Quarterly Economic Observer

Summer 2012

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Nevin Economic Research Institute

About NERI and this publication

The Nevin Economic Research Institute (NERI) has been established to provide information, analysis and economic policy alternatives. Named in honour of Dr Dónal Nevin, scholar, trade unionist and socialist who gave a life of service to the common good, the Institute aims to undertake research that will be of relevance to the Trade Union movement and the general public across the island of Ireland.

This is the second Quarterly Economic Observer (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. The QEO complements the NERI Quarterly Economic Facts (QEF) which provides a set of statistical indicators to underpin our analysis. The data cited in this Observer are the latest available as of 22 June. The final draft of this document was completed on 23 June.

This report has been prepared by staff of the Institute. The analyses and views expressed in this publication do not necessarily reflect those of the Irish Congress of Trade Unions or the unions supporting the work of the Institute.

Further information about NERI may be obtained at our website
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The Nevin Economic Research Institute

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Executive Summary

The most recent data released by various agencies indicates that fiscal austerity is not working. Unemployment in the Republic of Ireland is projected to remain close to 15% of the workforce in the immediate future while the level of domestic demand continues to contract or stagnate and the indications for export growth are not encouraging as Ireland's key trading partners enter a new recession. The crisis in public finances across Europe is not only linked to a crisis of market confidence and monetary stability: there is a crisis in the 'real economy' where aggregate demand is falling and long-term unemployment and personal, corporate and government debt is embedded. Given the unprecedented uncertainty in which European Union member states find themselves coupled with the risk of a new and prolonged depression across Europe we argue for a cautious fiscal stance, here, based on the principle of 'doing no further harm' allied to the urgent need to bring forward in the shortest possible time frame a programme of investment in priority infrastructure.

In this Quarterly we present the case for a movement towards fiscal sustainability through a balance of measures including:

- Initiation of a targeted, frontloaded and timely investment stimulus drawing on a mix of public, private and European Investment Bank funds;
- No further cuts in the *overall* level of discretionary voted capital and current expenditure;
- A medium-term reduction in public expenditure associated with high levels of unemployment and an increase in revenue buoyancy through growth-enhancing measures over time; and
- A closing of existing tax breaks and reliefs and a graduated and incremental increase in the average target tax-take for high-income households with the aim of reducing the government deficit to below 3% of GDP by 2017.

1 Introduction

In the Spring 2012 Quarterly Economic Observer of the Nevin Economic Research Institute (NERI) a detailed proposal was outlined for an investment stimulus in both jurisdictions of Ireland (NERI, 2012). Subsequently, the Irish Congress of Trade Unions (2012) published a proposal for how such an investment programme would be funded and delivered. The aim of this proposal is to begin the process of reversing the decline in domestic investment and aggregate demand and raise confidence and hope against a background of continuing high levels of unemployment.

Given the severe shortcomings in social and economic infrastructure there is need for an accelerated programme of public and private investment. The proposed initiative to leverage private sector investment in domestic infrastructure should be pursued as a matter of priority. It has been estimated that the combined value of pension funds is in the Republic of Ireland is in excess of €70 billion with the vast majority of this invested abroad, there remains a real opportunity to attract some of this funding into Irish projects and assets. As an alternative, it is proposed that the pension levy be waived if a pension fund invests a fixed multiple of the 0.6% in the Republic, that is currently taxed on the value of Irish pension funds. Exemption would have to be conditional on investment in approved activities. These sources of funding could be combined with inward overseas investment in long-term projects with high returns such as in renewable energy.

The NERI will publish two policy research papers which will examine in greater depth the options for funding and project delivery – for Northern Ireland and the Republic of Ireland later this year. Each paper will assess the options for linking private pension fund investment, along with public sources of funding, to priority infrastructure.

In this Quarterly we focus on the role of fiscal policy including the public capital programme in the Republic of Ireland. The context for this is the continuing unemployment crisis linked to the depressed level of domestic demand. At the same time we link the immediate response of fiscal policy to the need to move towards a different economic and social model over the coming ten years – one that is closer to European Union norms of public spending and taxation. Fiscal policy is only one element of a range of social changes required to rebuild the economy and improve the well-being of communities and individuals. Policies in relation to the reform of banking, industrial and service sectors as well as measures to facilitate innovation and enterprise in both public and private sectors need to be developed. In forthcoming Quarterly editions, we will turn our attention to these other vital and complementary strands of an alternative economic and social strategy.

Recent economic trends in both parts of Ireland are reviewed in Section 2. Section 3 provides an overview of recent macro-economic projections made by various agencies out to 2017 or earlier. In Section 4 we explore the implications of a different budgetary stance in the Republic of Ireland. It is intended to extend this analysis to Northern Ireland in later editions of the Quarterly Economic Observer.

2 Overview of Recent Economic Trends

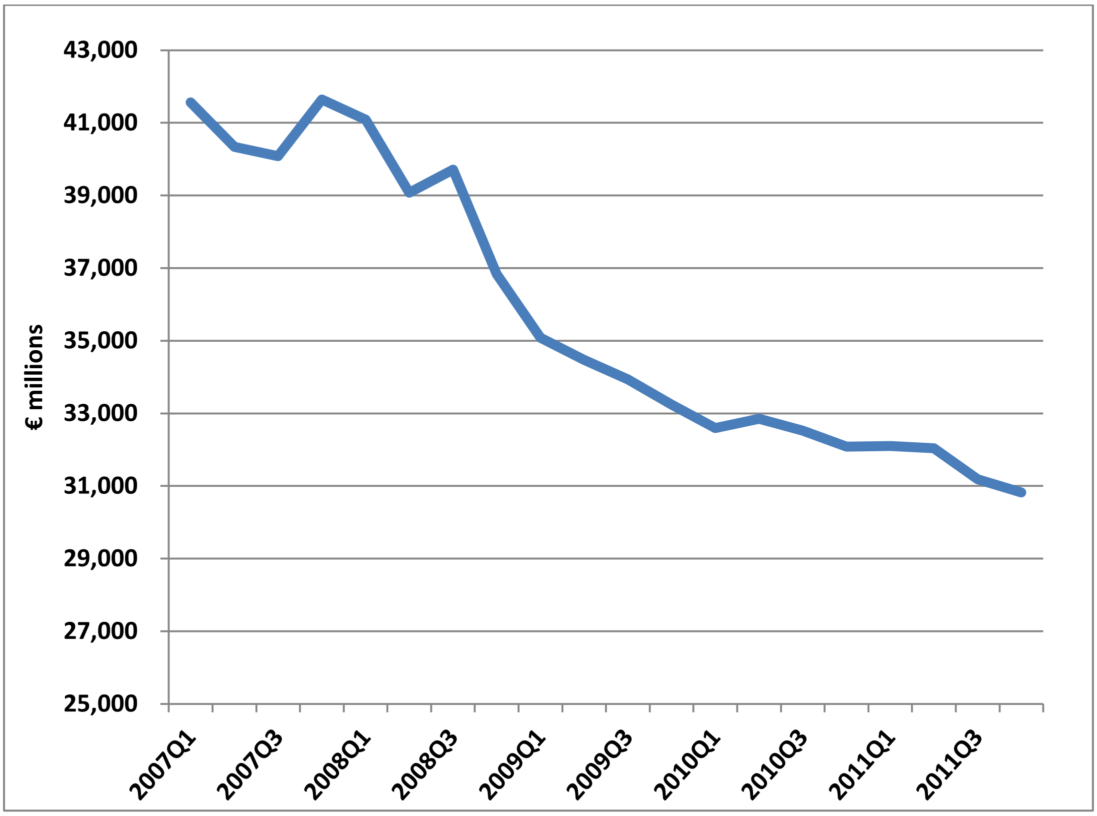
Following a sharp downturn in 2009 in the economies of Northern Ireland and the Republic the total amount of output has been relatively stagnant in 2010 and 2011. Recent provisional estimates of quarterly GDP have signalled a fresh recession in both the Irish and UK economies beginning in the latter half of 2011. Many Eurozone economies appear to be entering a new phase of stagnation, if not recession, following a weak recovery in 2010 in some countries. Continuing uncertainty and rising unemployment in most countries is undermining consumer and investor confidence. On the positive side, recent discussions at the political level to increase investment across Europe and stimulate economic growth are welcome. The nature, scale and timing of such measures remain to be clarified, however.

