Fiscal Policy for 2012

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Objectives

In framing the Budget for 2012 the objective must be to ensure that the economy returns to a sustainable growth path, while minimising the cost of achieving that long term objective. Over the last two decades, when the debt burden was low, the objective should have been to use the annual Budget to maintain the level of economic activity as close as possible to the growth in potential output and not to exceed it. Over the period 2003 to 2007 this should have involved a progressive tightening of fiscal policy to reduce excess demand in the economy. Instead the opposite happened with the consequences that we know today (Bergin *et al.*, 2011).

Role of Fiscal Policy

The mushrooming of the national debt since 2008 means that the theoretical role of fiscal policy in minimising deviations of actual output from its potential has been superseded by the need to return the economy to a sustainable growth path where the debt burden is tolerable and falling. Because of the exceptional level of the debt burden today, in setting fiscal policy this preoccupation with ensuring the long-term sustainability of the economy must take precedence over the theoretical role of managing the level of activity.

The reasons why it is essential to give precedence to bringing the debt burden under control are firstly that we are uncertain about the future and secondly that the simple arithmetic of compound interest means that delayed adjustment only creates a bigger hill to climb in the future.[2] If we were certain about our forecast that the economy will eventually return to reasonable growth, and if the world were also certain about this forecast, it might well be different. Under those circumstances the interest rate facing the government on its borrowing would be exceptionally low, as in the case in Germany today. In turn this would make the costs of delay very low and the option of a different approach to fiscal policy would be possible. However, the reality is very different – there is no certainty about the future and the potential cost of borrowing remains very high.

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[2] To the extent that the interest rate reflects the debtor's discount rate, agents should be indifferent between the low debt today and the higher debt tomorrow. That said, if the interest rate contains a risk premium that does not enter the calculation of the debtor's discount factor (as it does today) , paying off the debt today is preferable.

In the first place it is impossible to be certain when the economy will return to normal growth.[3] This makes it difficult to predict how big a mountain of debt would build up if adjustment was postponed waiting for that recovery. A further shock to the economy could delay recovery, with consequential adverse effects on the rising national debt. Under such circumstances the cost of delayed adjustment could potentially be very large.

Secondly, because of the uncertainty about the future, the marginal interest rate facing the government, when it exhausts the exceptionally generous EU/IMF support in 2014, will be high. That interest rate will be crucially dependent on the market assessment of the sustainability of the Irish debt burden when Ireland returns to the financial markets. If the market were certain that the debt burden was not a problem then the interest rate would be low. However, we saw over the last year how worries about the sustainability of that debt burden could send the interest rate facing Irish borrowers to truly remarkable levels. If the existing debt burden is to be supportable the interest rate on funding that debt in 2014 and thereafter must be reasonable. To achieve such an interest rate outcome it will firstly be necessary to convince the people of Ireland that the debt burden is sustainable. Secondly, it will be essential to convince the rest of the world that there is a very high probability of Ireland succeeding in this objective and that the debt will eventually be repaid. This has already necessitated a huge fiscal adjustment between 2008 and 2010 of 10 per cent of GDP. The only way to achieve these objectives today is to take further major action to tackle the problem of the rising debt, even at the cost of implementing tough fiscal policies at a time when actual output is well below its long run potential.

Fiscal Adjustment Path

The key task for fiscal policy is to return the economy to a growth path where Government borrowing is eliminated within a reasonable time scale, leaving the country with a sustainable level of debt. Over the course of the autumn of 2010 it became apparent that, because of the very high level of borrowing and the burden of the debt to be incurred to bail out the banks, this could not be achieved in one year so that it was essential to put in place a process of fiscal adjustment over a number of years. As a result a programme of adjustment was agreed by the previous government last November 2010 and accepted by the incoming government in March 2011 with limited modifications. The phasing and magnitude of this reduction in the government deficit over the period 2011-15 was planned so as to reduce borrowing to 3 per cent of GDP by 2015. It was estimated at the time that this would require cuts in expenditure or increases in taxes amounting, *ex ante*[4], to a cumulative €15 billion over the period 2011-15.

