditure. As a result, Ireland was expected to become a net contributor to the EU budget over the course of this MFF (Laffan and Tonra, 2005). The more severe contraction of the Irish economy since 2007 relative to other EU Member States may have the effect of postponing, but not preventing, this day.

The Irish government made its own submission to the budget consultation process (Department of Finance, 2008a). On the financing side, this emphasised its opposition to dedicated EU taxation revenues and any move away from a GNI-based basis for EU finances. On the expenditure side, it sought continued significant funding for agricultural and rural development spending, the concentration of structural and cohesion funds on the new member states, and an enhanced role for other areas of EU activity. As a small open economy with an obvious interest in a cohesive and well-functioning EU budget, it is not surprising that we should favour the consideration of potential EU spending initiatives on their merits. However, past experience suggests that net contributors do not welcome an expanded EU budget, and Ireland will also need to be mindful that it will enter these negotiations (as will the other Member States) in a severely weakened public finance position. We will argue that this implies no real expansion in the current size of the EU budget, and that this will require the government to make choices between its budget priorities. We will also argue that taking explicit account of the net balances position of Member States rather than ignoring it will make it more likely that an optimal EU budgetary outcome can be achieved.

Section 2 of the paper provides a short overview of EU budgetary policy. Section 3 discusses the trends in Ireland's net budgetary position. Section 4 reviews some of the main ideas in circulation for reform of the EU budget and assesses their implications for Ireland. Section 5 concludes with some recommendations for the Irish negotiating position.

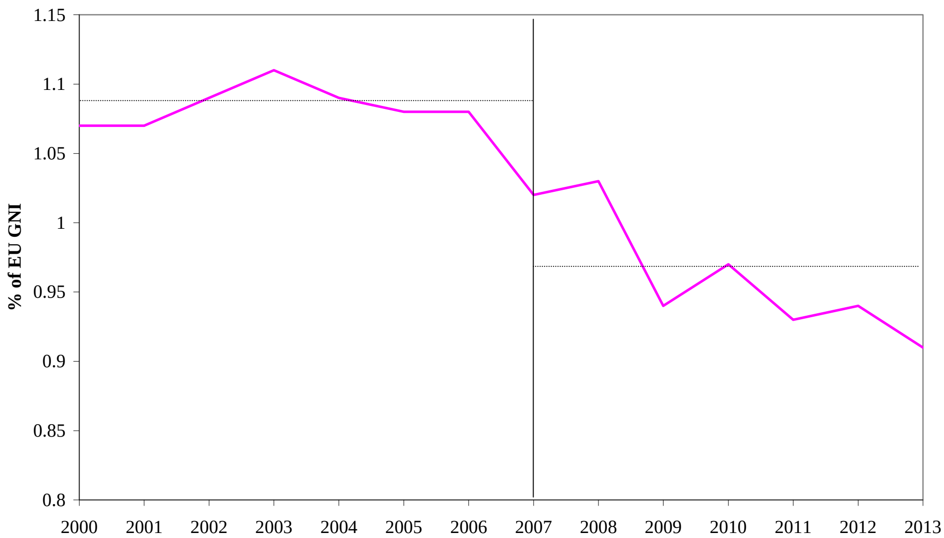
2. The EU Budget – An Overview

EU public finances are shaped through two basic instruments. The first of these is the medium-term financial framework (MFF). Within the scope of the MFF Member States define EU budget expenditure limits for a fixed period at the level of total expenditure and for the main expenditure categories. The procedure is concluded by an inter-institutional agreement between the European Parliament, the European Council and the European Commission. The second instrument is the annual EU budget which is de facto the implementing instrument of the MFF. An important constitutional obligation is the requirement for the EU budget always to balance. Under the existing treaties, the MFF is not a legally binding act but a voluntary agreement of these three institutions to collectively take a decision regarding the EU's MFF.

The Treaty of Lisbon would change decision-making on budgetary matters by bringing the MFF into the Treaty (article 312) and involving Parliament in the decision (Council must obtain the consent of Parliament). According to the provision, a proposal of the European Commission would first be adopted by a simple majority of the European Parliament and then sent to the European Council. This revised order of procedure would put Member States in the European Council under greater pressure regarding the MFF than at present since it would be more difficult to completely or significantly change the decisions of the European Parliament regarding the structure and/or size of expenditure. Decisions would continue to be taken by unanimity, but the European Council could authorise the Council to decide by qualified majority voting. The Treaty would apply co-decision between Council and Parliament to the annual budget, while eliminating the category of compulsory expenditures that effectively excludes agricultural spending from Parliament's remit.

The relative size of the EU budget is shown in Figure 1. As the Commission's (2007) budget consultation paper noted, the EU budget is large in absolute terms (over €120 billion per year) but small as a percentage of total EU public expenditure (less than 2½ per cent). Although it has increased in real terms over time, it has shrunk as a proportion of EU GNI, while the responsibilities assigned to the Union have increased. The current legal limit for total EU revenue, which has to equal total expenditure, is 1.31 per cent of EU gross national income (GNI) for appropriations for commitments and 1.24 per cent of EU GNI for appropriations for payments. In practice, EU expenditure in the 2007-13 MFF will average less than 1 per cent of EU GNI.

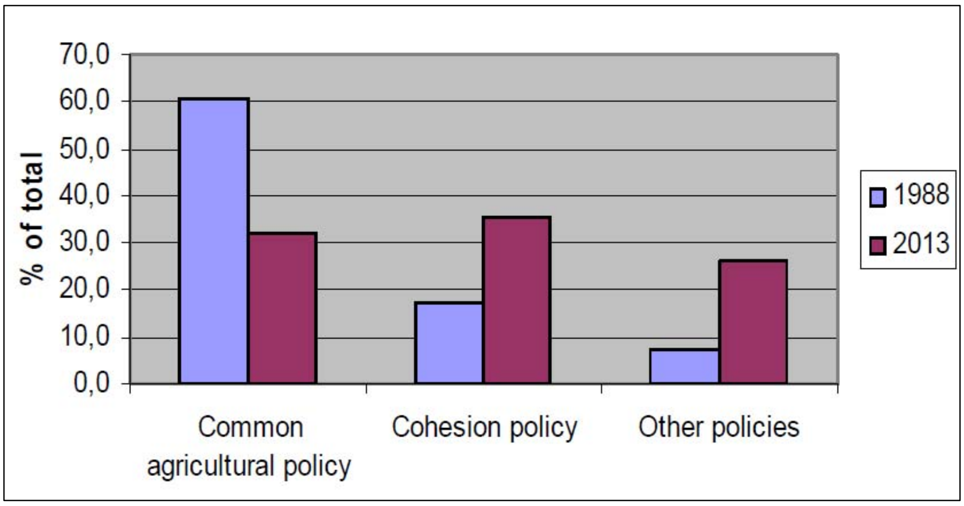
Figure 1: Relative Size of the EU Budget



Source: Commission of the European Communities (2007). The figures for 2008-13 are those agreed in the MFF.