At this crucial juncture in the economic, political and social crisis affecting much of the European Union it is vital to consider the impact of continuing a co-ordinated fiscal austerity across the Union. The anaemic recovery in economic activity in the Republic of Ireland in 2011 was due in large part to the strong performance of Irish exports especially in the first half of last year. It is unlikely that this performance will be repeated in 2012 due to the pressure of contracting demand in the main trading partners. Chart 1 shows the continuing contraction in the level of domestic demand since the beginning of 2008. Domestic demand is the sum of government consumption, total investment and personal consumption.

An overview of recent trends in both Ireland and the United Kingdom is provided in Table 1. It is clear that the Republic of Ireland has endured the worst effects of recession with the rate of employment in 2011 a full 10 percentage points below the 2007 level. The annual average rate of unemployment was 14.4% in the Republic in 2011 compared to 4.6% in 2007. The contraction in output as measured by Gross Domestic Product was particularly severe in the first two years of recession. The level of GDP has been stabilised over the two year period from 2010 to 2011 due to the positive impact of export growth. However, the news on the unemployment side is extremely worrying. The rate of unemployment has been estimated by the Central Statistics Office to be 14.7% in the first quarter of 2012 (CSO, 2012). This represents an increase of 0.6% points since the first quarter of 2011. This is the highest rate since the early 1990s and there are no signs that this rate will fall significantly in the coming two years. This rate is forecasted in the Summer 2012 ESRI Quarterly Economic

Commentary to rise to 14.9% in 2012 with a fall of 13,000 in total employment over 2011 (Duffy, Durkan and O'Sullivan, 2012).

Chart 1 Trends in the real value of domestic demand (Republic of Ireland) – quarterly data 2007-2011



Source: CSO: Quarterly National Accounts.
Notes: Domestic Demand = Personal Consumption + Government Consumption + Investment. Domestic demand chiefly differs from Gross Domestic Product due to the size of net exports = exports – imports.

Falling GDP in the Republic of Ireland in the last two quarters of 2011 along with a cumulative decline of 26% in real terms in domestic demand from the end of 2007 to the end of 2011 testifies to the failure of fiscal austerity to kick-start economic activity. A huge expectation has been placed on export performance to pull the economy out of recession and negate the impact of domestic contraction. However, export growth in the latter half of 2011 has not been sufficient to prevent a small, but significant, decline in Gross Domestic Product (GDP) over the second half of 2011.

Now entering its fifth year of consecutive domestic contraction, the economy of the Republic of Ireland has proved disappointing as an example to other European States struggling with debt, rising unemployment and stagnant economies.

Table 1 Some key economic trends in Ireland and the UK

		2007	2008	2009	2010	2011
Total Employment	ROI	69.2	67.6	62.2	60.1	59.2
(% of Working Age Population)	NI	68.8	68.2	64.8	66.0	67.1
	UK	71.5	71.5	69.9	69.5	69.5
Unemployment	ROI	4.6	6.3	11.9	13.7	14.4
(% of labour force)	NI	4.1	4.6	6.3	6.9	7.3
	UK	5.3	5.6	7.6	7.8	8.0
GDP	ROI	5.2	-3.0	-7.0	-0.4	0.7
(% volume change for each year)	NI*	3.0	-2.7	-5.1	0.4	-
	UK	3.5	-1.1	-4.4	2.1	0.7

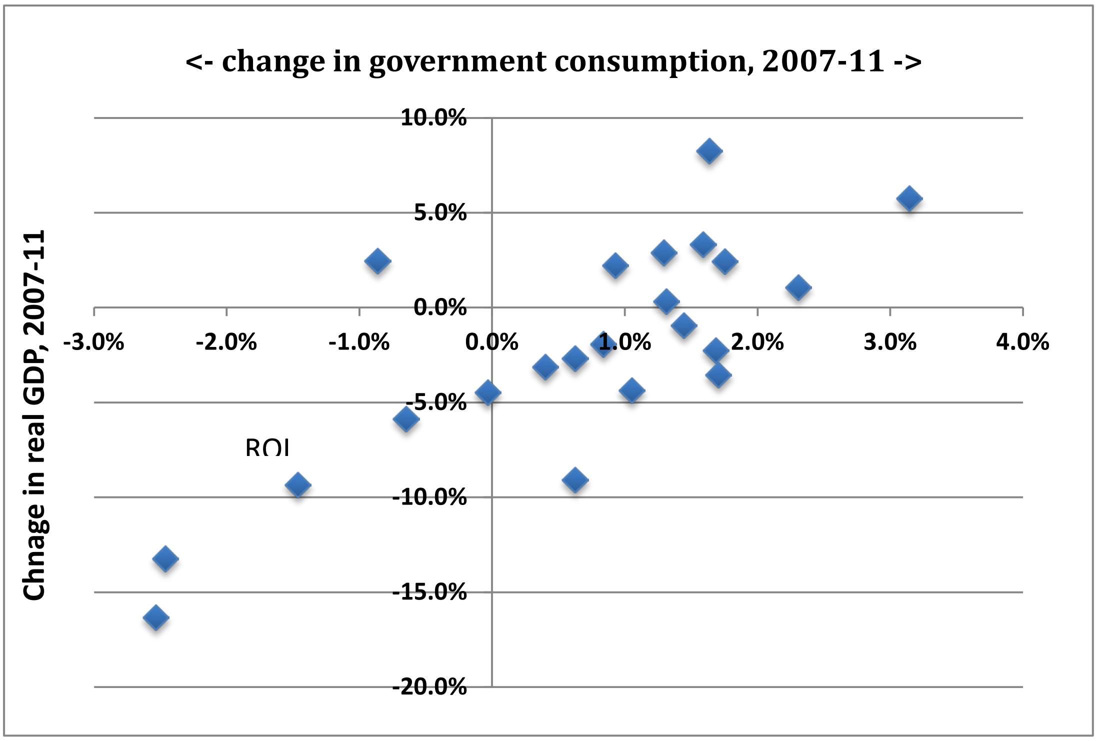
Source: ROI and UK labour market data refer to the whole year and were taken from the Eurostat database. Northern Ireland labour market data is for the period January to March of each year from the Northern Ireland Labour Force Survey. GDP data for ROI and UK are from the OECD Economic Outlook database. Northern Ireland Gross Value Added data are from ONS Regional Trends Series.

Notes: ROI = Republic of Ireland, NI = Northern Ireland and UK = United Kingdom.
* Northern Ireland output refers to Gross Value Added (GVA).
Total employment refers to all persons in employment (ILO definition) aged 15-64 as a proportion of all persons aged 15-64. Unemployment is calculated on an ILO definition basis and refers to persons aged 15-74.

