View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Archive of European Integration

Budget 2009

by

Joe Durkan

UCD

FFS/ESRI Budget Perspectives Conference

October 2008

ESRI

Introduction

Since the recovery from the 1980's depression the economy has performed extraordinarily well. However, during that period it experienced two growth cycles, in the early 1990's and again in the early 2000's, when output was well above and well below potential, but did not record negative growth. The economy is now in a further cycle, this time accompanied by negative growth. Fiscal policy throughout this whole period has been pro-cyclical, and this characteristic has accentuated the difficulties faced by policymakers in framing the budget for 2009 and future years. This paper looks at the origins and consequences of this approach and indicates the policy implications.

Background

The framework within which fiscal policy is considered in this paper is that of potential output and deviations from potential output. Potential output growth is difficult to measure, particularly given the supply side changes in the economy over the past two decades. The increase in participation rates, reduced unemployment among long-term unemployed and migration all impact on measures of potential, as does any improvement in the functioning of markets or a major change in relative prices. The concept of potential output is clear but its measurement is difficult, witness the two approaches adopted in Ireland-a time series approach and a production function approach. Both suffered from a failure to take account properly of an improvement in the functioning of markets, while the former had the additional weakness that poor performance implied poor potential, and the latter required additional assumptions about Total Factor Productivity, something we are still learning about. In spite of measurement difficulties the concept is important.

The economy will sometimes grow faster than potential and sometimes slower. If potential output growth is sufficiently high the economy will rarely experience negative growth-but will have growth cycles. It is this that characterised economic performance in the OECD area in the 25 years to 1973, and seemed to characterise the experience here until this cycle.

For a short period it was believed, elsewhere and here, that the business cycle could be eliminated-keeping the economy on its potential growth path. This proved to be illusory, for both practical and theoretical reasons. The practical reasons, in particular the failure to predict and failing that, then to identify turning points, lay behind the fiscal imbalances that emerged here in the 1970's and which took a decade to correct.

One consequence of that period is that policymakers are unlikely to make the same mistake again-but unfortunately they made new mistakes and the difficulties faced by the economy today are partly a result of this.

Post-depression rules for fiscal policy

Once the 1970's and 1980's fiscal crisis was corrected policymakers were constrained by the desire to meet the Maastricht criteria. Thereafter they evolved a new rule for policy:

Spend it if you have it, and don't spend it if you don't have it. (Rule A)

The effect of the application of this rule was pro-cyclical. As a consequence the economy grew too fast in the late 1990's and too slowly in the early 2000's as potential budget surpluses were translated into increased public expenditure and reduced taxes and conversely. By 1999 the economy was effectively fully employed, and the pressure on resources was exaggerated by EMU when lower interest rates encouraged the emergence of a housing boom, itself compounded by tax changes designed to stimulate the housing sector when the economy had weakened in the early 2000's. Thereafter the economy experienced wage and price inflation –added to by the weakness of the euro. The

economy entered a new phase of development with growth based on domestic demand rather than competitiveness and exports. The pressure on resources was eased somewhat by very high levels of immigration, but wage and price inflation remained high and an external deficit re-emerged. Within the monetary union the external deficit seemed to pose no problem, but the collapse of interbank markets and the shortages of liquidity over the past year suggest that this benign view needs to be modified-though it is difficult to see how the financial sector could have been insulated from the general financial crisis, given that the same practices were well in operation here. The principal difficulty with criticism of policy was that the economy grew by more than 5% since 2000 so everything was fine?

There was an alternative view of fiscal policy:

Budget should always be neutral (Rule B)

With the application of this rule the automatic stabilisers would dampen down fluctuations in the economy. This would have limited the excessive growth of the late 1990's and limited the weakness of the early 2000's and possibly also the early 1990's. The implications of **Rule B** for the public finances are very different than those from **Rule A.** As a consequence there would sometimes be budget deficits and sometimes budget surpluses rather than budget balance.

The objective should be budget balance (or perhaps a slight deficit/surplus) over the business cycle-a sort of golden rule which is now possible with the reform of the Stability and Growth Pact. If the course of the business cycle could be predicted, than policymakers could use discretionary policy, deliberately damping down excess growth in the upturn and stimulating it in the downturn. Even then it is difficult to see how this can be done in a non-distortionary way. The decline in nominal interest rates with the monetary union was always likely to lead to an increase in housing demand, so that even if other causal factors could not have been predicted, this characteristic alone of the

monetary union should have led policymakers to be cautious and use expenditure shifting (reducing) measures rather than expenditure increasing measures.

However the application of this rule is somewhat counterintuitive for policymakers. There is always pressure for more expenditure or lower taxes or both. When the public finances improve because the economy has performed better than expected the natural tendency for policymakers is to spend any emerging surplus. This has now become part of budget expectations-witness media comment before each of the last three budgets. This rule allows such changes, but they are not financed by temporary tax revenues. There is an absolute need to distinguish between the business cycle effect, composition effects and the trend effect. This does not exclude tax changes or expenditure changes where the budget remains in balance, where the objective is to increase the level of services or expand existing ones, subject to providing value. Recent calls for increasing the proportion of GDP devoted to public expenditure/taxes in line with other EU countries miss the point of value, ignore the characteristics of public expenditure in other countries (defence expenditure, social security pensions rather than private pensions supplemented by modest social security pensions, different age profile impacting on health expenditure, use of GDP rather than GNP for expenditure measures).