The changing composition of EU budget expenditure as agreed in the 2007-13 MFF is shown in Figure 2. Traditionally, CAP spending has been the single largest component of the EU budget, but it has now been overtaken by cohesion policy. In 1965, CAP payments (excluding rural development) absorbed 35.7 per cent of the budget and rose to 70.8 per cent in 1985. In the first year of the 1988-1992 financial framework, CAP expenditure still represented 60.7 per cent of the budget. By 2013, the share of CAP spending on market and income support will have almost halved (32 per cent), following a decrease in real terms in the current financing period (Commission of the European Communities, 2007).

Figure 2: Expenditure Structure of the EU Budget, 1988-2013



Source: Commission of the European Communities (2007).

Only 6 per cent of the European budget was spent on cohesion policy in 1965. This share increased only slightly until the 1980s (10.8 per cent in 1985). The Single European Act put a new emphasis on economic and social cohesion and was accompanied by a significant increase of cohesion spending. The amounts earmarked for structural actions rose to 17.2 per cent by 1988, and will represent 35.7 per cent of the EU budget in 2013 (Commission of the European Communities, 2007).

Funding for other policies (mainly related to competitiveness, external actions and rural development) was originally very limited. In the first financial framework only 7.3 per cent of the budget was reserved for these areas. But the new emphasis on economic development and competitiveness will see the share of such policies rise to 26 per cent in 2013, of which 10.2 per cent for competitiveness, 6.3 per cent for external actions and 7.3 per cent for rural development (Commission of the European Communities, 2007).

With regard to the sources of budgetary revenue, an initial phase of national contributions was replaced, from 1970 on, by a system of own resources. Four own resources are currently distinguished:

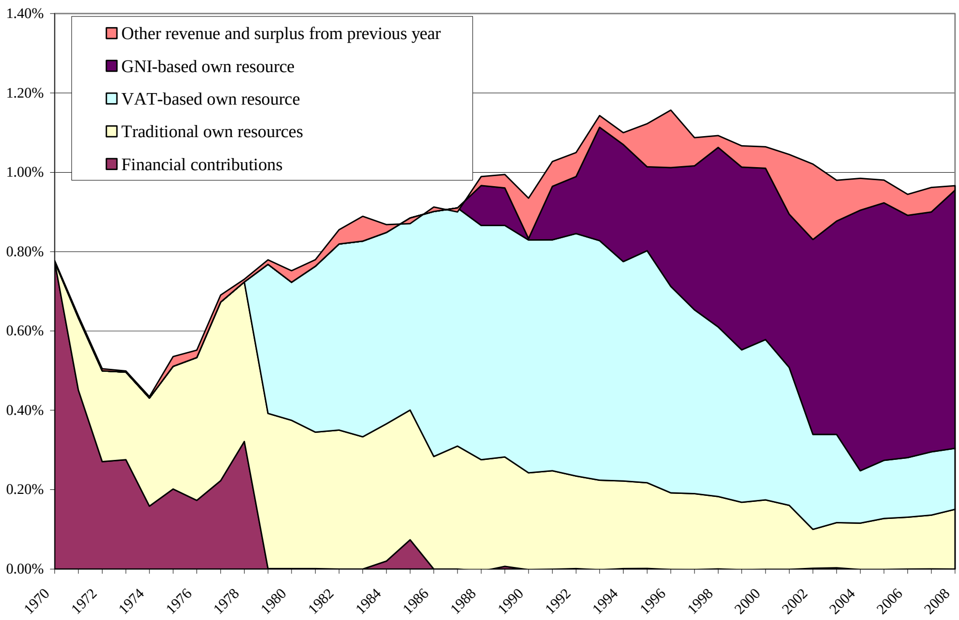
- Levies on agricultural products entering the EU from elsewhere and sugar levies paid by European sugar farmers (the latter due to diminish sharply as a result of recent sugar policy reforms);

- Customs duties on imports of goods subject to the common external tariff;

- A proportion of the receipts from national value added taxes (VAT), harmonised to reflect differences in coverage and rates, now with differentiated take-up rates;

- The gross national income (GNI) resource which is called up in proportion to the GNI of Member States, albeit now with a temporary annual reduction for the Netherlands and Sweden as part of the growth of corrective mechanisms to address unacceptable net balance outcomes.

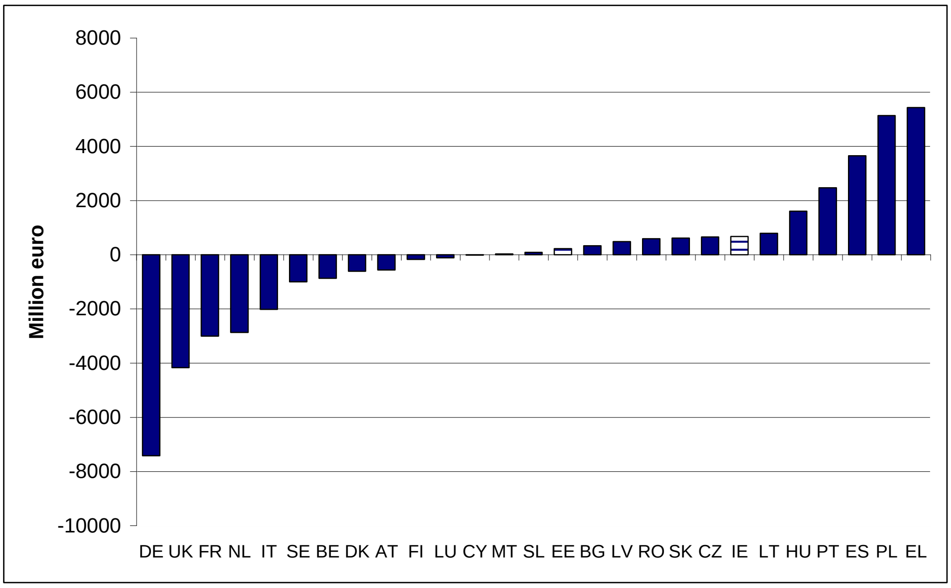
Figure 3: Revenue Structure of the EU Budget, 1988-2013



Source: Commission of the European Communities (2008b, 2008c).

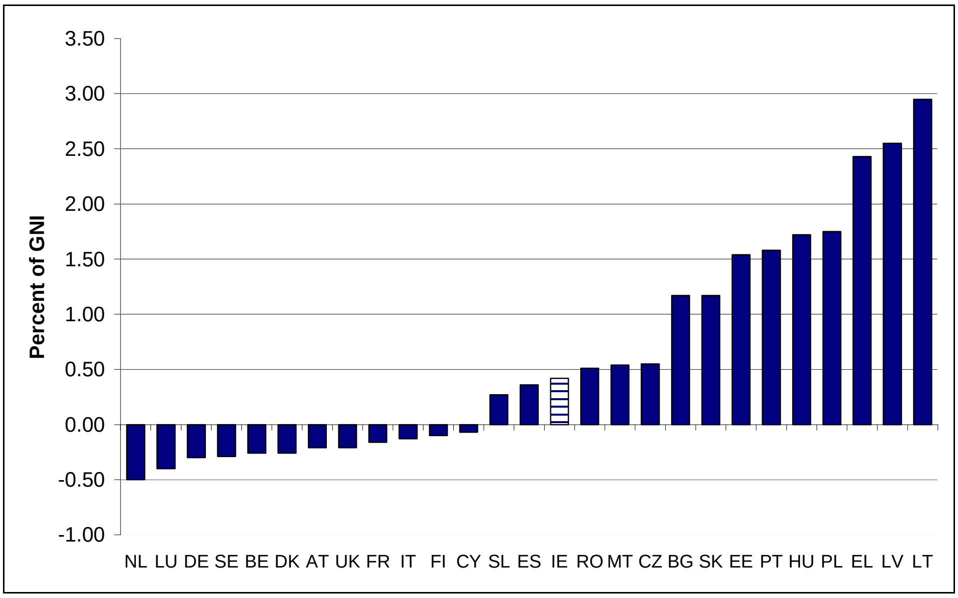
As Figure 3 shows, the own resources system has evolved significantly since the beginning of the first financial framework. In 1988, the GNI resource made up less than 11 per cent of EU financing, compared to 28 per cent provided by custom duties and agricultural levies and 57 per cent by the VAT-based own resource. In 2013, the GNI resource will provide about 74 per cent of the EU financing, against 13 per cent for customs and agricultural levies and 12 per cent for the VAT-based resource.

