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Exploring Alternative Fiscal Pathways

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* This paper was presented at the Dublin Economics Workshop on 12 October 2012. The views expressed in this paper are the sole responsibility of the authors. It is intended to present a revised version of this paper as a NERI Working Paper later in 2012. Comments and suggestions are welcome. Tom.healy@NERInstitute.net
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Summary

Public sector deficit reduction has become an overriding concern and preoccupation of policy-makers across Europe. The situation in many countries is acute given the high level of general government debt and the continuing high level of government deficits half a decade into the current economic crisis. The prospect of a lost decade and even a lost generation looms in the case of Ireland.

The objective of sustainable public finances in Ireland is strongly related to regenerating economic activity in the immediate years ahead. With a prolonged delay in returning to 'normal economic growth' it is important to explore what choices exist to change the level and composition of public finances in Ireland. In this paper, our focus is on the possible options for moving towards a smaller government deficit given different scenarios at world and domestic levels. Our central theses are:

- There is some scope for pro-active domestic fiscal policies to generate growth, at least by ceasing to cause further harm by excessive or unnecessary fiscal contractions.
- There is considerable scope on the part of domestic policy to change the *composition* of fiscal consolidation.

In this paper we have drawn on the NERI implementation of the HERMIN macro-economic model to explore the possible impact on (i) public finances (ii) employment and (iii) total output assuming the following:

Global scenarios

- Slow economic recovery in the key trading partner economies
- An economic slump in partner economies
- A rapid recovery following a slowdown or recession in the second half of 2012

Domestic fiscal responses

- ‘Plan A’ as outlined in the most recent Stability Programme Update (April 2012) and incorporated into the Memorandum of Understanding with the Troika and subject to change and adaptation depending on which global scenario prevails.
- ‘Plan B’ as outlined in this paper and subject to adaptation depending on which global scenario prevails. Plan B places greater emphasis on increasing taxes and greater investment.

Our results show that a tax based consolidation allied to an investment stimulus could return Ireland to fiscal stability and be less destructive in terms of GDP growth and employment. Such a policy approach should not take from the urgent need to debate how Irish society needs to position itself in terms of institutional reform, enterprise, taxes, public services and global competitiveness.

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1 Introduction

In this paper we explore alternative fiscal responses in the context of a small and very open economy half of one decade into the current economic crisis and half-ways through a four-year lending programme involving a Troika of lending agencies¹.

The global and European context for a discussion of domestic fiscal stance is characterised by sluggish economic growth in many advanced economies coupled with an over-hang of personal, corporate and public debt. De-leveraging in the household, corporate and government sector is holding back economic growth especially in the government sector where pro-cyclical responses have tended to reduce aggregate demand, increase unemployment and reduce spending among consumers and investors, a point acknowledged in a recent IMF report (International Monetary Fund, 2012a).

Capital markets expect governments to deliver fiscal austerity and avoid banking collapses and when governments fail to deliver on these they stand at risk of being punished with continuing high borrowing rates that can effectively exclude them from normal market banking. At the same time when governments deliver on fiscal austerity and socialise private debt (the two not being unrelated) the markets may also punish governments with continuing high borrowing rates as economies falter and sovereign and banking debt remain hopelessly inter-twined.

We are all in a bad place.

Doing nothing to redress severe fiscal imbalances is not an option. Yet, seeking to narrow fiscal imbalances without sufficient regard for other imbalances – trade, corporate and household – is a recipe for continuing stagnation and unintentionally continuing high government deficits. Unemployment and under-employment of labour remains a core problem as it destroys lives and

¹ To which may be added three European Union member states – UK, Sweden and Denmark – with whom bilateral loans were agreed in November 2010.

communities, holds back economic recovery, impacts on the cost of social transfers, undermines government revenue buoyancy and threatens long-term social cohesion.

The risks and limitations of a fiscal austerity approach across Europe, and very much *de rigueur* in Ireland since 2008, are acknowledged by most commentators. This approach – which we refer to as Plan A throughout this paper – is taking a lot longer to deliver than initially expected. Front-loaded fiscal contractions in 2010 and 2011 have failed to deliver the necessary growth and confidence to lift investment and consumption on the side of domestic demand. Export-led growth is proving useful in arresting a decline in GDP or GNI – however it has not been sufficient to make inroads into unemployment. Toughing it out and being patient seems to be the proverbial advice and wisdom as Ireland waits for a possible deal on banking and a recovery in the world economy – eventually.