The immediate fiscal outlook is extremely challenging. Add to this the continuing crisis of confidence with regard to the Euro and the lack of a political solution to the interlocking problems of private debt, public debt and co-ordinated fiscal austerity across the European Union. The European common currency and with it the European project is confronted with an existential crisis. The fiscal crisis has been greatly exacerbated by the monetary-banking crisis especially in countries such as Ireland. However, in response, the fiscal crisis has reinforced a crisis in banking as job losses, high levels of personal indebtedness and declining incomes resulting from cut backs to expenditure have continued to undermine bank solvency.

Previous projections of growth in GDP and employment by various agencies have been revised downwards not because of weak export demand – export markets have been very buoyant at least up to mid-2011. Rather, they have been revised because the evidence now emerging strongly suggests that the negative domestic economy impacts of fiscal contraction were under-estimated. The relationship between fiscal austerity and growth in GDP is complex. However, a contrasting of growth in real GDP with the change in the volume of government consumption over the four year period, 2007-2011 points towards a strong association between fiscal austerity and poor economic performance (Chart 2). Such an association does not conclusively prove one-way causality from fiscal austerity to lower or negative economic growth. However it does point to the lack of any convincing evidence that cutting back on public expenditure has generated confidence and renewed household or private sector consumption and investment.

Chart 2 How European countries compare on fiscal austerity and growth in GDP



Source: Eurostat online data

Modelling simulations used by Bergin, Conefrey, Fitzgerald and Kearney (2010) point towards a likely negative impact on GDP of somewhere in the region of 0.4-0.5% for every €1 billion in fiscal adjustment (=0.6% of GDP). For example a cut of €1bn (=0.6% of GDP) arising from lower employment lowers GDP by between 0.8% and 0.9% in the first four years following the adjustment. A cut of €1 billion in capital spending lowers GDP by 0.1 and 0.3% (with the proviso that this is likely to be an under-estimate as supply-side impacts are not accounted for[1]). A cut of €1 billion in public sector wage rates would lower GDP by between 0.2 and 0.3%. A similar overall negative impact is likely for the same level of adjustment on the revenue side. All of these estimates are

[1] Bergin, Conefrey, Fitzgerald and Kearney (2010) state that: 'These simulations do not take account of the significant positive supply side effects from public investment'

based on static conditions with regard to markets and credit conditions and reflect pre-2008 relationships.

An alternative economic strategy rests on the idea that central to economic recovery is the creation of sustainable employment. Job creation will bring people back into gainful employment, boost revenues to Government and increase consumer and investor confidence. The core problem is lack of demand – especially domestic demand. Unemployment soared in the Republic of Ireland in 2008 and 2009 as investment collapsed, consumption fell and fiscal contraction reinforced the downward spiral in domestic activity. This greatly added to the strains on public finances as the numbers claiming benefits rose and as eligibility for social transfers increased sharply. Every cut in spending by government added to the recessionary fire storms of 2009-2010 as consumers cut back on discretionary spending and as public authorities cut back on their budgets.

3 Macro-economic Projections to 2017

Table 2a updates information provided in the NERI Quarterly Economic Observer (Spring). Data for 2010 reflect the last forecast or projection made by various agencies before 1 January 2010. Similarly, data for 2011 reflect the last forecast or projection made by various agencies before 1 January 2011. The projections for 2012 and later year come from the latest release of projections by various agencies listed in Table 2a. There is an apparent slight worsening in expectations for both GDP and unemployment (Table 2b) compared to the last NERI QEO (Spring). In a number of cases projections have been extended out to 2015 or later. The overall indications are for very sluggish growth in GDP in 2012 with all projections in the -0.1 to + 0.7% range. There is an expectation of a modest pick-up of GDP growth in 2013 according to all projections. Agencies such as the Department of Finance and the IMF project a renewal of a trend real growth rate of close to 3% from 2015 onwards. However, there is considerable uncertainty with regard to the timing and scale of economic recovery given international developments. Most projections envisage a modest recovery in domestic demand from 2014 onwards with a relatively strong export growth performance a feature of economic recovery especially from 2014 onwards. A sustained recovery in both domestic demand and net external demand (exports minus imports) is far from sure and the continuing impact of fiscal austerity allied to problems of high personal and corporate debt is acting as a strong drag on the level of domestic demand.

It should to be noted that the latest set of Department of Finance projections to 2015 (Department of Finance, 2012) are based on the assumption of a significant continuing growth in net exports as an offset for falling or stagnant domestic demand. Only by 2014 and 2015 is there any recovery in domestic demand. Even then, the projected annual growth rate is under 1%. Based on past experience it seems very unlikely that employment levels will recover to any significant extent without a significant boost to domestic demand.

Table 2a Overview of recent projections of change in real GDP (Republic of Ireland)

	2010	2011	2012	2013	2014	2015	2016	2017
Outcomes	**-0.4**	**0.7**						
Department of Finance	-1.3	1.7	0.7	2.2	3.0	3.0	-	-
Central Bank	-2.3	2.4	0.5	2.1	-	-	-	-
EU Commission	-1.4	0.9	0.5	1.9	-	-	-	-
IMF	-2.5	2.3	0.5	1.9	2.5	2.8	2.9	2.9
OECD	-2.3	1.5	0.6	2.1	-	-	-	-
ESRI (QEC)	-0.25	2.25	0.6	2.2	-	-	-	-
Ernst and Young	-0.6	1.1	-0.1	0.6	1.4	3.0	-	-
Goodbody	-1.1	1.2	0.7	1.8	2.1	2.9	-	-
NCB	-0.3	1.0	0.3	1.7	2.0	2.2	-	-

Source: Department of Finance Stability Programme Update (April 2012); Central Bank: Quarterly Bulletin (April 2012); European Commission (May 2012); IMF: Sixth Review Under the Extended Arrangement (June, 2012); OECD: Economic Outlook (May 2012); ESRI: Quarterly Economic Commentary (June 2012); Ernst and Young: Economic Eye, June (2012); Goodbody: Irish Economy Q2 2012 Health Check (May 2012); NCB: Irish Economy Monitor (June 2012).

Notes: Data sources for Outcomes: Central Statistics Office and Eurostat.
Previous forecasts for 2010-2011: Forecasts made at the end of the previous year (2009 and 2010, respectively, for 2010 and 2011)
Current forecasts for 2012-2014 as of June 2012 or the most recent period.

Table 2b Overview of recent projections of Unemployment as % labour force (Republic of Ireland)

	2010	2011	2012	2013	2014	2015	2016	2017
Outcomes	**13.7**	**14.4**						
Department of Finance	13.2	13.2	14.3	13.6	12.8	11.7		
Central Bank	14.0	13.3	14.4	14.0	-	-	-	-
EU Commission	14.0	13.5	14.3	13.6	-	-	-	-
IMF	15.5	13.0	14.3	13.7	13.0	12.3	11.3	10.4
OECD	14.0	13.6	14.5	14.4	-	-	-	-
ESRI (QEC)	13.75	13.5	14.9	14.7	-	-	-	-
Ernst and Young	13.2	12.7	14.9	15.2	15.1	14.4	-	-
Goodbody	14.1	13.3	13.6	13.0	12.6	-	-	-
NCB	13.0	13.0	14.2	13.6	12.4	10.5	-	-

Source: See table 2a.
Notes: See table 2a.

Table 2c provides an overview of recent economic forecasts for the Northern Ireland economy. Growth in Gross Value Added (the nearest proxy to GDP) is expected to remain sluggish for the remainder of this year and marginally recover next year.