Figure 4: Net Operating Budgetary Balances by Member State, Million Euro, 2007



Source: Own extraction based on Commission of the European Communities (2008b).

Figure 5: Net Operating Budgetary Balances by Member State, % GNI, 2007



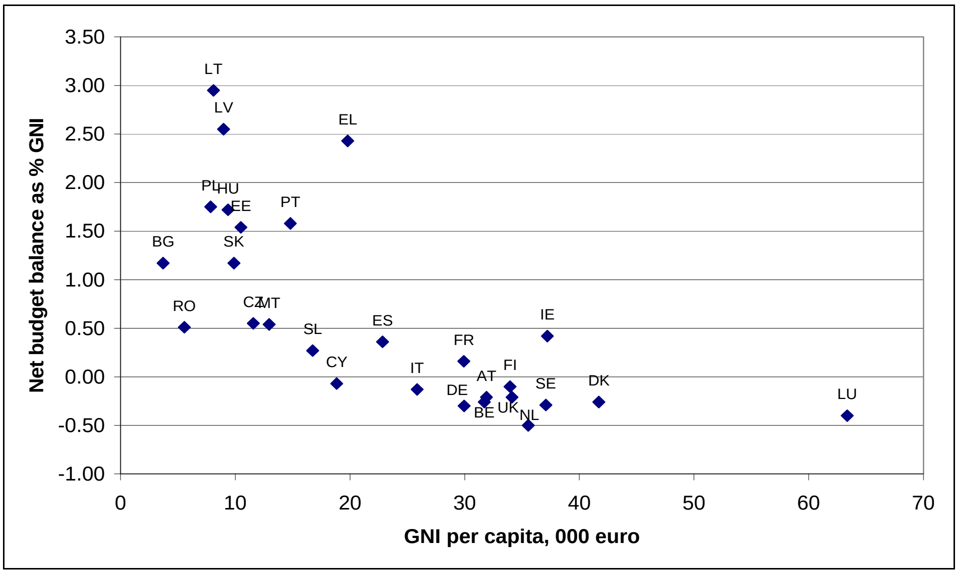
Source: Own extraction based on Commission of the European Communities (2008b).

Figure 4 and Figure 5 show that the operation of the EU budget leads to significant transfers among Member States. The recent accession of twelve new Member States with per capita incomes significantly below the EU average means that many more of the older Member States have now become net contributors. However, in the early 1980s, only Germany and the UK were significant net contributors to the EU budget and, following a series of increasingly strident demands by the UK government under Mrs Thatcher, it was recognised that this was inequitable given the UK's low level of prosperity relative to its EU partners. After a series of ad hoc adjustments, the 1984 Fontainebleau agreement, according to which "…any Member State sustaining a budgetary burden which is excessive in relation to its relative prosperity may benefit from a correction at the appropriate time", introduced a special UK rebate which has remained in place ever since. This UK correction reimburses 66 per cent of the difference between UK GNI- and VAT-contributions to the budget and UK receipts. At the same time, Germany (as the only other substantial net contributor) was asked to pay only a part-share of its *ex ante* contribution to the UK rebate, with other countries having to make up the shortfall pro rata.

In subsequent years other permanent or temporary corrections have been introduced on the income side to address complaints about unacceptable net balances. These corrections include lump-sum payments to the Netherlands and Sweden, reduced VAT call-rates for the Netherlands, Sweden, Germany and Austria, as well as a flat rate retention of 25 per cent of customs duties and agricultural levies for Member States collecting them which particularly benefited the Netherlands. On the expenditure side, special payments have been agreed under the Structural Funds for a large number of Member States. These modifications have considerably reduced the simplicity and transparency of the EU budget. More importantly, …*this logic, alongside the increasing focus placed on a narrow 'accounting' approach with the main objective of maximising returns, has led to tensions between Member States and has coloured the public debate about the value of EU spending and the benefits of EU membership itself* (Commission of the European Communities, 2007).

Commonly accepted notions of equity would require that net financial burdens should be distributed in proportion to ability to pay. Hence, richer member states should pay more than poorer ones, and countries with the same level of real income should have similar financial positions. Much of the current dissatisfaction with the structure of the EU budget arises from the perceived unfairness particularly among the net contributors where countries with very similar levels of GNI per capita make very different contributions to the EU budget. But, as Figure 6 demonstrates, similar inequities occur among net beneficiaries.[5] The figure shows that while there is a rough relationship between net financial burdens and ability to pay, countries at the same level of real income often pay very different amounts. For example, Greece, Ireland and Luxembourg are extraordinarily well treated given their income levels. France and Germany have approximately the same income per capita, but the latter's deficit is roughly twice the size of the former's. A similar discrepancy exists between Finland and the Netherlands. On the opposite end of the income scale, Hungary receives much more than Romania despite a higher per capita income, as does Portugal compared to the Czech Republic.

Figure 6: Operating Budget Balances Versus GNI Per Capita, 2007



Source: Commission of the European Communities (2008b); DG Ecofin AMECO database; own calculations.

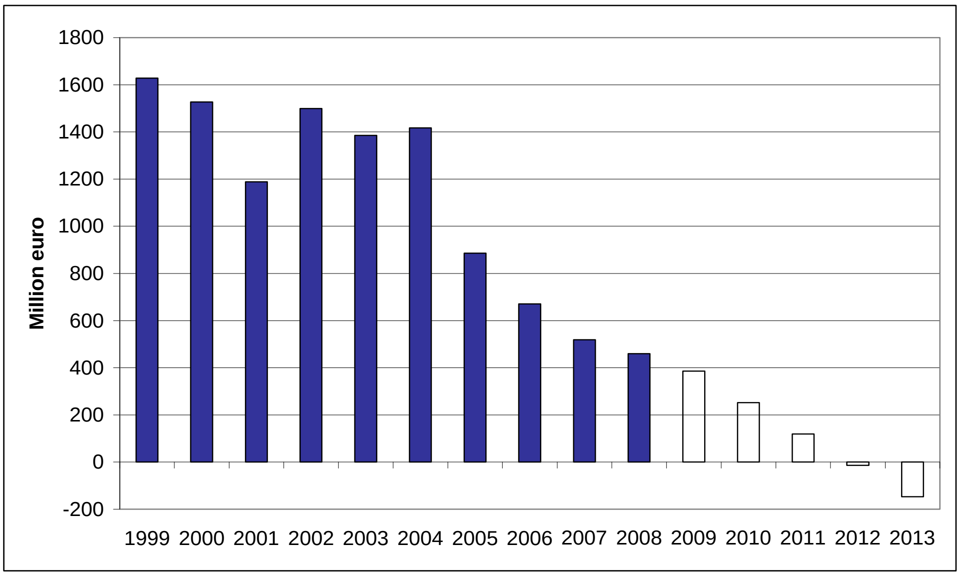
3. Ireland's Net Budgetary Position

Ireland's net budgetary position has always been positive, although steadily diminishing. At its high point in the early 1990s, transfers contributed 5-6 per cent of Irish GDP. In 1999, the transfer was equivalent to 1.8 per cent of Irish GDP, and by 2008 this had fallen to 0.02 per cent of GDP (Figure 7). A crude extrapolation of the trend suggests that Ireland would make the switch to being a net contributor before 2013. While too much credence