The need for a ‘better, fairer way’ has been debated in Ireland over the last four years. But what exactly is a ‘better, fairer way’? Will it work? What evidence supports alternative adjustment or policy scenarios? We are not in a position to give a comprehensive response on all of these questions and in the space of this paper we can only explore some of the options. If Plan A is more ambitious than mere fiscal adjustment – it addresses market inefficiencies, banking reform and competitiveness then any possible alternative approach, which we refer to here as Plan B, is much broader than a plan to merely fix public finances. Any plan to fix public finances must be linked to on-going institutional reform in both public and private sectors as well as the development of policies and measures to address a deficiency in indigenous enterprise as well as a badly functioning banking system in terms of its contribution to economic recovery and its potential draw on exchequer resources should further recapitalisations be required.

Stylised labels such as Plan A and Plan B can serve to focus discussion on questions of what type of society is possible and desirable in the future and

what range of economic and social policies are required to make that possible. In this paper we address, only, the fiscal dimension of an alternative economic plan.

2 Modelling assumptions

The starting point for any analysis of domestic fiscal choices in a small open economy is the world economy. We concur with Bradley and Untiedt (2012:53):

Nobody today really understands where the world economy is bound tomorrow.

It should be noted that most forecasters expect sluggish economic growth and a slow recovery with the prospect of rising unemployment in the short-term and continuing high unemployment for the remainder of the decade. These outcomes depend on a range of global scenarios from quick economic recovery to a renewed international recession. On the basis of a contractionary fiscal stance for the foreseeable future it is not expected that domestic demand or employment will recover for at least a number of years – even under the assumption of a rapid international recovery.

We have used the following three scenarios in this paper:

Medium Scenario *Slow economic recovery in the key trading partner economies*

We have assumed that the Eurozone's demand for imports falls by -0.3% in 2012 grows at 0.9% in 2013, after which it picks up to reach 4.5% from 2014 onwards. UK demand for imports grows at 0.8% in 2012, 2% in 2013 and 4.5% from 2014 onwards, while import demand in the US grows at 2.3% in 2012, 2% in 2013 and 4.5% onwards.

Pessimistic Scenario - *An economic slump in partner economies*

In this scenario corresponding to a prolonged slump in our key trading partners it is assumed that the volume of imports demanded by our export partners is the same as in the above scenario for 2012 but declines by 1% in 2013 and again in 2014 with modest growth of 2% per annum thereafter.

Optimistic Scenario - *Fast recovery global recovery*

The demand for imports from our trade partners is the same as for 2012, and then increases by 4.5% per annum thereafter.

In all scenarios wholesale prices of our trading partners are assumed to grow at 1% per year. Also in all scenarios public investment spill over effects are set at half their normal levels. This is, perhaps, overly conservative and is likely to be an underestimate.

3 One domestic policy response - Plan A

We refer to the current policy approach as Plan A. It involves a process of continuing contraction in government consumption and investment while hoping that private consumption and investment will eventually take off as export-led growth pulls the locomotive forward. Internal devaluation through fiscal austerity, wage restraint and labour market reforms are part of a bigger package to improve competitiveness and thus encourage export growth in the belief that cutting wages, social transfers and reductions in the cost of labour and more flexible rules for employing labour can give enterprises a competitive edge on others. A reduction in the size of General Government is also a clear goal of this strategy if primary public expenditure as a proportion of GDP (or GNI) is a relevant indicator.

It is far from clear that any of these policies have been successful or key to recent growth in market services and related activities – the one bright spot on an otherwise depressed economic scene. That borrowing costs on the bond markets are down to 2010 levels is encouraging. However, the observation that economic conditions have stabilised with no evidence of large-scale further worsening is cold comfort considering that all the fiscal front-loading in 2010 and 2011 has not paved the way for rapid recovery. The slowdown in Eurozone economies is hardly a reason for why many of the optimistic forecasts did not come true and general government debt has continued to rise.

The consensus view supported by the Irish Fiscal Advisory Council along with other economic commentators including the Central Bank, Department of Finance and the ESRI as well as international agencies including those that form the ‘Troika’ is that significant further discretionary cuts in spending are unavoidable and necessary. Irish Fiscal Advisory Council (2012:39) has stated that:

At a more disaggregated level, the SPU [Stability Programme Update] projections show the need for significant real expenditure reductions in all main categories, notwithstanding underlying spending pressures. Given

the extent of the required total adjustment, the Council again urges that all adjustment margins be kept under close review, including tax rates, public-sector pay and pensions and welfare rates.

Table 1 shows planned discretionary reductions to current and capital expenditure over the next three years. A discretionary expenditure decision is one which involves a change to payment rates or programme eligibility or access. A non-discretionary expenditure change occurs when as a result of changes in unemployment, household income or interest payments on general debt additional or less public expenditure is incurred. Unemployment is a major driver of non-discretionary expenditure since for given rates of payment and eligibility to various supports, expenditure rises (falls) when unemployment increases (decreases).