Table 2c Overview of recent projections of real Gross Value Added (GVA) and Unemployment (Northern Ireland)

	2012	2013	2014	2015
Gross Value Added				
Ernst & Young	0.1	1.0	2.1	2.1
PWC	0.2	1.4	-	-
Oxford Economics	0.3	1.5	-	-
Unemployment % Labour Force				
Ernst & Young	8.1	9.0	9.2	9.1
Oxford Economics	7.8	-	-	-

Source: Ernst and Young: Economic Eye, (2012); PWC: Economic Outlook March (2012); Northern Bank/Oxford Economics: NB Quarterly Economic Overview Q2 2012.

Notes: Gross Value Added differs from GDP by the difference between taxes and government subsidies.

4 Getting the Balance of Fiscal Policy Right

It is expected that under current policy plans further reductions are expected in both discretionary current and capital expenditure. Discretionary expenditure decisions relate to areas where rates of programme payment or service eligibility are changed. Non-discretionary expenditure refers to areas where provision is determined by demand for a given level of programme eligibility or payment rate or by conditions outside direct policy influence in the short-run (such as for example the rate of interest paid on borrowings). It is possible for total public expenditure to remain constant or even increase as discretionary expenditure is reduced. For example, rising unemployment, other things equal, increases public expenditure as the numbers receiving assistance increases.

The medium-term aim of existing policy is to arrive at a government deficit of no more than 3.0% in 2015. The Comprehensive Expenditure Review published by the Department of Public Expenditure and Reform (2011) envisages a total reduction in spending of €7.75 billion over the four year period 2012-2015 (€2.2 billion of which is being implemented in this fiscal year). These adjustments are in addition to changes on the revenue side and come on top of a total of €25 billion in discretionary fiscal adjustments since the Autumn of 2008 (including adjustments in 2012). A summary of proposed or current fiscal adjustments is provided in Table 3.

Table 3 Medium-Term Public Expenditure Reductions, € billion

	2012	2013	2014	2015
Current	1.45	1.70	1.90	1.30
Capital	0.75	0.55	0.10	0.00
Total	2.20	2.25	2.00	1.30

Source: Comprehensive Expenditure Review (Department of Public Expenditure and Reform, 2011).

The evidence reviewed in Section 2 indicates that fiscal austerity, to date, has compounded problems of high unemployment and depressed or falling domestic demand. Austerity fatigue is undermining confidence and hope. The key challenge should be to maintain public services and avoid inflicting further damage on the domestic economy. Where possible, areas of expenditure that are possible to cut without damage to economic recovery and without negative impact on low to middle-income households should be reduced. The money saved should be redirected into public expenditure to improve community health services, expand early childhood education, provide better training to the unemployed and add to funding for recovery investment. The overall level of discretionary expenditure as a proportion of GDP should be held roughly constant.

Debate in relation to public finances frequently takes place without regard for what vision is possible and desirable for society in the future. The level and composition of spending and revenue are discussed mainly at the level of technical and accounting level with insufficient regard for the wider and medium-term impact of decisions. Closing the gap between spending and revenue involves much more than discretionary changes to payments and taxes. It concerns putting in place sustainable revenue flows that go towards high-quality public services and a fairer distribution of income. There is no necessary contradiction between having high and sustainable levels of public spending and revenue – if society so choses – and proceeding with a pro-business and pro-competition policy and pursuing a sound fiscal policy. If society decides to pay for, and insist on, quality public services then this is what it can get.

Public expenditure does not guarantee better outcomes in areas such as health, education or income equality. It is necessary to change the direction of spending and improve efficiency through public sector reform. However, it seems extremely difficult if not impossible to realise positive social change by taking Ireland further away from EU norms of spending and taxation such as envisaged under existing policies.

4.1 A Vision of Society that is Feasible and Desirable for 2022

The NESC model of the Developmental Welfare State can provide an important conceptual reference. It is possible to become a more competitive and dynamic economy and move towards a model of taxation and welfare that guarantees a basic income, adequate education and healthcare. Many Nordic countries appear to have managed this. However, to move towards this type of model requires a huge change in mentality and in institutional culture. Citizens will not accept or vote for higher taxes and public spending without:

- a major change in the way public services are organised, controlled and funded so that they deliver in an efficient and equitable way what they are meant to;

- a fairer way of paying for public services so that those on high income or wealth pay relatively more taxes than those who do not.

The fiscal crisis in Ireland points to the need for a new departure in spending and revenue collection:

- Ireland needs to move closer to European Union norms of spending and revenue-raising – the era of low taxes and widespread and inequitable tax reliefs must come to an end;
- The structure of taxation needs to change towards higher taxes on immobile property, capital income and high-energy consumption.

Without a vision a society perishes. The 'Nordic Model' is not a panacea. There is no one model that can be plugged in and applied elsewhere. Still, lessons can be learned and aspects of social organisation in other countries can be used.

In Sweden the work of two economists – Gosta Rehn and Rudolf Meidner – played a crucial role in post-war Sweden. Rehn and Meidner developed an economic model based on the interaction of a strict fiscal discipline with a generous solidarity wage and social safety network coupled with an active labour market policy (Erixon, 2008). Aspects of this model are worth exploring in the context of rebuilding society and its economy. Two important features need to be considered alongside the Scandinavian experience:

- The role of unpaid workers and carers and the question of a basic income for all members of society
- The need to radically change the carbon content of production and consumption and develop alternatives to fossil fuel energy.

The timescale for change is typically long. However, now is a critical moment in history where, following the implosion of an old model of capitalism, a new or modified one is possible. It may not be possible to agree on many of the details of what it might look like or how it could be possible to get there. One thing can be sure – doing nothing or waiting for the storms to lift and repeating the strategies that we thought worked in the past is not acceptable.

A ten year vision needs to be developed for the implementation of a realistic and imaginative economic plan. Restoring economic growth and moving toward a different social model will take time. The long-term goal could be a 'Nordic' type social contract possible where trust, cooperation and consensus are built around (i) high taxes (ii) relatively generous social provision and (iii) solidarity across all social groups.

A key challenge to be addressed – especially during the current extreme difficulties exacerbated by a deficiency in domestic demand along with the heavy cost to tax-payers of continuing to bail out the banks – is whether or not we can afford to fund 'universalist' programmes of income support and public service provision. In times of public resource scarcity and pressure on budgets is there a case for means-testing and targeting of scarce public funds? Should this principle be applied to areas such as child benefit, medical cards, higher education tuition fees, free travel for senior citizens? Why should those who can afford to pay be subsidised from taxes levied on the hard-earned income of the workers? On the other hand it may be argued that 'universalism' is justified on grounds of economic efficiency and social justice even in times of scarcity because:

- Universalism in social goods provision engenders a strong social bond such as in the case of a high-quality universal social health provision in many European countries where everyone benefits and to which everyone contributes within their means;
- Means-testing and 'targetting' can entail administrative costs and may miss the desired target for a number of reasons including low take-up, social stigma, inappropriate criteria, poor administrative data etc.

It is questionable that much of the debate relating to 'universalism' is really about targetting in favour of the poor. Rather it is about taking from those already on average or high incomes while not necessarily improving the net position of the low-income households. The push to reduce the size of the State and the level of universal social provision is part of a concerted effort internationally.