[5] A more sophisticated analysis was undertaken by de la Fuente, Domenech and Rant (2008) to show the relationship between member states' relative prosperity and their net financial positions in 2006. These authors use income per capita in normalised PPS units (roughly speaking, euros of average purchasing power) measured in percentage deviations from the EU average, as an indicator of relative prosperity, while financial positions are measured by what they call per capita relative real balances. Their evidence supports the same conclusion of inequity in the distribution of net balances across Member States.

should not be given to this simple simulation, there is no doubt that Ireland will be a net contributor over the period of the next MFF.

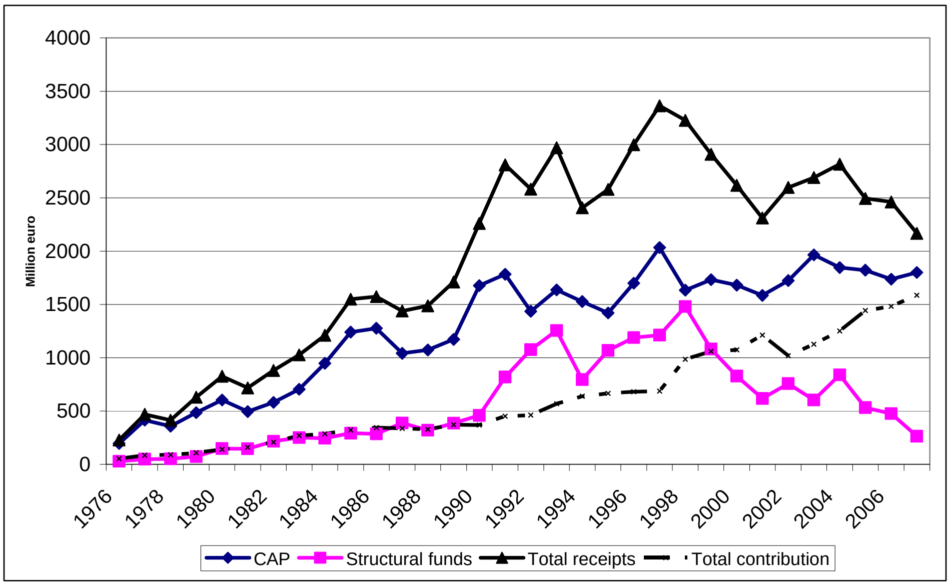
Figure 7: Ireland Actual and Projected Net Operating Budget Balances, 1999-2013



Source: Department of Finance (2008b). Projections from 2009 onwards based on a linear trend.

Further insight into the factors behind the trend in net receipts can be found in the decomposition in Figure 8. On the one hand, Structural Fund receipts peaked in 1998 at almost €1.5 billion and have fallen since then to €264 million in 2007. CAP receipts peaked a little earlier at €2 billion in

Figure 8: Composition of Irish Receipts and Expenditure, 1976-2007, Million Euro

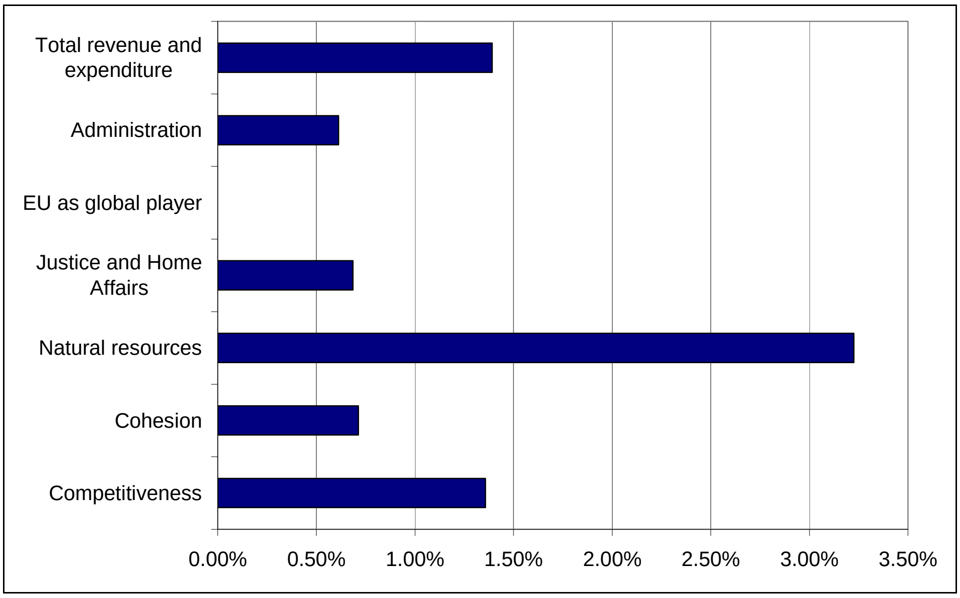


Source: Own extraction based on Commission of the European Communities (2008b).

1997 and have remained roughly constant since then.[6] At the same time, our contributions to the EU budget have grown steadily from €1 billion in 1998 to €1.6 billion in 2007.[7]

Even when Ireland becomes an overall net contributor to the EU budget, there will still be budget headings and budget lines where the net balance remains positive and thus where there is a self-interested rationale to seek to maintain expenditure in these areas. Agricultural and rural development expenditure falls into this category (Figures 9 and 10) where the rate of return on every euro contributed to the EU agricultural budget yields a return of more than €2. However, possible future policy changes which are discussed below could result in a rather different story in the next MFF. For the other main budget headings, Ireland is now a net contributor. For the heading 'Europe as a global player' there is by definition no corresponding expenditure in Ireland. This will also be the case for the Cohesion heading in the next MFF. Thus, the more spending in the next MFF is reallocated away from agriculture towards other spending priorities, the greater Ireland's net contribution will be.