Table 1 Medium-Term Fiscal Discretionary Adjustments € billion (Plan A)

	2013	2014	2015
Current	1.70	1.90	1.30
Capital	0.55	0.10	0.00
Total Expenditure	2.25	2.00	1.30
Total Revenue	1.25	1.1	0.7
Overall Total	3.5	3.1	2.0

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

In total, a cumulative reduction of €5.85 billion is planned in discretionary expenditure cuts in the course of the next three years along with a discretionary revenue adjustment of €3.05 billion. This plan is predicated on what may now be regarded as optimistic forecasts of growth in GDP at least in the immediate two years ahead – 2013-2014. The vast bulk of the planned cut of €5.85 billion is made of planned cuts to current spending (€5.2 billion) in the three Budgets for 2013, 2014 and 2015.

Table 2 provides an overview of the main expenditure headings indicated by the Department of Finance last April in its Stability Update Programme. Plan A envisages a sharp contraction in the amount of public spending devoted to

public current and capital services excluding interest payments on debt. Non-interest payment spending is referred to as 'primary expenditure'. Primary expenditure is set to fall from 40% in 2012 to 33.2% in 2015 placing Ireland firmly at the bottom of the EU27 in terms of primary public expenditure for services and social supports. This would represent a major shift in the overall role of the state in the economy and its impact on employment, incomes and social equality – the full implications of which have not been adequately explored or spelt out in the documentation supporting fiscal reviews.

Table 2 Projected General Government Revenue and Expenditure (Plan A) % GDP

		2012	2013	2014	2015
A	Total Expenditure	44.1	43.5	40.8	38.8
B	Total Revenue	35.8	35.9	36.1	36.0
C=A-B	Borrowing (Government Deficit)	-8.3	-7.5	-4.8	-2.8
D	Interest on debt (included in total expenditure above)	4.1	5.6	5.5	5.6
A-D	Primary Expenditure (expenditure less interest payments)	40.0	37.9	35.3	33.2
	<i>Components of primary expenditure</i>				
	Staff compensation	11.5	10.9	10.3	9.7
	Social transfers	17.3	16.5	15.3	14.5
	Other current spending	5.2	4.9	4.5	4.2
	Public capital spending	2.5	2.3	2.1	2.0
	Not classified above	3.5	3.3	3.0	2.9

Source: Stability Programme Update. Page 49. Table A1. (Department of Finance, 2012).

It may be argued that there is merit in staying the fiscal course if only because it gives greater certainty and confidence to investors, consumers and our international lending agencies that we know what we are doing and can deliver on a lowering of the government deficit within a manageable time frame.

Why fix it if it is not broken?

However, no analyst or commentator can deny that the continuing path of expenditure-weighted fiscal consolidation comes at a cost in terms of high or

possibly even higher unemployment, a diminution in the quality of many public services (even if it is possible to 'do more with less') and a continuing outward flow of young and highly educated persons with little prospect of working in Ireland in the immediate foreseeable future. Neither can it be denied that there is considerable international and domestic uncertainty and that the successful delivery of a budget and debt targets very much depends on achieving fast economic growth very soon. The budget and debt sustainability arithmetic is not encouraging once nominal growth stays below 3% per annum. The overhang of socialised private debt which was, unjustly, transferred to sovereign debt will increasingly constitute a major drag on public finances. Even in the event of a significant write-down (extremely unlikely) or re-scheduling of Promissory Note debt (possible) or a mutualisation of such debt as part of a Eurobond solution (unknown likelihood) the extent of total sovereign debt and the cost of servicing it will continue to place a huge strain on public finances.

Plan A rests very explicitly on the unquestioned assumption that the international literature suggests spending cuts are to be preferred to tax increases when aiming for fiscal correction. Implicitly, there is near universal acceptance that the total share of public expenditure as a proportion of national income must decline. On this basis, discussion of budgetary choices is kept within a narrow and tight set of assumed constraints.

However, the evidence in regard to cuts versus taxes is far from conclusive. Work by Alesina and other economists is often cited in support of a cuts policy over taxes. However, a review by the IMF Fiscal Monitor (International Monetary Fund, 2012b) of fiscal multipliers found a more positive growth impact of tax measures over expenditure. In a review of various macro-economic models used by organisations such as the IMF and EU, Coenen et al. (2012) found that the models reviewed by them show a negative effect of austerity, with spending cuts being more damaging than tax increases.

In a recent review in the IMF's latest World Economic Outlook, Blanchard and Leigh (2012) examine whether forecasters have underestimated short-term negative effects of austerity, and conclude that it has been underestimated. Fiscal multipliers typically used to generate forecasts have usually been in the region of 0.5, but that the actual multipliers may be considerable higher, in the range of 0.9 to 1.7. In particular, they found that the effects on investment and consumption have been underestimated.