4.2 Government Spending

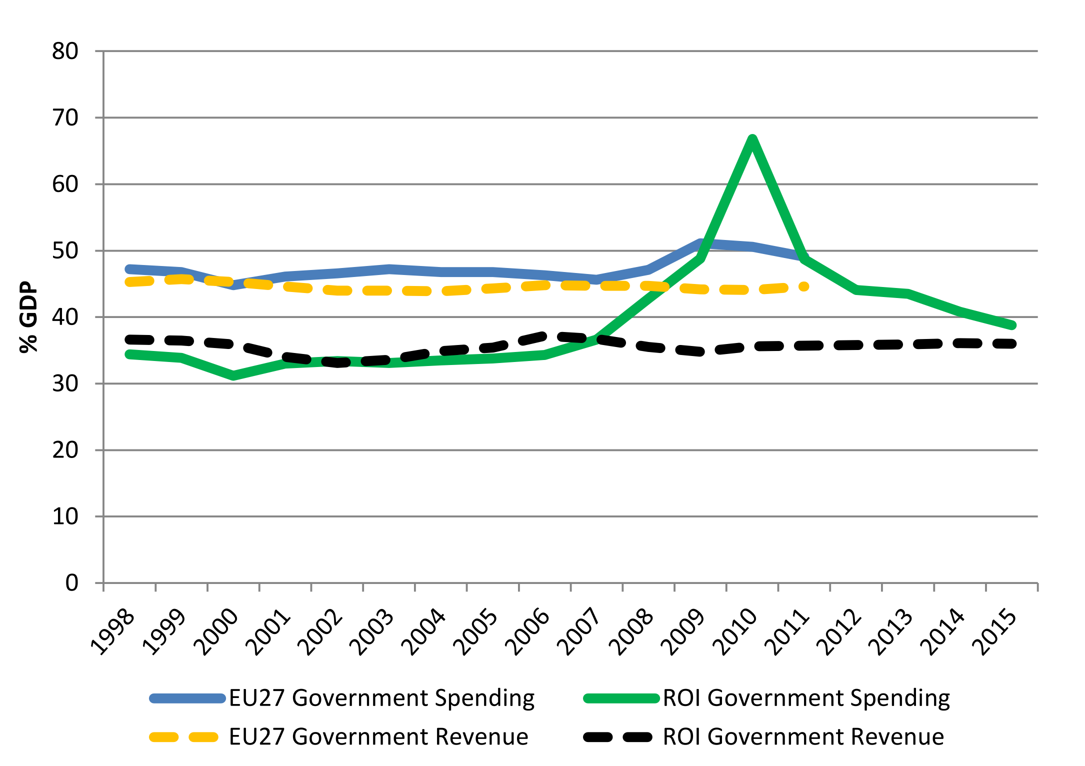
The institutions of the European Union and the International Monetary Fund are less concerned with the details and composition of expenditure and revenue than with the long-term sustainability of public finances and the need to comply with a pattern of moderate primary surpluses/deficits and sustainable levels of public debt. To arrive at this point, member states have choices on how to do it. In the case of the Republic of

Ireland, the choice made in the last decade had been for low levels of spending, low levels of revenue (as % of GDP) and a very cautious approach to debt and deficit financing – up to 2008. Ireland was the poster child for fiscal rectitude up to that year. However, the tax base was built to some degree on the sands of the property boom fuelled as it was by a galaxy of tax reliefs and incentives (see Collins and Walsh, 2010). The collapse in revenue in 2008-2009 accompanied by a sharp increase in welfare-related spending acted as a temporary stabiliser. However, the cumulative effect of cuts in spending and increases in taxes which were introduced in successive budgets from 2008 onwards negated much of this temporary impact.

Chart 3 presents data on trends in total Government expenditure since the late 1990s. Spending and revenue (which includes taxes and other receipts) tracked each other up to 2007 at a low percentage of GDP by EU standards. The arrival of recession in 2008 suddenly depleted revenue and raised spending as a result of escalating unemployment. Far from there being an 'explosion' in public spending prior to the crisis in 2008, public spending tracked growth in GDP as did revenue – notwithstanding cuts in tax rates and increases in tax breaks in the course of the early part of the last decade.

The peak in spending in 2010 reflects the huge temporary one-off banking recapitalisation of Anglo-Irish and INBS in that year. Total government expenditure was also impacted – but to a much lesser extent – by bank recapitalisation in 2009 and in 2011. A striking feature of fiscal adjustment as pursued, here, both before and after the November 2010 Troika Agreement is that it has leaned on expenditure and not on tax. When measured as a percentage of GDP, the entire adjustment planned and foreseen to to 2015 is on the expenditure side with the share of total revenue in GDP staying constant over the remainder of the adjustment period. Total revenue is projected to remain at a relatively low level of around 36% up to 2015 (Department of Finance, 2012:49) – on the basis of what may now be considered optimistic forecasts for GDP. On the other hand, total spending is projected to fall sharply from an estimated level of 48.7% of GDP in 2011 (or 45.0% if the impact of a further one-off banking recapitalisation in July 2011 is excluded) to 38.8% in 2015. In other words, the entire burden of adjustment as a proportion of GDP falls on expenditure.

Chart 3 Trends in Total General Government Expenditure and Revenue – Republic of Ireland (1998-2015)