Figure 9: Irish Shares of EU Expenditure Categories, 2007

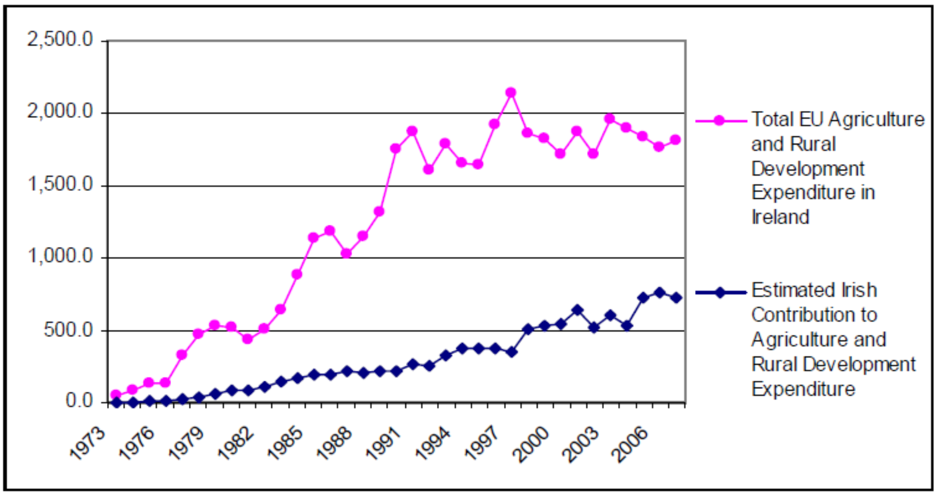


Source: Commission of the European Communities (2008).

[6] In addition to budget transfers under the CAP, Ireland has also benefited in net terms from the CAP's market support policies which have raised the EU price for farm commodities above world market prices. The size of this net trade transfer has reduced in recent years due to CAP reform but it amounted to €760 million in 2008 (Department of Agriculture, Fisheries and Food, 2009).

[7] Note that the figures in the Commission source used for Figure 8 differ slightly from the Department of Finance source used for Figure 7 due to different accounting periods and practices.

Figure 10: Net Balance on Agricultural Payments, 1973-2007, €Million



Source: Department of Agriculture, Fisheries and Food (2009).

4. Reforming the Budget

The budget review consultation exercise revealed some widely-shared concerns about the EU budget (Commission of the European Communities, 2008a). On the expenditure side, the dominance of traditional spending areas such as the CAP and cohesion means that the EU is not well equipped to deal effectively with some of the challenges that it faces. These include the new tasks identified in the Lisbon Treaty of growth and competitiveness, climate change, energy, migration, as well as foreign and security policy. On the revenue side, there is concern about the dependence of EU revenues on the GNI resource which is seen by some as more of a national contribution than a genuine 'own resource'. Many proposals have been made to substitute some or all of this resource with new sources of EU taxation. It is also accepted that the haphazard growth in corrective mechanisms to address the issue of excessive net balances has given rise to a non-transparent and complex budgetary system in which Member States focus almost exclusively on their net return position rather than evaluating proposals for EU spending on their own merits. *Indeed, rather than being a negotiation about what policies the EU should fund and why, a large part of the budget negotiations has been about net payments, with finance ministers judged more by how much they acquire or give away than the policies they support* (Begg, 2007).

THE FUTURE SIZE OF THE EU BUDGET

One view of the future size of the EU budget is that it should emerge from assessments of the value added from EU expenditure and should not be determined a priori (the 'bottom up' approach). This is the position of the Irish government in its contribution to the budget consultation. From the point of view of realpolitik, this position may be seen as naïve. For some time now, the discourse in Europe about public spending has been to limit its growth, even if this has been knocked off course by the need for action to counter the deflationary impact of the global financial collapse. However, governments will emerge from the current recession with significantly higher debt-to-GNI ratios and will be looking for ways to reduce their spending as soon as economic conditions allow. In this context, the 'top down' approach in which the level of total expenditure is determined first, followed by discussions of what to finance from the available funds, may well be preferred. This was, after all, the approach adopted in preparing the current

MFF, following a letter from the governments of the six largest net contributors in January 2004 to the President of the Commission to demand that the total budget be maintained below 1 per cent of gross national income (GNI), rather than the 1.24 per cent ceiling of the Union's GNI initially proposed by the Commission. The compromise formula subsequently presented by the Luxembourg presidency did not go beyond a 1.06 per cent of GNI ceiling for commitments and a 1 per cent GNI ceiling for payment appropriations.

The other major difficulty in increasing the size of the EU budget is that, as we have noted, EU spending inevitably redistributes resources across the Member States. This is the case even if such expenditure is focused exclusively on identified European public goods. The debate over increasing EU spending on R&D provides a good example. There is widespread support for increased EU spending on research, technological development and innovation (Commission of the European Communities, 2008a). It is also apparently sensible to ensure the greatest return from this expenditure by allocating projects on the basis of excellence. But Member States with weaker research infrastructures fear they will lose from this focus because they will not be able to win funding competitively.[8] The fact that not all Member States may benefit, or benefit proportionately, even from a policy which yields an unambiguous positive effect for the EU as a whole imposes a very high standard for agreeing additional EU spending. Not only must such spending demonstrate positive value added for the EU as a whole, but it cannot impose a net cost on any member State (Begg, 2007). Thus, the debate over the appropriate size of the budget invariably is seen through the prism of Member States' net balances. Put simply, net contributors tend to favour a smaller budget whereas net beneficiaries will tend to push for a more expansive one.

REFORM OF EU SPENDING

In evaluating the structure and size of EU budget spending, economic analysis begins with the notions of subsidiarity and proportionality derived from the literature on fiscal federalism, which seeks to provide normative criteria for the assignment of government responsibilities and expenditure to different levels of government. The notions of subsidiarity and proportionality were formally incorporated into the EU Treaties with the Treaty of Amsterdam.[9] This expresses a preference for public spending (and decision-making more generally) to occur at more decentralised levels of government, i.e. at Member State level, unless there is clear value added from Community action. Community value added may occur where there are economies of scale, where there are important externalities or spillovers across national boundaries, and where citizen preferences across the Union are likely to be fairly homogeneous. In addition to these economic

[8] The EU's research framework programmes in this context have been called Structural Funds for the rich (Begg, 2007).

[9] The relevant article states:

- In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.
- Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.

arguments there may be political motives for the EU to take on responsibility for other categories of expenditure, such as solidarity between Member States or promoting a European identity, although not all such expenditure if justified on these grounds alone would appear compatible with the subsidiarity article now in the Treaties.

A number of studies have attempted to set out the desirable size and composition of the EU budget based on these principles (see, for example, Sapir, 2003; Ecorys *et al.*, 2008). These analyses generally conclude that some existing expenditure, particularly under the Competitiveness and Growth heading, the first pillar of the CAP as well as much Rural Development spending, should be shifted from the EU to the Member States. At the same time, there is a case at least in principle for increased EU spending on transport and energy, on security, foreign aid and neighbourhood policies and on environment and climate change, although some of this might replace Member State spending so that overall public spending would not increase.[10]

The Commission in its summary of contributions to the budget review consultation noted that there is widespread support for considerably reoriented spending priorities with many contributions advocating reductions in spending on agriculture and increased spending on research, energy and external policies. These priorities were also supported by the Department of Finance (2008) submission, although with more ambiguous language on the size of agricultural spending. The submission underlines that Ireland …*is committed to maintaining a strong and effective CAP which will support a vigorous, consumer-focused agricultural production base in Europe*… on the questionable grounds that this will help to ensure food security for European consumers. However, it does not actually make any specific reference to the desirable level of future funding, although it does argue rather lamely that the twin requirements of …*[providing] a secure and sustainable food supply* and …*substantially reducing greenhouse gas emissions*… and the interaction between them should be an objective supported by the EU budget (*sic*).