In summary Plan A is not without costs and it may not deliver on its narrow remit of lowering the government deficit to 3% of GDP by 2015 as our analysis in the next section will show.

4 Another way - Plan B

4.1 Fiscal adjustment in 2013 Budget

A policy stance proposed by Nevin Economic Research Institute (2012a) is that the present level of public spending as a percentage of GDP be held at its present 2012 level of 44% and as close as possible to the current European average level of over 45%. This approach is referred to as 'Plan B'. In terms of Budget 2013 the following was proposed:

- Cancellation of planned cuts in public capital spending (€550 million in 2013)
- Cancellation of planned cuts in public current spending amounting to €1,300 billion leaving savings of around €400 million through the 'Croke Park Agreement'.
- Additional discretionary revenue measures yielding €2.3 billion in a full year allocated.

The sum of €2.3 billion in additional discretionary revenue measures in 2013 is allocated as follows:

- the carry-over of €300million from Budget 2012;
- €1.15 billion from changes to the application of PRSI and USC on unearned income and reforms to tax credits and reliefs for high-income earners;
- €200 million from a new wealth tax;
- €100 million from a reform of capital gains and capital acquisition;
- €50 million from Corporation Tax;
- €300 million from a Site Value Tax; and
- €200 million from excise duties.

The difference in the overall composition of the fiscal adjustment as between Plans A and B is shown in Table 3 below.

Table 3 Fiscal Adjustments under Plan A and Plan B in 2013

Plan A	Ex-ante adjustment €bn	Ex-post adjustment €bn	Net adjustment % GDP
<i>Current spending</i>	-1.70		-
<i>Capital spending</i>	-0.55		-
Reduced Expenditure	-2.25	+1.25	-0.6
Additional Revenue	+1.25	+2.10	+0.1
Total consolidation*	3.5	-	-

Plan B	Ex-ante adjustment €bn	Ex-post adjustment €bn	Net adjustment % GDP
<i>Current spending</i>	-0.4		-
<i>Capital spending</i>	0		-
Reduced Expenditure	-0.4	+3.1	-0.1
Additional Revenue	+2.3	+3.8	+0.7
Total consolidation*	2.7	-	-

Note: Ex-ante adjustment represents the total value of changes to expenditure or revenue as a result of discretionary changes to payment rates or eligibility to services or tax liability. Ex-post adjustment represents the change in the percentage of GDP accounted for by expenditure or revenue after account is taken of discretionary changes, revenue buoyancy, non-discretionary variations in spending (e.g. lower unemployment) and changes arising from demand for public services driven by demography and other factors.
* Total fiscal consolidation is the sum of revenue changes and expenditure changes regardless of the sign on the constituent numbers.

4.2 Using an investment shock to kick start growth and employment

As part of a Plan B a significant investment in infrastructure was proposed (Nevin Economic Research Institute, 2012a and 2012b). This would be equivalent to an annual average additional injection of 1.5% of GDP over a six-year period². An additional investment schedule could include €0.5 billion in 2013; €3 billion in 2014; €4 billion in 2015, €3 billion in 2016; €3 billion in 2017; and €1.5 billion in 2018. This scale and timing of investment is discussed further in the Spring edition of the Quarterly Economic Observer (Nevin Economic Research Institute, 2012a). This would allow for a phasing-in of investment following cost-benefit evaluation as well as a gradual phasing out towards the end of the period to avoid a negative shock to the economy. Any investment strategy should undergo a cost benefit analysis (required for all projects costing more than €30m) to demonstrate that it is in the long-term

² A five-year period was suggested in the NERI report of March 2012 (Nevin Economic Research Institute, 2012b)

interest of society to make these investments (i.e. the benefits exceed the costs). Assistance from the European Investment Bank in the evaluations and funding of projects would also be sought.

The effects of an investment stimulus are examined using the NERI's implementation of the HERMIN model. The HERMIN model is used by the European Commission to measure the impact of EU Cohesion Funds and explicitly incorporates the openness of the Irish economy. It has been found that the multiplier effects of an investment stimulus are large, with an impact multiplier of approximately 1.6 and a cumulative multiplier in the range of 5.2 and 6.2 (O'Farrell, 2012). These large multipliers are due to the high level of unemployment in the Irish economy, which reduces crowding out effects, and the fall in tender prices for construction projects. Though the increase in demand leads to an increase in imports in the first year, the effect is short lived, and the beneficial supply side effects of improved infrastructure lead to higher net exports.