The current situation

If the economy were faced with just a cyclical downturn then **Rule B** provides a simple solution-do nothing. Since we have not followed this consistently we are not starting out from a position of balance in the public finances, even if the economy were at potential. Hence there is more going on with the public finances than this.

First, public expenditure and tax changes made in previous budgets were based on the implicit assumption that the economy was not above potential. Cyclical increases in tax revenue were regarded as permanent and expenditure and tax changes were made on this assumption. Thus fiscal policy for 2009 is not starting from a position of balance. Even

by the 2008 budget there was no recognition that the economy had been flat from the first quarter of 2007, and the economy has deteriorated since then. Since the economy was above potential the implication is that there is a structural budget issue. This is an almost inevitable consequence of **Rule A** i.e. the rule itself guarantees a structural budget deficit and consequently the need for correction of the public finances.

Second, there has been a loss of retail business and tax revenue to the North as prices have not adjusted to exchange rate changes. Sterling weakness relative to the euro has been in evidence since 2007 yet the price level for much grocery items, many UK sourced, has not reflected this. The level of cross-border shopping is non-trivial.

Third, the car market has been distorted by changes in VRT and registration regime, by changing the relative prices of new cars and the existing stock. Much of the existing stock experienced a decline in value with the change in regime and this affects willingness to trade. This has revenue implications for the public finances and exacerbated the cyclical effect anyway in the market.

Fourth, on the revenue side there was a further problem. In addition to revenues being high for cyclical reasons there was a "composition" effect deriving from stamp duties, mostly from the second-hand housing market and from capital gains tax. In 2001, 2004 and 2006 total receipts from these taxes were €1.75 bn, €3.6bn and €6.7bn. Revenue from these fell to €6.3 bn in 2007 but has collapsed this year perhaps to 2004 levels and will not recover quickly. The direct link of such revenues to the business cycle is not straightforward, so that even without the current decline in output these revenues were set to fall. Unfortunately they were regarded as permanent, and revenue and tax changes reflected this.

Finally, the level of potential output and potential output growth may have been adversely affected by the credit crisis. This looks very much like a structural shift-real interest rates have increased and the intermediation capacity of the financial sector has been reduced. This is always a problem with framing policy-is there just a cyclical

downturn or has potential output itself shifted. Unfortunately in this case both have occurred.

Implications

It follows from the above that we cannot expect a cyclical recovery with the public finances returning to balance. There is also the likelihood of slower growth in the medium term. Hence there is a need to deal with the public finance issue. The question is how far must this be pushed. If the economy were at potential then the budget deficit would be a minimum of 2.5% GDP. This is based on simple rule of thumb, as measures of the elasticity of the deficit with respect to output are uncertain. If the trend of potential output has shifted downward then this would obviously be higher. The actual outcome for 2008 is likely to be a deficit of 5-6% GDP reflecting the depth of the downturn. The budget problem is the structural deficit, and this must be addressed.

In addition to the budget issue there is also the fact that the economy is in recession. It follows from the earlier analysis that discretionary policy should not be used. The situation is exacerbated by the loss of competitiveness referred to earlier. Unfortunately we have no instrument for dealing with this. This is precisely the problem identified prior to monetary union-the need for a flexible labour market. Since wage rates rarely fall there is a need to go back to "social consensus" model as originally practiced with focus on pay. Even with this, the coverage by employees directly by national agreements is low. The latest agreement a step in right direction on pay, but there is too much of the rhetoric of the 1970's and this fails to recognise the current situation. The situation could be eased if the price level were lower, a natural expectation given the €/£, so need to look more aggressively at some markets in competition terms.

In terms of the public finance adjustment the focus should be to operate on all fronts. The structural issue arose because of tax changes and expenditure increases so that the object should be to claw these back. It is important to remember that we are not in a 1980's situation. The following list gives a flavour of what is needed.

(i) Eliminate/phase out/reduce many tax breaks

(ii) Apply uniform fuel taxes by activity

(iii) Maintain current levels of tax credits for several years

(iv) Limit the growth in expenditure-11 month wage freeze helps here

(v) Rethink approach to capital expenditure “minister in favour” not an adequate basis

(vi) Need for ex post evaluation of large projects to see what lessons can be learned-at what point ex post was sunk cost case not valid

(vii) In 1980’s “capital” was a euphemism for waste. Why is “capital” now uniformly good? Think of Luas-beneficiaries obviously in favour, but was it worth it? Why was the upgrade of the N9 translated into the M9?

(viii) Too many state bodies and excessive regulation, except for banking

(ix) Many state services too high cost – health, education-driven by excessive levels of pay.

(x) avoid easy solutions-cutting expenditure where it is easy.

What happens when the public finances are corrected and the economy is back at potential

Take on board **Rule B** as an operating rule for short term fluctuations in the economy. Then concentrate on increasing the level of potential output.