We noted earlier that, even if Ireland's overall net balance on EU budgetary expenditure turns negative in the next MFF, on current policies it would continue to benefit strongly from maintaining a significant CAP share in the overall EU budget. Ireland's submission to the budget review is consistent with these trends, in that it argues for only gradual changes to the CAP while focusing on a better targeting of Structural Funds on the less developed Member States rather than any overall increase in their budget.

But maintaining agriculture's share in the next MFF will be difficult if, at the same time, there is no agreement to raise the overall size of the EU budget. In this scenario, the CAP budget provision would be the only source of additional funding for the new challenges the EU would like to address. This could lead either to a common decision to significantly reduce overall

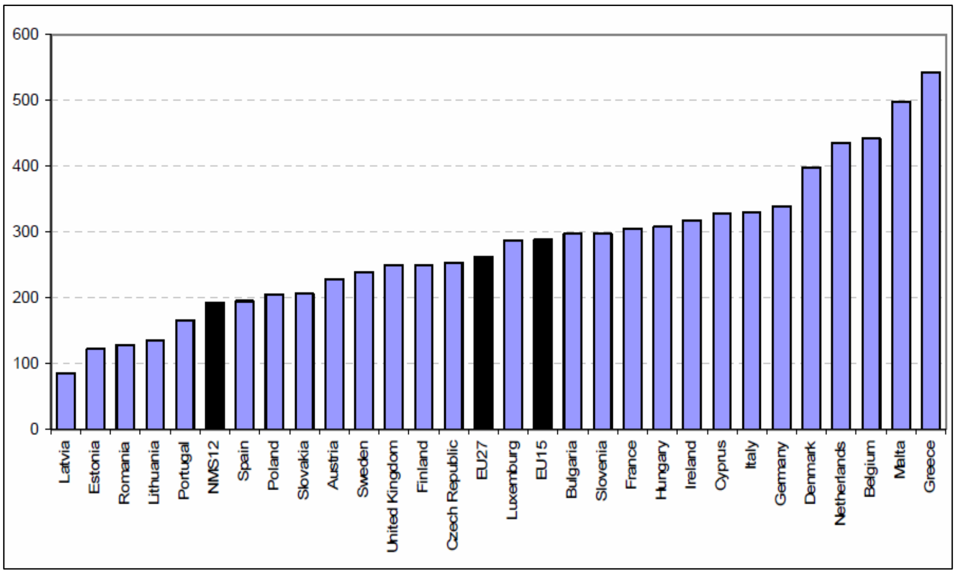
[10] In summarising the contributions to the budget review consultation, the Commission notes that: Issues often referred to as European public goods are, among others, transnational infrastructure investments, protection of the environment, maintaining food security and safety, promoting European identity (e.g. by means of mobility programmes in education), balanced economic and social development or external border protection (Commission of the European Communities, 2008b).

agricultural expenditure, or to maintain a high level of overall spending but to require national co-financing also of Pillar 1 expenditure as now required for Pillar 2, in either case freeing up resources in the EU budget for other spending priorities.

Even if the overall share of CAP spending in the EU budget were maintained, it is arguable if Ireland could maintain its current disproportionately high share of these funds. Neither of the last two CAP reforms (the Fischler 2003 reform which introduced the Single Farm Payment, and the more recent 2008 Health Check) upset the allocation of EU budget revenues between Member States. One consequence of this is that countries and regions which received intensive levels of agricultural support in the past have now converted these into high levels of direct payments per hectare.

Figure 11 shows the large disparities that will exist between Member States in the levels of direct payments per hectare even in 2014 (when the phasing in of direct payments in the new Member States will be complete). Payments in the new Member States are noticeably lower than in the older Member States. The new Member States have already made clear that a continuation of these disparities into the new MFF would not be acceptable. The Commission has favoured the use of the flat-rate regional system within countries for making direct payments to farmers, and the same logic would suggest a move towards greater equalisation (even if not full equalisation) of direct payments across countries. In general, there will be pressure to adopt a distribution key for CAP (including rural development) expenditures which is more based on objective criteria than historical shares. Any move in this direction is likely to reduce Ireland's benefit-cost ratio from EU agricultural

Figure 11: Average Direct Payment Per Member State (€ Per Hectare)



Source: Velazquez (2008).

expenditure in the new MFF period.[11]

REFORM OF EU REVENUE SOURCES

Two main groups of reform proposals have been put forward for common budget revenues: (i) simplification of the present system of own resources; (ii) enlargement of the EU fiscal base with the introduction of new own resources through one or more EU taxes.

The most common suggestion for simplification is the replacement of the VAT-based resource by the GNI resource. As a mechanism for funding, the GNI resource has a number of advantages (Begg *et al.,* 2008). It makes it easy to predict how much each Member State will contribute. It is equitable in respecting the 'ability to pay' principle by asking Member States to pay equal proportions of their income. Indeed, if there were ever a political decision to vary gross contribution rates to the EU budget by asking Member States to pay in different proportions of their GNIs, it would be a relatively easy matter to do so by adjusting the call-up rates. Its third advantage is that it is an open-ended resource in the sense that Member States are committed to transferring sufficient money to match the EU's agreed expenditure. This means that the EU does not need to worry about fluctuations in the revenue flows from particular taxes and will not face a financing problem, provided that Member States do not renege on their commitments.

Already, because of the ceilings and other modifications made to the VAT-based resource, it operates very much like the GNI resource. Its share in total own resources has also fallen significantly, and it would simplify Member States' calculation of their contributions if it were substituted completely by the GNI resource. The survey of Member State representatives undertaken by Begg *et al.* (2008) suggested that this would be a popular step, and it is also the revenue reform supported in the Irish government's budget consultation submission. Going even further and substituting the 'traditional own resources' (agricultural levies and customs duties) might also be a possibility but there seems to be a more general acceptance that these revenues should accrue to the EU budget.

Nonetheless, the current system of own resources has its critics, notably in the European Parliament. Although the GNI resource is legally considered an 'own resource' of the EU, in practice it functions like a national contribution. It encourages Member States to enter the budget process with a determination to keep 'their' national contribution to a minimum. It means that the visibility of EU funding from the point of view of citizens is non-existent, meaning that public knowledge of the EU budget

[11] Some illustrative examples of alternative distribution keys for CAP Pillar 1 and Pillar 2 expenditure can be found in Zarhnt (2009). Interestingly, for Pillar 1 spending, Zarhnt's modelling suggests that Ireland could actually benefit from an alternative distribution key compared to the continuation of historical shares, particularly if the key puts a high weight on either agricultural area or GDP per capita, although there appears to be some internal inconsistency in the data used to arrive at this conclusion. However, Ireland would lose heavily from any reorientation of Pillar 2 spending to one based on more objective environmental criteria. Overall, even assuming that the overall CAP budget was maintained at roughly its current size, his illustrative modeling shows Ireland losing anything from €127 million to €565 million depending on the relative shares devoted to Pillar 1 and Pillar 2 and the criteria used to make up the new distribution keys.

is scanty and often ill-informed. There is the – admittedly distant – fear that a Member State might withhold its contributions as a bargaining mechanism over the budget. For these reasons, there is minority support for the view that the EU should be granted new tax-raising powers, either to complement or substitute completely for the GNI resource.