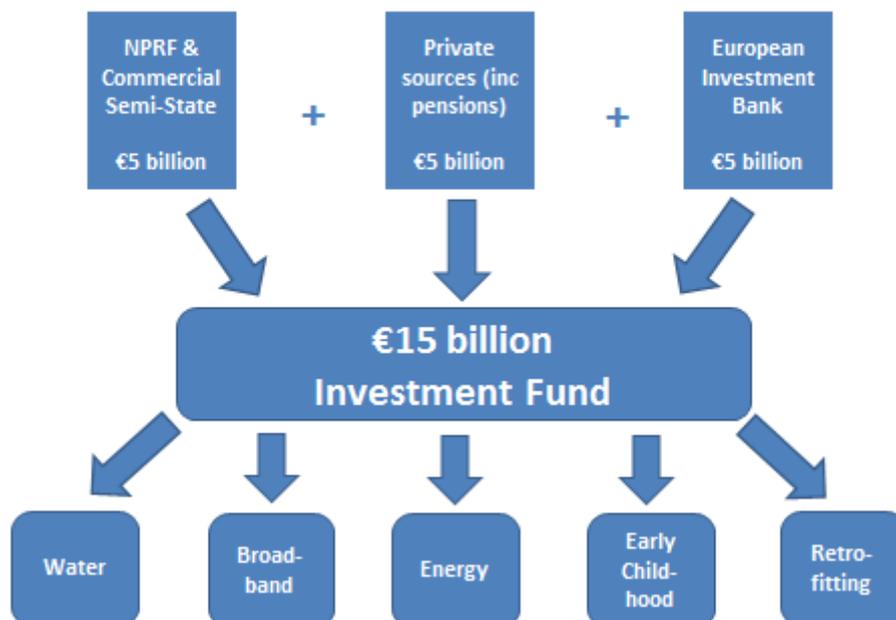
The research finds that an investment stimulus of €1bn for one year would create approximately 16,800 additional jobs (both direct and indirect) in the short-term and approximately 700 in the long-term. Due to greater tax revenues due to higher GDP, the net cost of a €1bn investment is €575 million. This is found to be self-financing, as the long term increase in tax revenue more than offsets the interest payments on the initial capital outlay. In designing an investment stimulus care must be taken to phase out its withdrawal, in order to prevent reverse Keynesian effects.

The funds for such a stimulus can be sourced from a mix of public, private and European/International sources with no additions to General Government Debt and with a likely lowering in the public sector deficit as a result of higher revenues and lower payments as unemployment falls. An overview of how a six-year investment stimulus might be funded and targeted is provided in the diagram below.

While construction employment was above its sustainable level during the boom, it can be argued that it has now undershot a long term sustainable level of employment. At the same time, staff from the IMF have given Ireland's infrastructure a 'red light' (Allard and Everaert, 2010) and Forfás (2012) has indicated infrastructural deficits in areas such as energy infrastructure, fibre optic cable (for use in broadband), and environmentally sustainable transport; amongst others.

Overview of a Six-Year Capital Investment Stimulus

– sources and uses (Republic of Ireland)



4.3 Fiscal adjustment in 2014-2018

We do not expect that, on the basis of Plan A, the Government will reach its budgetary target of 3% by 2015. We estimate that the government deficit will be in the range of -4.2 to -6.5 % of GDP in 2015 depending on which global economic scenario is assumed. These results are consistent with projections made by Bradley and Untiedt (2012). Under a range of assumptions about international economic trends, they do not project a fall in the government deficit below 6% before 2016 – implying non-compliance with current budgetary targets even on the basis of a continuing intense domestic fiscal adjustment. We therefore envisage, under Plan A and on the assumption of a slow international recovery, a prolongation of the adjustment period out to 2017 no matter which of the three global scenarios outlined in Section 2 is adopted.

Under Plan B further fiscal adjustments are projected for 2014-2018. The adjustment would entail:

- pegging public spending at close to EU levels together with;
- a graduated increase in the share of general government revenue in GDP coupled with;
- an investment shock of €15 billion over a six year period.

Ireland continues to be a low-tax economy. As a proportion of Gross Domestic Product, Government raises less in various types of taxes combined than most other European countries. Even if Gross National Product were to be used for comparison there is still a shortfall in revenue because much of the difference between GDP and GNP is in the form of corporation profits which are repatriated abroad and are still subject to tax in this jurisdiction albeit at a much reduced rate³.

³ International comparisons of public expenditure are complicated in the case of Ireland due to the large gap between GNP and GDP resulting from large net outward factor income flows. We will return to this issue in future editions of the Observer. We regard GDP as the most meaningful measure of the total taxable amount of income and production in the country in a

A menu of possible revenue changes may be considered. The following is provided merely as one possible set of revenue adjustments:

- Given the relatively low rate of employer contributions to social security by European standards, we assume a one-off raising of the effective rate of employer PRSI by 1% in 2014 and further 1% in 2015 (where the base is compensation of employees), and the effective rate of employee PRSI by 1% in 2016.
- A combination of discretionary and partial buoyancy full-year increases in direct taxes (which include income tax and a new wealth tax) over and above those planned in the Stability Programme Update equivalent to €1.6 billion in 2014, €2.4 billion in 2015, €0.6 billion in 2016 and €0.6 billion in 2017.
- Cumulative increases in capital transaction taxes of €100 million in 2013 and 2014, €500m in 2015, €300m in 2016, and €600m in 2017.
- From 2013 to 2017 reforms to corporation tax including carry-over of losses in previous years could raise an additional €125m each year from 2014 to 2017.
- In 2015 indirect taxes are increased by €0.2 billion.