In assessing how appropriate this plan for budgetary adjustment is to current circumstances it is necessary to determine how much of the current deficit is structural

[3] In the very unlikely event that the EU does not manage to save the EU financial system from its current crisis the outcome could be a further dramatic fall in output in the EU as a whole and, as a consequence, also in Ireland.

[4] While a tax increase (or expenditure cut) may be designed to bring in €x billion in revenue, because of the contractionary effect of the tax increase, the actual impact on the deficit will be substantially lower than the headline tax increase would suggest.

and how much is cyclical: i.e. how much will remain when the economy has returned to capacity output and how much will disappear as the gap between potential and actual output is closed. This is not a simple exercise and the rather simplistic methodology used by the EU for this purpose is not suitable for the Irish economy (Department of Finance, 2003, Bergin, *et al.*, 2010).

In a recent paper (FitzGerald and Kearney, 2011) we took the forecast of the Department of Finance for the period to 2015 (Department of Finance, 2011) and we adjusted it to take account of the lower than expected costs of recapitalising the banks and the major reduction in the interest rate on borrowing from the EU/IMF agreed at the EU Council in July 2011. On this basis, after the planned fiscal adjustment over the period 2011-14, the deficit would be down to 1.5 percentage points of GDP by 2015 and would be likely to disappear in the following two years with a neutral fiscal policy. This would mean that the planned fiscal action for the period 2012-14 would be more than adequate to eliminate the structural deficit.

However, this "simulation" is only one of a range of possible outcomes for the Irish economy. Any slowdown in the EU and US in the second half of 2011 and into 2012 would reduce growth in Ireland below that anticipated, with a consequential negative impact on the deficit. Also, any other unexpected shock hitting the Irish economy over the next few years could derail the adjustment. Thus it is possible that the actual outcome could be worse than foreseen when the plan was adopted. Of course, as indicated in Bergin *et al.*, 2010, it is also possible that the recovery could be more vigorous than anticipated, leading to a more rapid reduction in the deficit. Thus it is necessary to consider the appropriateness of the current plans for fiscal policy in the context of the considerable uncertainty that exists about the future growth path of the economy.

While it is possible that the economy could outperform current forecasts as well as underperform, the cost of deviations from the planned adjustment path are likely to be asymmetrical. If the reduction in government borrowing were to take place more slowly than anticipated this could lead to a loss of confidence in financial markets. In turn this would almost certainly result in substantially higher interest rates, greatly magnifying the cost of a slower adjustment. On the other hand, outperformance is likely to have a smaller benefit in terms of reducing interest rates, as financial markets are in any event beginning to factor in an Irish exit from the crisis. This argues for erring on the side of caution and ensuring that the targets for reducing borrowing leave scope for limited potential unpleasant surprises along the way.

Conclusions

On the basis of current information the planned fiscal action over the period 2011-14 should be more than enough to eliminate the underlying structural deficit. As economic activity returns to normal the cyclical upturn would eliminate the remaining deficit by 2016 or 2017 at the latest.[5] This planned adjustment process is necessary to clearly demonstrate that the Irish economy can and will return to a reasonable and sustainable rate of growth in the medium term. Ideally, having set out the plan to eliminate the

[5] The intermediate target is to reduce government borrowing to a maximum of 3per cent of GDP by 2015.

structural deficit within the set time scale, it should be possible to allow limited deviations from that path, either above or below it, if the outturn for economic growth proves to be somewhat different from the forecasts. Provided the rather different outturn did not result in a changed assessment of the structural deficit, the planned adjustment would still achieve its objective. Committing to an appropriate fiscal adjustment plan and sticking to it unless there is a major change in circumstances should, over time, add to the credibility of policy.