There have been various attempts made to suggest suitable candidates for EU taxes. A Commission study (2004) discussed three kinds of tax as possible new own resources in the future: (i) a tax based on energy consumption; (ii) a modulated VAT; (iii) a tax based on corporate income. Other options proposed in the study commissioned by the Commission for the budget review include a tax on flights, assigning the proceeds from the auction of Emissions Trading Permits or some other variant on a carbon tax, or assigning seignorage from the European Central Bank (Begg *et al.*, 2008). However, none of these suggestions has the potential of the first three to be anything more than a niche resource.

Given the level of satisfaction among Member States with the GNI resource, there appears to be little appetite to embark on the project of designing a new EU tax. Indeed, any switch to particular taxes or identifiable sources of funding for the EU budget could create problems of assuring sufficient resources and disrupt the painstakingly constructed compromises on who pays what and receives what (Begg *et al.,* 2008). Thus, the government's position in the budget negotiations to seek a replacement of the VAT resource by the GNI resource appears a sensible one.

ADDRESSING THE NET BALANCES ISSUE

The relative growth in GNI-based financing has been associated with increasing resort to correction mechanisms which have proliferated since the 1984 Fontainebleau European Council which gave rise to the UK rebate. It is generally accepted that the uneven distribution of expenditure between the Member States (especially on the CAP) is at the root of the political demands for corrections, notably where the amounts spent vary between countries of similar levels of prosperity, although imbalances in gross payments into the budget have also played a part for some (Begg *et al.*, 2008). While the reasoning behind corrections is to reduce net contributions, the mechanisms involved vary. Different Member States are treated differently, thus undermining the fairness of the GNI resource.

There are essentially four options to address the problem of unacceptable net balances. The first is to hope that the gradual reform of the EU budget, particularly on the expenditure side, will lead to a more balanced and equitable pattern of net budgetary balances over time such that the pressure for ad hoc corrections will disappear. This is the position of the Irish government in its submission to the budget review consultation: *Ireland considers rebates as unsuited to the long-term funding of the Union. It considers that these rebates should be gradually phased out, consistent with the concerns of the major net contributors. We see little merit in alternative approaches such as a General Correction Mechanism and hold that the ultimate objective should be an end to rebates.* (Department of Finance, 2008a). The difficulty with this approach is that correction mechanisms have proliferated even as limited reform of EU budget expenditure has taken place, so that there is not much basis for optimism that the problem will automatically solve itself.

A second approach is pursued by those who wish to substitute separate EU taxes for the GNI resource. Their argument is that, if the EU were financed by earmarked taxes, this would mean that Member States would no longer be concerned with their net budgetary balances. The taxes would be borne by corporations, consumers, air travellers or polluters, and the net balances would simply reflect the geographical distribution of these taxpayers across the Union. Again, this seems a rather overly-optimistic expectation, especially given that the front-runner for an EU tax is a modulated VAT which would not look hugely different to the current VAT-based resource.

The third approach is to address the issue of net balances by linking Member State net balances explicitly to their levels of relative prosperity. This option of a generalised correction mechanism was supported in the Begg report (2008). For example, the Commission's proposal for a generalised correction mechanism in its 2004 report on own resources had the following features:

- Every Member State would be entitled to a rebate on its contribution to the EU budget;
- Eligibility for a rebate would be triggered when its contribution reached a threshold of 0.35 per cent of GNI;
- The refund rate would take the form of a 66 per cent abatement of that net contribution (the same percentage as the Fontainebleau rebate for the UK);
- The overall maximum refund available for all rebates would be capped at €7.5 billion a year.

The most radical approach would be to change the structure of the EU budgetary system in such a way that the unavoidable conflict over distributional issues is treated explicitly so that it does not spill over into the rest of the budget discussion. This option can be regarded as taking *juste retour* thinking to its logical conclusion. Its proponents criticise the Commission's proposal for not going far enough in that it tackles only one side of the problem (excessive deficits but not excessive surpluses), it does so only partially and it introduces an unnecessary discontinuity in the form of a fixed deficit threshold below which no corrective action would be taken.

According to this fourth approach the EU budget procedure would be carried out in three phases (de la Fuente, Domench and Rant, 2008). In the first phase, Member States would agree on the extent of redistribution, in absolute terms, between net receiver and net contributor countries, and as a consequence, on the 'target net financial positions' of every Member State. In the second stage, Member States would negotiate on the individual policies to be financed from the budget as well as sources of financing. This would give rise to a set of implicit net financial positions of individual Member States. A new budgetary instrument would be introduced to execute a system of horizontal transfers across Member States so that, regardless of the decision on expenditure policies and financing, the ultimate distribution of net budget balances would be brought into line with that agreed in the first stage. According to its proponents, the great advantage of this system is that it would do away with the common pool problem in setting EU budget priorities. Each Member State would have an incentive to consider proposals for EU spending on their own merits, and not with regard to how it is likely to affect their net budget position.

The benefit of a correction mechanism is that it would encourage Member States to look at the substance of proposals for additional spending, rather than to their impact on each country's net budget balance. There are clearly opportunities for spending on EU public goods which would yield positive and significant benefits to Ireland through non-budgetary channels. There are various permutations possible when it comes to addressing the issue of net budget balances, ranging from the continuation of ad hoc corrections to Member States receipts and expenditures, the introduction of a more generalised correction mechanism or enshrining the logic of *juste retour* into the budget procedure itself. The government's position that rebates should be eliminated and that Member States should accept the outcome of applying the standard budget rules may turn out to be wishful thinking. More important, failing to explicitly address the net balances issue may result in a sub-optimal outcome in terms both of the overall level of the EU budget in the next MFF and in its spending priorities. Because Ireland benefits disproportionately from the agricultural budget, any correction mechanism would diminish the benefits Ireland receives from EU budgetary operations. On the other hand, the scale of these disproportionate benefits is likely to diminish because of the independent pressures for reform of EU spending priorities and agricultural spending in particular, meaning that a correction mechanism would be less likely to result in further additional contributions from Ireland to the EU budget in the next MFF period.

5. Conclusions

There was general dissatisfaction with the 2004-06 round of negotiations over the medium-term financial framework for the period 2007-2013 amongst national governments, the EU Commission and the EU Parliament. Those in favour of a more expansive EU budget were frustrated by the limits placed on the budget size, which has been shrinking relative to EU GNI over the past decade and is planned to go on decreasing. On the other hand, those in favour of a smaller but 'smarter' budget were frustrated by their failure to effect a shift in spending priorities. Member States' insistence on seeing the budget negotiations through the lens of 'net national balances' meant that possible new spending proposals to help the EU to address new challenges were never properly considered. This dissatisfaction was such that, *…at the very moment when they were reaching agreement on a budget nobody liked, all players were calling for a mid-term review in which all aspects of the EU budgetary procedures, expenditures and financing devices, would be discussed afresh* (Begg *et al.*, 2008).