It should be noted that the analysis is based on effective tax rates. Therefore some changes (especial with regard to income tax) could be achieved by increases in wages (in real terms) and people drifting into higher tax brackets rather than adjustments to tax rates or tax reliefs and credits. We refer to this as partial buoyancy impacts to distinguish it from buoyancy that arises from more people at work and paying taxes or more tax receipts generated from higher incomes at given tax rates.

On the expenditure side, a menu of possible adjustments are possible. Here is one possible set:

- Reversal of planned cuts in public capital spending in 2014 €0.1 billion.

year. While it is the case that the effective or average tax rate on net factor income flows is lower than for the rest of domestic economic activity, all of GDP is taxable and remains relevant to a consideration of the total amount of income liable for tax (see Collins, 2011 and Bristow, 2004).

- The public sector pay bill declines as projected in the Stability Programme Update (April 2012).
- Social transfers are held constant in real terms (from 2013 to 2014) and increase at 2% in real terms per annum from 2015.
- Non-wage consumption and non-cash social transfers are increased by 2% in 2014, 4% per annum from 2015 to 2017, and 2% per annum from 2018 onwards.

A Plan B adjustment over 2014-2018 would entail a gradual increase in the share of general government revenue from 38.5% in 2014 to 41.7% of GDP in 2017.

Table 4 An alternative and gradual fiscal adjustment towards EU norms of public spending and revenue (slow international recovery scenario)

	2012	2013	2014	2015	2016	2017
Plan A – official forecast						
Expenditure	44.1	43.5	40.8	38.8	36.4	36.0
Revenue	35.8	35.9	36.1	36.0	34.3	34.1
Deficit	-8.3	-7.5	-4.8	-2.8	-2.2	-1.8
Expenditure EU27 (unweighted mean)	45.9	45.1	44.3	43.7	43.3	42.9
Plan A – NERI projection						
Expenditure	43.1	43.3	42.2	41.4	40.6	39.8
Revenue	35.5	35.5	36.2	36.5	36.7	36.5
Deficit	7.6	7.2	5.7	4.7	4.1	3.5
Plan B – NERI projection						
Expenditure	43.1	44.0	42.9	42.8	42.8	42.3
Revenue	35.5	36.8	38.5	40.8	41.5	41.7
Deficit	7.6	7.2	4.4	1.9	1.3	0.7

The official forecast is drawn from the April 2012 Stability Programme Update for years 2012 to 2015, and the October 2012 IMF World Economic Outlook for 2016 and 2017. NERI projections are based on the medium scenario.

5 Projecting the outcomes

5.1 Introduction

This section addresses the question of how Plans A and B impact on public finances, employment and output. All three are closely inter-related as changes to employment and unemployment impact on government revenue and expenditure.

We have used the NERI implementation of the HERMIN model⁴ to examine the impacts of combining an investment stimulus with a mainly tax-based fiscal consolidation over the coming five years. As with all models there is a considerable margin of error in projecting future outcomes and the past may be a poor guide to the future as behaviour and policy respond in unforeseen ways against a context of considerable uncertainty globally as well as domestically.

The HERMIN model uses macro-economic data to allow researchers to bring together different production sectors of the economy in a complex model that relates producer, consumer, investor and labour market behaviour to external developments in trade, prices and currency movements. The model allows us to distinguish by broad spending and tax headings.

To examine the impacts of Plan A and Plan B we had to estimate a 'baseline construct' where Government makes no discretionary changes to spending or revenue. A 'baseline construct' enables us to measure the impact of any fiscal package compared to a 'do nothing' scenario. To construct a baseline for 2013 we have reversed the €550m planned cut in public investment for 2013 and €100m cut in 2014, after which public investment is held constant. Public sector wages and employment are held constant in this baseline scenario. Non-wage government consumption and non-cash social transfers are kept at 2012 levels (in both real and nominal terms). Effective direct and indirect taxes are