This implies that if the outcome of the more favourable developments earlier this year (lower bank recapitalisation costs and lower interest rates) is that the fiscal target for next year will be exceeded, this outperformance should be welcomed and the fiscal adjustment for 2012 (or subsequent years) should not be changed. It would just see a more rapid approach to the targeted elimination of the deficit (leaving more room for negative surprises in future years). However, as discussed above, because of the asymmetrical costs of under rather than over-performance, the same may not be true if lower world growth were to result in a likely failure to meet the deficit target for 2012. If the changed growth scenario suggested a permanent increase in the underlying structural deficit it would certainly merit remedial action.

On the basis of current forecasts, the targeted adjustment over the period 2011-14 of €15 billion still seems broadly appropriate. However, as planned at the end of 2010 it left limited room for under performance by the economy in terms of growth in any of the intervening years. As mentioned above, since that plan was drawn up there have been two positive developments which will make it easier to achieve the planned target for reducing the borrowing requirement to 3 per cent of GDP by 2015: the lower than expected cost of recapitalising the banks and the very substantial reduction in the interest rate on the EU/IMF funds. Over the course of 2011 the budget targets have also generally been exceeded. Together these developments suggest that the planned medium term fiscal adjustment could result in the deficit falling below the target next year.

However, more recent developments outside Ireland, in the EU and the US, suggest that the world economy may under-perform in this year and into next year. If this slowdown in world growth were to have a serious negative effect on the Irish economy this year and next year it could see the target for the deficit in 2012 (8.6% of GDP) being missed if the leeway already built up this year proved inadequate.

It is, as yet too early to forecast the likely economic growth trajectory for 2012. It is appropriate to await further information up to the end of November of this year before finalising a view of what will happen in 2012. At that point a decision obviously has to be made about the size of the fiscal adjustment to be incorporated in the Budget for 2012. If the 8.6 per cent of GDP target for borrowing looks very likely to be achieved with a fiscal adjustment of €3.6 billion next year, then there should be no change in the size of that adjustment. However, if there is any chance that the deficit target could be missed it would be appropriate to plan for a slightly tougher fiscal adjustment in 2012 in the range €3.6 billion to €4 billion. Such an approach would signal the government’s long term commitment to putting the public finances on a sustainable footing while still remaining close to the medium term plan. It should not be necessary to offset all of any potentially temporary slowdown in world economic growth to maintain the credibility of Irish economic policy. Major changes in the Plan should only be implemented if new information suggests that the structural deficit is significantly greater or less than currently envisaged.

As well as putting the economy on a sustainable growth path, the plan for fiscal adjustment must, wherever possible, encourage a return to growth in domestic demand. As discussed above, current uncertainty about the future is aggravating the tendency for households and consumers to rebuild their balance sheets very rapidly, resulting in no growth in domestic demand and a move into substantial balance of payments surplus. While one option would be to accelerate the fiscal adjustment, so that by 2013 or 2014 households and companies would know that it was completed, this could prove very painful in the short term. The contractionary impact of the accelerated adjustment would itself add to uncertainty among households and companies, which might not dissipate until the adjustment was very clearly seen to be completed. There is little evidence that the contractionary effects would be more than offset by a dramatic change in consumer and investment confidence in the immediate future (Bradley and Whelan, 1997, IMF, 2010).

An alternative strategy, which would probably be preferable, would be to try and give greater certainty to agents in the domestic economy by spelling out in detail the way the future adjustment in the public finances will be undertaken: particulars of the tax increases and increases in charge to come over the next 3 years as well as particulars of where the cuts in spending will take place. This would allow people to plan for the future. As such a plan was implemented and seen to be on course, it would enhance confidence that an end to the adjustment was in sight by 2013 or 2014, allowing people to begin to consume and to invest in a more normal fashion.

In addition to providing a more detailed plan for fiscal adjustment out to 2014, the actual measures chosen in the Budget should be designed to be job friendly as well as being clearly fair in locating the burden of adjustment on those best able to pay. This would suggest implementing the recommendations of the Commission on Taxation, with a move to significant property taxes and other charges, which do not impact directly on the labour market. Changes in the welfare system should aim to reduce poverty traps rather than to create new ones. Obviously the cuts in expenditure should be combined with major structural changes in service delivery to enhance productivity, minimising their impact on public welfare.

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