The forthcoming negotiations on the next MFF will address four issues simultaneously: (i) the overall size of the EU budget; (ii) the budget allocation to spending priorities; (iii) sources of funding; and (iv) corrections to Member State net balances. If the Treaty of Lisbon comes into force, the European Parliament will have a much greater role in setting the budget agenda than heretofore. Ireland moves into uncharted waters in these negotiations because we have in the past been significant beneficiaries from the EU budget. Our negotiating objectives were simple: maintain agricultural spending and seek as large a transfer from Structural Funds as possible. In the next MFF, Ireland will be an overall net budget contributor and we will also enter the negotiations with a greatly weakened public finance position. We will still continue to benefit from agricultural spending, albeit to a much smaller extent than before. However, we are clearly a net contributor to the spending areas likely to be increased in the next financial framework. What influence will this have on the negotiating position we adopt?

The government's approach to these negotiations was signalled in its submission to the budget reform consultation. It does not seek to limit the size of the EU budget a priori, preferring to see the size of the budget determined at the conclusion of the negotiation process and reflecting the agreed policy priorities of the Union. It supports an expanded set of policy priorities for the budget, including more focus on productivity-enhancing policies and policies that implement EU climate-energy objectives, while also wanting only gradual changes to the CAP. It supports the maintenance of Structural and Cohesion Fund spending but would like to see it more targeted on the less developed Member States. These priorities suggest that it would favour a somewhat larger budget relative to EU GNI than we have had to date. It would welcome a simplification of EU budget revenues, maintaining the predominant role of the GNI resource and firmly opposing any suggestion of an EU tax. On the other hand, it has come out against any generalised correction mechanism to deal with the net balances problem and favours the gradual elimination of all existing rebates. It seems to believe that the gradual reorientation of EU spending will resolve the issue of the perceived unfairness of the net balances over time, although its proposal for greater targeting of Structural Fund spending would, in fact, exacerbate the imbalances for some Member States.

The deteriorating public finance position even since this submission was made is likely to severely limit the government's enthusiasm for a larger EU budget. Other Member States will also be seeking to consolidate their public finances and will want to limit the size of the EU budget. The unknown quantity is the role of the European Parliament if the Treaty of Lisbon enters into force. The Parliament is likely to favour a larger EU budget than the Member States, and following the Lisbon Treaty will be in a stronger position to influence the outcome. Nonetheless, the probability is that the current 1 per cent operational ceiling on the size of the EU budget will be continued. This makes it all the more important that the best use is made of the expenditure ceiling agreed. Unfortunately, the net balance issue will come to be the driving force behind the Irish negotiating position (as for other Member States), with potentially damaging consequences for the structure of the EU budget. There is an additional incentive to defend agricultural spending because of its positive net transfer effect. In other words, agricultural spending has a premium attached to it over and above its intrinsic value to the Irish economy because of the attached resource transfer. On the other hand, there is a negative incentive attached to increasing expenditure on European public goods in the EU budget for the opposite reason. The intrinsic value to the Irish economy is reduced by the fact that there is also a corresponding outflow. Because these distortions influence each Member State's approach to the budget, the outcome is likely to be sub-optimal. The unseemly bargaining over the spending to be funded from the European Economic Recovery Plan in 2009 or, closer to home, the demand that we continue to fund the Rural Environment Protection programme because otherwise we will 'lose' the money from Brussels, are examples of the way mixing the distributional consequences of budget decisions with their allocative justification distorts incentives.

For this reason, I am attracted by the radical proposal by de la Fuente *et al.* (2008) to keep the two issues totally separate. This requires initial agreement on the degree of redistribution to be achieved through the EU budget, but such a coefficient is already implicit in the current financial framework, albeit with many individual exceptions. A generalised correction mechanism, stripped of some of the weaknesses of the Commission's (2004) proposal, could be an alternative approach. In my view, it would be desirable to support the introduction of either approach in the next financial framework. It would not remove disagreement on the overall size of the EU budget, as this would still determine the absolute size of net payments and contributions. However, it would allow the government to focus on ensuring an efficient allocation of EU budget resources, in line with the challenges and priorities facing the EU in the coming period.

REFERENCES

BEGG, I., 2007. "The 2008/09 EU Budget Review", EU-Consent EU-Budget Working Paper No. 3.

BEGG, I., H. ENDERLEIN, J. LE CACHEUX and M. MRAK, 2008. *Financing of the European Union Budget,* Final Report. Study for the European Commission, Directorate-General for Budget.

COMMISSION OF THE EUROPEAN COMMUNITIES, 2004. Financing the European Union: Commission Report on the Operation of the Own Resources System, COM(2004) 505, Brussels.

COMMISSION OF THE EUROPEAN COMMUNITIES, 2007. Reforming the Budget, Changing Europe: A Public Consultation Paper in View of the 2008/2009 Budget Review, SEC (2007) 1188, Brussels.

COMMISSION OF THE EUROPEAN COMMUNITIES, 2008a. *Reforming the Budget, Changing Europe: Short Summary of Contributions*, SEC(2008)2739, Brussels.

COMMISSION OF THE EUROPEAN COMMUNITIES, 2008b. *EU Budget 2007 Financial Report*, Brussels.

COMMISSION OF THE EUROPEAN COMMUNITIES, 2008c. General Budget of the European Union for the Financial Year 2008, Brussels.

DE LA FUENTE, A., R. DOMENCH and V. RANT, 2008. "Addressing the Net Balances Problem as a Prerequisite for EU Budget Reform: A Proposal," CESInfo 51, 4. Published online 0: ifp013v1-ifp013.

DEPARTMENT OF AGRICULTURE, FISHERIES AND FOOD, 2009. Annual Review and Outlook for Agriculture, Fisheries and Food 2008-2009, Dublin.

DEPARTMENT OF FINANCE, 2008a. "Ireland's Contribution to the Public Consultation on the Review of the EU Budget". http://www.finance.gov.ie/documents/publications/other/EU_Budget_review_aug08.pdf, accessed 28 June 2009.

DEPARTMENT OF FINANCE, 2008b. *Budgetary and Economic Statistics*, Dublin, September.

ECORYS, 2008. Netherland Bureau for Economic Policy Analysis and Institute for Economic Research. A Study on EU Spending, commissioned by the European Commission, Rotterdam.

LAFFAN, B. and B. TONRA, 2005. "Europe and the International Dimension" in J. Coakley and M. Gallagher (eds.), *Politics in the Republic of Ireland*, Fourth Edition, London: Routledge.

Le CACHEUX, J. 2007. "The Poisonous Budget Rebate Debate", *Studies and Research*, No. 41, Notre Europe, Paris.

RICHTER, S., 2008. "Facing the monster 'juste retour' on the net financial position of member states vis-à-vis the EU budget and a proposal for reform", EU-Consent EU-Budget Working Paper No. 7.

SAPIR, A. et al., 2003. An Agenda for a Growing Europe, Report of an independent expert panel to the President of the EU Commission, Luxembourg: Official Publications Office of the EU.

VELAZQUEZ, B., 2008. "The Single Payment Scheme in the Impact Assessment of the CAP 'Health Check'", Paper prepared for the 109th EAAE Seminar. 'The CAP after the Fischler Reform: National Implementations, Impact Assessment and the Agenda for Future Reforms', Viterbo, Italy, November 20-21.

ZAHRNT, V., 2009. "Public Money for Public Goods: Winners and Losers from CAP Reform", ECIPE Working Paper No. 08/2009, Brussels, European Centre for International Political Economy, www.ecipe.org.