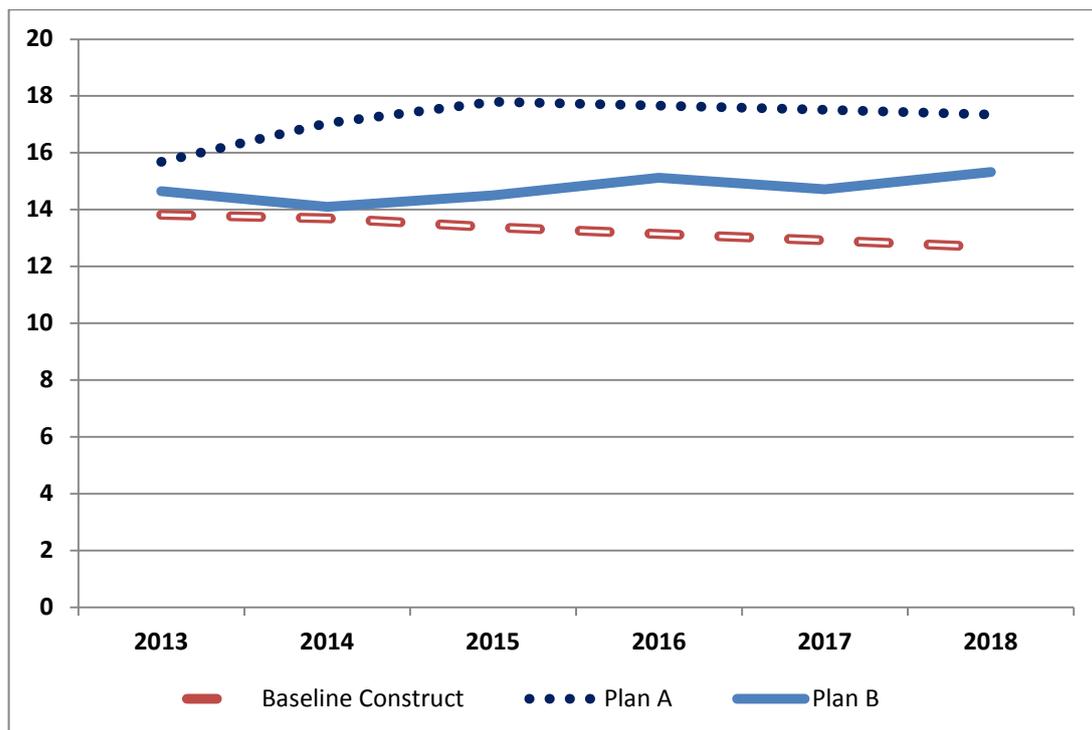
⁴ The HERMIN macro model of the Irish economy is part of the Cohesion System of HERMIN models currently used by DG Regional Policy for the purposes of analysis of the impacts of Structural Funds on long-term development. We thank the Commission for permission to make use of the model for our work. All responsibility for such use and interpretations of the results is ours alone.

kept at 2012 levels. Total social transfers are kept constant in real terms, no adjustment is made for changes in employment.

5.2 Impact on employment

The results of the simulation of Plan A and Plan B over a six year period are shown in Chart 1.

Chart 1 Projected unemployment – slow international recovery scenario (and no change in net migration)



Note: Projections are made under the assumption of no demographic change or change in labour participation.

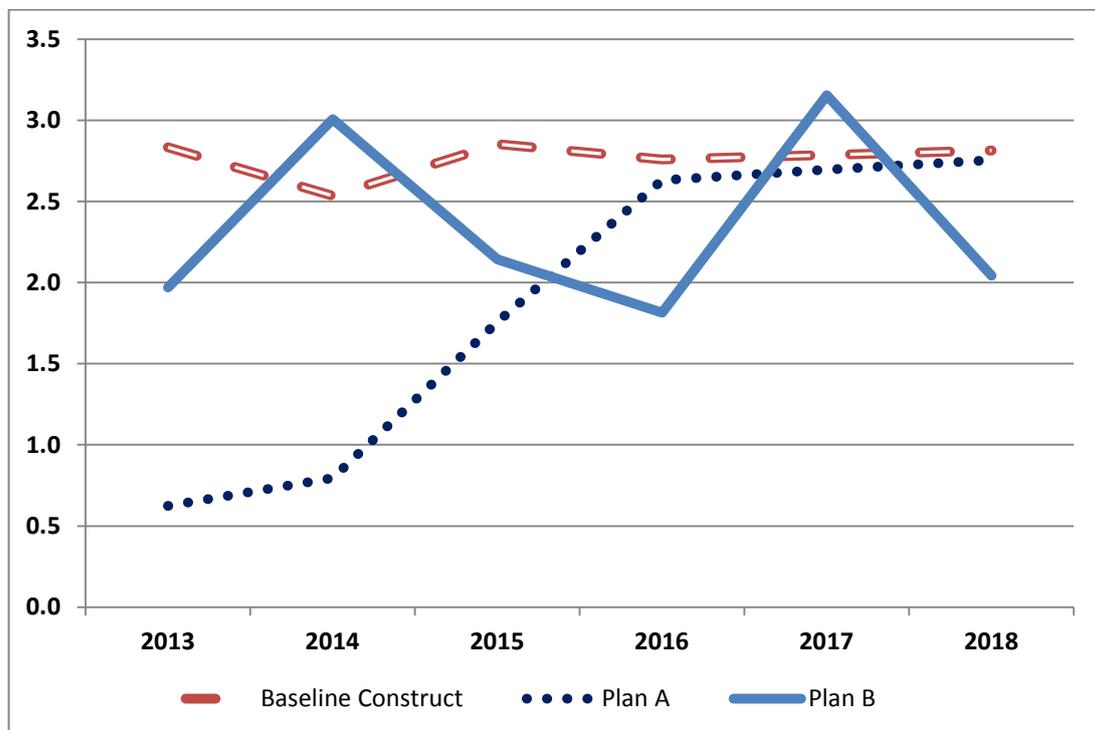
Contrasting the baseline with Plan and Plan B indicates that fiscal adjustment is costly in terms of unemployment. Plan A has a particularly negative impact on unemployment with the rate rising to a peak of 18% in 2015. This outcome is marginally worse than that estimated by Bradley and Untiedt (2012:67) where they assumed a slow international recovery and a continuation of existing domestic fiscal austerity. Plan B does lower unemployment initially but the rate begins to rise again in 2014 in the absence of significant additional net outward migration. This occurs as the investment stimulus peaks in 2015, and is then slowly removed. Also the tax measures are back loaded to the point where the