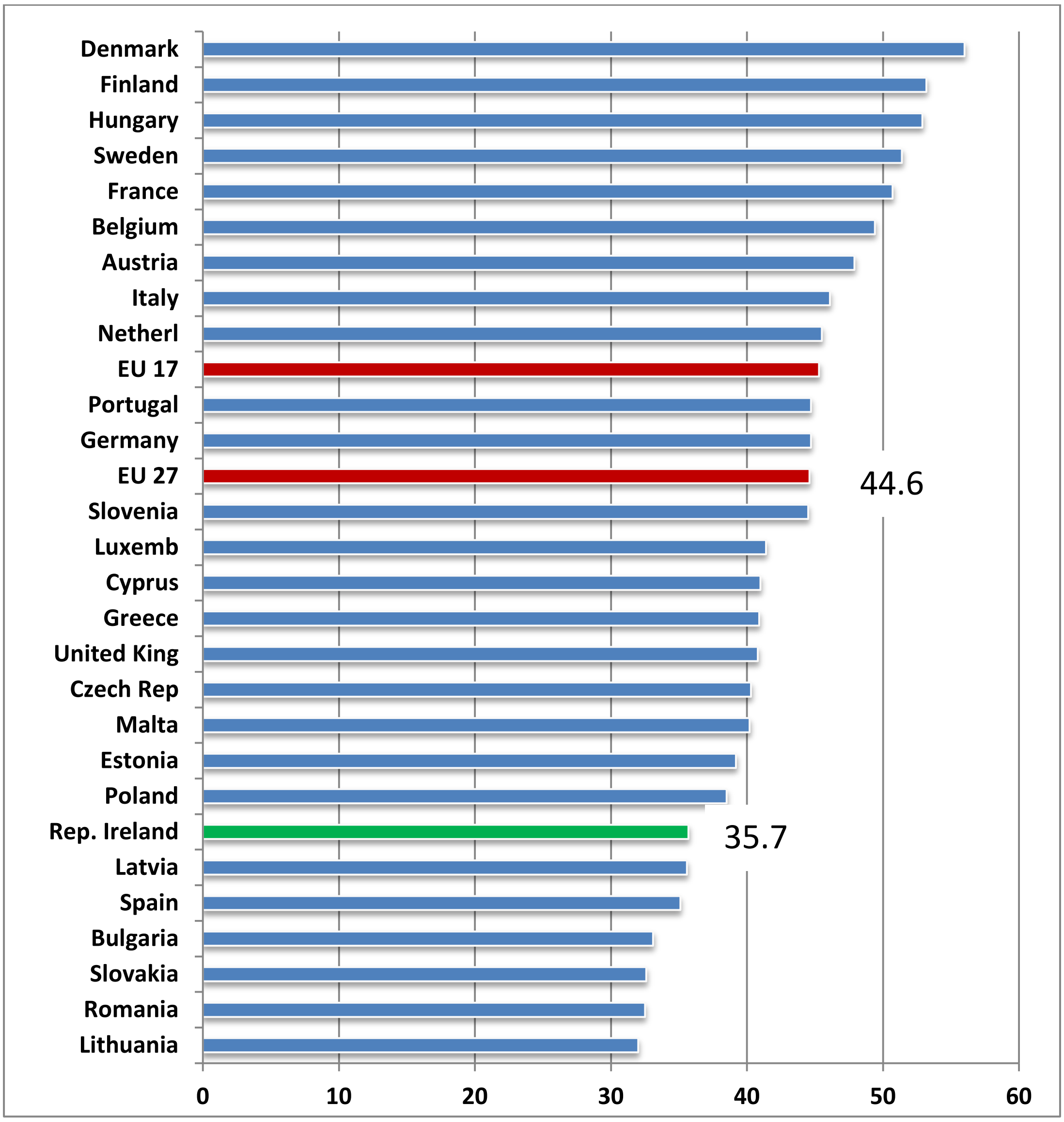


Source: Eurostat. Refer to indicator 7.1 in the NERI Quarterly Economic Facts (Summer 2012).

The implication of the overall fiscal adjustment package, if carried through, will be to shrink the size of Government spending as % of GDP to a level shared by EU member states at the bottom end of the European league. Chart 4, below, compares EU States in terms of the percentage of GDP collected in Revenue in 2011. Clearly, Ireland is close to the bottom shown in this comparison.

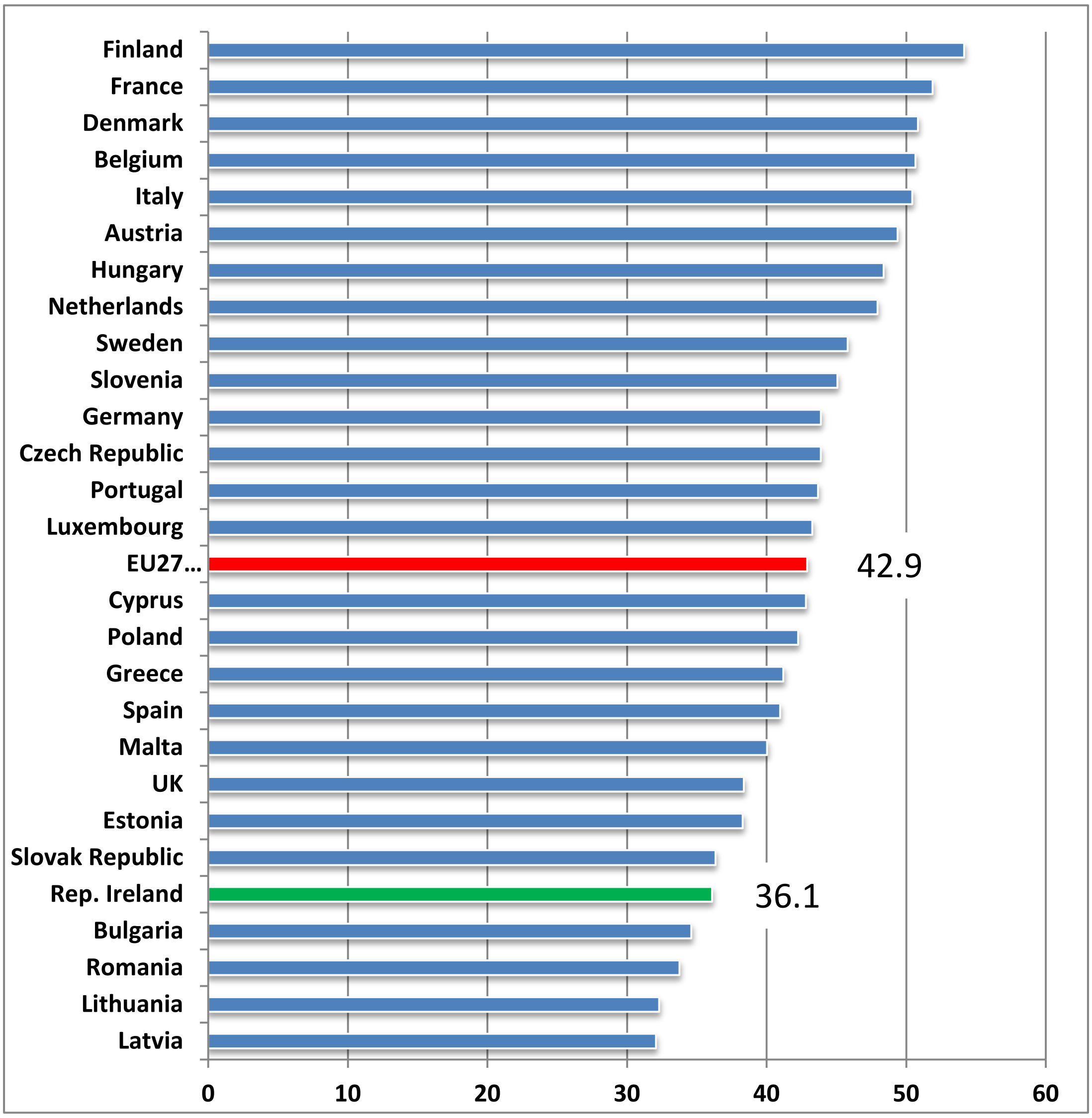
What are the consequences of pursuing a programme that leans so heavily on expenditure reductions? Chart 5 shows data for total government spending in 2017 from the International Monetary Fund World Economic Outlook updated in April of 2012. The IMF forecast is for a spread of values for General Government expenditure as a percentage of GDP ranging from 32.1% in Latvia up to 54.1% for Finland with Ireland at 36.1%. The unweighted average of values for all 27 current member states of the European Union in 2017 is 42.9%. However, taking the EU27 as a whole the average spending proportion is 45.2% (some of the larger countries happen to be bigger spenders and thereby pull the weighted mean upwards). It should be noted that the projected level of spending in Ireland in 2017 (36.1%) includes a projected 5.5% in interest payments leaving only a projected 30.6% for public services. This latter figure would be the lowest level of spending – as a % of GDP – for any EU27 country since most countries are not projected to have such a high level of interest payments as Ireland.

Chart 4 General Government Revenue as a % of GDP– EU member states (2011)



Source: Eurostat. Refer to indicator 7.2 in the NERI Quarterly Economic Facts (Summer 2012).

Chart 5: Projected General Government Expenditure % GDP, 2017



Source: International Monetary Fund World Economic Outlook database (last updated on April 2012).

On the basis of current trends, the IMF envisages a decline in the proportion of government spending across most EU27 member states. Ireland is second only to Greece in the size of the fall in point percentage terms between 2011 and 2017 (see Table 4).

Table 4 Trends in General Government Expenditure, 2007, 2011, 2015 and 2017 (IMF)

	Actual		Projected		
	2007	2011	2015	2017	% change (2011-2017)
Finland	47.4	54.0	54.6	54.1	0.1
France	52.6	56.3	53.6	51.9	-4.4
Denmark	50.8	56.0	53.4	50.8	-5.1
Belgium	48.3	53.5	51.1	50.7	-2.8
Italy	47.6	50.0	50.6	50.4	0.5
Austria	48.6	50.4	49.8	49.4	-1.1
Hungary	50.6	48.4	48.6	48.4	0.0
Netherlands	45.1	50.0	49.5	47.9	-2.1
Sweden	49.0	49.1	46.8	45.8	-3.3
Slovenia	40.3	47.7	45.6	45.1	-2.6
Germany	43.5	45.6	44.1	43.9	-1.7
Czech Republic	41.0	44.5	44.0	43.9	-0.7
Portugal	44.4	48.7	44.0	43.7	-5.0
Luxembourg	36.3	41.6	43.4	43.3	1.6
Cyprus	41.5	47.4	42.8	42.8	-4.6
Poland	42.2	44.5	42.9	42.3	-2.2
Greece	46.7	49.7	41.2	41.2	-8.5
Spain	39.2	43.6	41.1	41.0	-2.6
Malta	42.8	43.2	41.1	40.0	-3.1
UK	40.3	45.7	40.9	38.4	-7.4
Estonia	34.9	43.1	40.1	38.3	-4.8
Slovak Republic	34.2	38.4	36.3	36.3	-2.0
Republic of Ireland	**36.2**	**44.1**	**37.5**	**36.1**	**-8.0**
Bulgaria	34.9	34.6	35.3	34.6	0.0
Romania	35.4	35.5	33.6	33.8	-1.7
Lithuania	34.8	39.3	35.4	32.3	-7.0
Latvia	35.7	39.3	33.8	32.1	-7.3
EU27 (weighted mean)	44.9	48.5	46.3	45.2	-3.2
EU27 (unweighted mean)	42.4	46.1	43.7	42.9	-3.2

Sources: International Monetary Fund World Economic Outlook, April 2012.

We propose an alternative approach to fiscal adjustment through a combination of the following measures:

– A slower pace of adjustment to allow for the need to avoid deepening the economic slump in domestic demand – we suggest a five-year period instead of the current three-year plan;

- A preservation of the quality and volume of public services and income support in key areas such as social welfare, health and education;
- Pegging total public expenditure at a level close to the IMF projected (unweighted) average for EU27 member states of 43% of GDP for 2017;
- A gradual increase in the proportion of government revenue towards average European norms over a five year period; and
- The bringing forward of an investment programme to address priority areas of infrastructural need and employment creation.

Aside from future savings arising from the 'Croke Park Agreement', the greatest contribution Government could make to avoiding further harm to domestic demand is to bring to an end further cuts in discretionary programme expenditure – current and capital. By not cutting further into capital spending in the budget for 2013, €550 million would be available for investment in job creation as part of an investment stimulus. By reversing the cuts in public capital funding in 2012 a further €750 million would be available for investment in priority infrastructure with long-term returns and short-term employment benefits as discussed in NERI (2012).

A discontinuation of cuts in overall current and capital spending is justifiable in order to arrest the haemorrhaging of domestic demand and restore confidence among consumers and investors. The Government has indicated a further total cut in discretionary expenditure of €5.5 billion over the period 2013-2015 (Table 3). Allowing for further savings in 2013-2015 under the Public Service Agreement 2010-2014 ('Croke Park' agreement) that form part of this total saving of €5.5 billion it could be assumed that total planned expenditure savings over 2013-2015 net of 'Croke Park' will be in the region of €5 billion. If, instead of cutting a further €5 billion from programme expenditure it were decided to retain this level of overall spending and stretch the adjustment period out by two years while increasing revenue it could still be possible to reach a government deficit target of less than 3% based on the latest IMF projections of GDP. An illustration of a possible adjustment pathway is provided in Table 5.

Table 5 An Alternative and Gradual Fiscal Adjustment towards EU norms of public spending and revenue

	2012	2013	2014	2015	2016	2017
Plan A						
Expenditure	42.7	41.9	39.6	37.5	36.5	36.1
Revenue	34.2	34.6	34.7	34.6	34.1	34.2
Deficit	-8.5	-7.4	-4.9	-2.9	-2.4	-1.9
Expenditure EU27 (unweighted mean)	***45.9***	***45.1***	***44.3***	***43.7***	***43.3***	***42.9***
Plan B (graduated)						
Expenditure	42.7	43.0	43.0	43.0	43.0	43.0
Revenue	34.2	**35.6**	**36.5**	**38.0**	**39.5**	**41.1**
Deficit	-8.5	-7.4	-6.5	-5.0	-3.5	-1.9
Plan B (frontloaded)						
Expenditure	42.7	43.0	43.0	43.0	43.0	43.0
Revenue	34.2	**35.6**	**38.1**	**40.1**	**40.6**	**41.1**
Deficit	-8.5	-7.4	-4.9	-2.9	-2.4	-1.9

According to the most recent projections of the public finances, a rising proportion of Government expenditure is destined to service public debt – interest expenditure is set to rise from 3.4 to 5.6% of GDP between 2011 and 2013. Some of this increase could be avoided through relief on Ireland's debt burden or a re-scheduling of repayments of interest on debts associated with Anglo-Irish/INBS Promissory Notes. If no such relief is achieved it could still be possible to ensure that total expenditure other than interest payments remains close to 40% of GDP. Any increases in revenue arising from increased output should be directed towards priority current and capital spending that improve infrastructure or alleviate poverty and thereby stimulate domestic demand.

4.3 Government Revenue

To increase government revenue gradually over a five year period will involve a combination of measures. On the assumption of some economic recovery and increase in employment it should be possible to anticipate some degree of tax revenue buoyancy especially if an investment stimulus were brought forward and further damaging cuts in spending avoided. Future editions of this Observer will explore these issues. Some areas of revenue collection place the Republic of Ireland out of line with other jurisdictions especially in areas such as employer social security contributions, local property-based taxes as well as taxes on wealth. Options to be considered by policy-makers including taxes targeted at high-wealth households based on citizenship and not residence (taking account of all types of assets and not just homes). The creation of a 'solidarity tax' on the super-rich including tax exiles would help to generate a good civic example and increase a greater sense of fairness. Allied to this various types of capital allowances, 'tax expenditures' and other reliefs need to be reviewed to ensure maximum economic efficiency as well as greater progressivity in tax incidence.

Given continuing economic uncertainty and the continuing pressures on disposable incomes of households as a result of changes in wages, prices and taxes care is needed in the timing, extent and composition of future changes to tax rates and eligibility. There is a case for raising taxes on all but the lowest of incomes. However, this needs to be done in a staged way over a long period of time allowing for some growth in real income at the average to below-average threshold of income before significantly raising taxes on these. Projections of average real compensation per employee (Department of Finance 2012:14-15) do not envisage any real growth until 2015 at the earliest. Even then, it is likely that real net take-home pay will be still in decline as the average tax burden increases on employees.

5 Conclusion

The aim of public policy should be to stabilise public finances in the medium-term around a target level of spending and revenue which fall within a normal European range of 40-45%. In the long-run Irish society has further choices about what balance of taxation and public service is optimal including going for even higher levels of spending and revenue akin to the position in some European states such as the Nordic countries.

In this Quarterly, we have argued that there is an urgent need to link the immediate response to the current economic crisis to a long-term vision of where we need to go and what type of society is possible and desirable.

The key to a successful alternative economic strategy is that a combination of measures is needed to stimulate growth and, at the same time, begin to close the public sector deficit. Instead of cutting spending and raising taxes to remove the deficit – such as is the case under the current approach to economic policy – an alternative approach is to hold spending as close as possible to its current level as a percentage of GDP. This implies a combination of fiscal measures which targets increases in spending power for low-income households and targets cuts in net income for high-income and high-wealth households better able to afford such adjustments. A timely and balanced series of adjustments can stimulate demand and, therefore, employment while redressing the worst effects of the recession on low-income households[2].

There is a better economically sound way and there is a fairer socially just way of growing the economy and repairing public finances. In the next Quarterly Economic Observer we will return to these issues by examining in detail the options for changing the quality and amounts of public expenditure and revenue over the coming five years.

[2] The most recent data on household income published by the Central Statistics Office indicate a sharp increase in income inequality in 2010. Refer to NERI Quarterly Economic Facts (section 4).

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6 Appendices (Supplementary Data)

Table 6.1 Overview of key economic trends since the onset of the current economic crisis – Republic of Ireland

	2007	2008	2009	2010	2011
Total Expenditure					
Personal consumption €m	93,872	95,671	85,214	82,592	81,113
Investment: private and public €m	48,486	39,430	25,293	18,074	15,915
Government consumption €m	28,530	29,955	28,503	26,222	25,111
Exports €m	152,389	150,181	145,902	157,673	165,277
Imports €m	135,328	133,877	121,037	127,901	131,692
Domestic Demand €m	170,888	165,056	139,010	126,888	122,139
Total Income					
GDP €m	189,933	179,990	160,596	155,992	156,438
GNP €m	163,413	154,673	132,233	128,207	123,879
Income from Agriculture €m	3,276	2,850	2,188	2,732	n/a
Income non-Agriculture: Wages €m	78,545	81,397	73,625	68,772	n/a
Income non-Agriculture: Other €m	67,123	56,783	49,458	53,155	n/a
Employment					
Labour Force	2,253,100	2,266,600	2,202,300	2,150,500	2,120,300
Labour Force Participation Rate %	64.6	64.2	62.5	61.2	60.4
Employment	2,149,800	2,107,100	1,922,400	1,851,500	1,805,500
Employment full-time	1,764,000	1,712,700	1,510,300	1,436,800	1,383,700
Employment part-time	385,800	394,400	412,100	414,700	421,800
Underemployment	n/a	92,900	108,900	108,800	135,700
Unemployment	103,300	159,400	279,800	299,000	314,700
Unemployment %	4.6	7.0	12.7	13.9	14.8
Long-term Unemployment	28,800	38,100	71,400	140,400	177,200
Long-term Unemployment %	1.3	1.7	3.2	6.5	8.4
Migration					
Immigration	109,500	83,800	57,300	30,800	42,300
Emigration	42,200	45,300	65,100	65,300	76,400
Net Migration	67,300	38,500	-7,800	-34,500	-34,100

	2007	2008	2009	2010	2011
Public Finances					
Total General Gov. spending €m	69,535	76,958	78,502	104,187	76,354
Total General Gov. revenue €m	69,655	63,751	55,719	55,342	55,839
General Gov. Balance €m	128	-13,196	-22,795	-48,607	-20,515
General Gov. Debt nominal €m	47,361	79,600	104,600	144,300	164,200
General Gov. Debt % GDP	24.9	44.2	65.2	92.5	105.4
Earnings and Prices					
Average earnings € per week	n/a	696.72	694.69	684.00	686.44
Average earnings % change	n/a	n/a	-0.3	-1.5	0.4
Average earnings % change – private sector	n/a	n/a	-2.3	-0.7	0.6
Average earnings % change - public sector	n/a	n/a	1.7	-3.6	-0.2
Inflation CPI %	4.9	4.1	-4.5	-1.0	2.6
Inflation HCPI %	2.8	3.1	-1.7	-1.6	1.1
Inequality and Poverty					
Gini coefficient	31.7	30.7	29.3	33.9	n/a
Quintile ratio	4.9	4.6	4.3	5.5	n/a
Relative poverty %	16.5	14.4	14.1	15.8	n/a
Consistent poverty %	5.1	4.2	5.5	6.2	n/a
Deprivation rate %	11.8	13.8	17.1	22.5	n/a

Sources: CSO Quarterly National Accounts; CSO National Income and Expenditure; CSO Quarterly National Household Survey; CSO Population and Migration Estimates; CSO Earnings and Labour Costs; CSO Consumer Price Index; CSO SILC Report 2010; Department of Finance Budget 2012; IMF Ireland Country Report March 2012; Department of Finance SPU update April 2012.

Notes: Earnings and labour market data are for Q3 in all years. Figures for 2011 are preliminary estimates.
National accounts data reported at current market prices.
Underemployment calculation - new series from 2008.
Total expenditure data for 2011 are preliminary estimates by the CSO.

Table 6.2 Overview of key economic trends since the onset of the current economic crisis – Northern Ireland

	2007	2008	2009	2010	2011
Total Expenditure					
Personal consumption £m	-	-	-	-	-
Investment: private and public £m	-	-	-	-	-
Government consumption £m	-	-	-	-	-
Exports £m	5,475	6,198	5,143	5,298	5,730
Imports £m	4,810	5,570	5,027	5,210	5,529
Domestic Demand £m	-	-	-	-	-
Total Income					
GVA £m	28,192	28,827	28,256	28,162	-
GNP £m	-	-	-	-	-
Income from Agriculture £m	454	383	319	-	-
Income non-Agriculture: Wages £m	-	-	-	-	-
Income non-Agriculture: Other £m	-	-	-	-	-
Employment					
Labour Force	818,000	826,000	806,000	832,000	849,000
Labour Force Participation Rate	60.6	60.6	58.5	59.9	60.6
Employment	785,000	788,000	756,000	774,000	788,000
Employment full-time	611,000	608,000	585,000	589,000	608,000
Employment part-time	171,000	174,000	167,000	180,000	172,000
Underemployment	16,000	17,000	27,000	27,000	32,000
Unemployment	33,000	38,000	51,000	58,000	62,000
Unemployment rate %	4.1	4.6	6.3	6.9	7.3
Long-term Unemployment	12,000	13,000	15,000	22,000	29,000
Long-term as % of Unemployed	36.4	33.9	29.8	37.8	47.7
Migration					
Immigration	19,369	15,350	12,690	11,854	-
Emigration	11,332	11,039	11,229	11,262	-
Net Migration	8,037	4,311	1,461	592	-

	2007	2008	2009	2010	2011
Public Finances					
Total General Gov. spending £m	16,790	17,832	18,898	19,294	-
Total General Gov. revenue £m	-	-	-	-	-
General Gov. Balance £m	-	-	-	-	-
General Gov. Debt nominal £m	-	-	-	-	-
General Gov. Debt % GDP	-	-	-	-	-
Nominal earnings and Prices					
Average earnings £ per week	329.9	345.0	354.6	354.7	360.0
Average earnings % change	2.2	4.6	2.8	0.0	1.5
Average earnings % change – private sector	-	-	-	-	3.5
Average earnings % change - public sector	-	-	-	-	3.9
Inflation CPI %	-	-	-	-	-
Inflation HCPI %	-	-	-	-	-
Inequality and Poverty					
Gini coefficient	-	-	-	-	-
Quintile ratio	-	-	-	-	-
Relative poverty %	-	-	-	-	-
Consistent poverty %	-	-	-	-	-
Deprivation rate %	-	-	-	-	-

Sources: HMT Public Expenditure Analysis 2011; DETI Labour Market Bulletin; HMT RTS; ONS Regional Trends; NISRA National Statistics; LFS Historical Data Series 1995-2011; LFS Quarterly Supplement; NISRA Northern Ireland Migration Flows; NISRA Annual Survey of Hours and Earnings.

Note: Where cells are blank the data are unavailable.

Notes

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