economy is more able to absorb the loss in aggregate demand caused by the tax increases. Under the slow recovery scenario, unemployment gradually declines following the completion of Plan B.

5.3 Impact on GDP

There is a significant upfront impact on GDP from Plan B while projected growth rates in real GDP tend to vary in the medium-term.

Chart 2 Projected real GDP growth – slow international recovery scenario

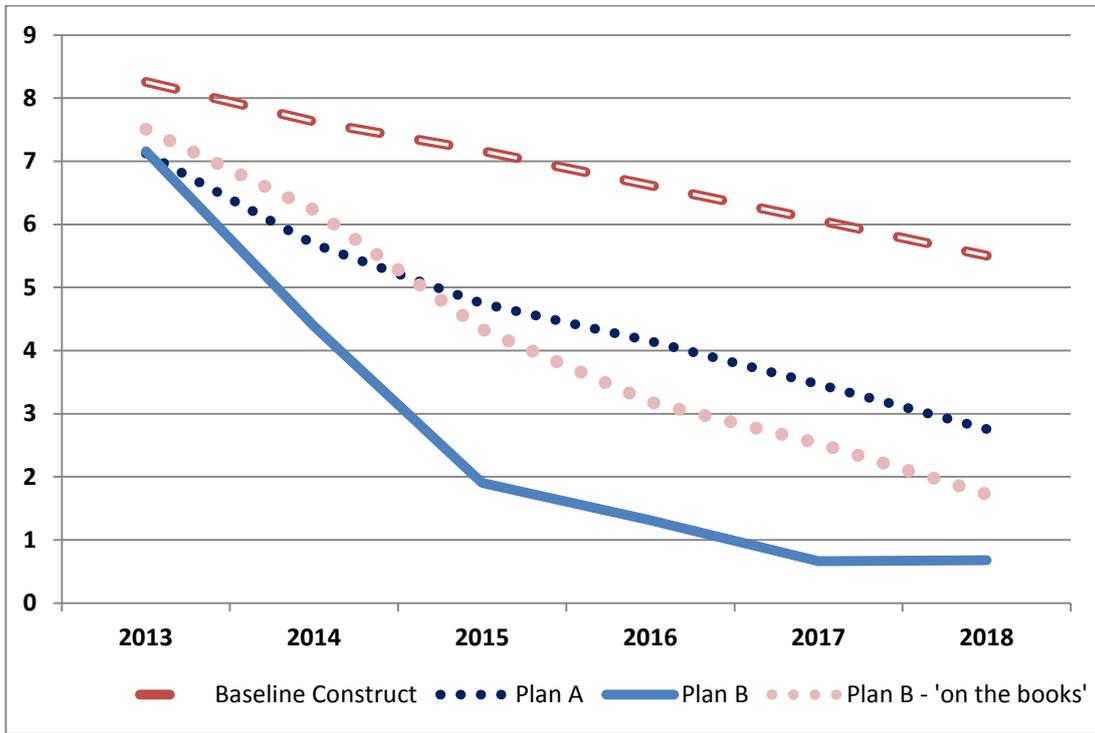


Note: Though Plan A shows higher growth in some years (as the investment stimulus is withdrawn), GDP under Plan A is at a lower level.

5.4 Impact on Government deficit and spending

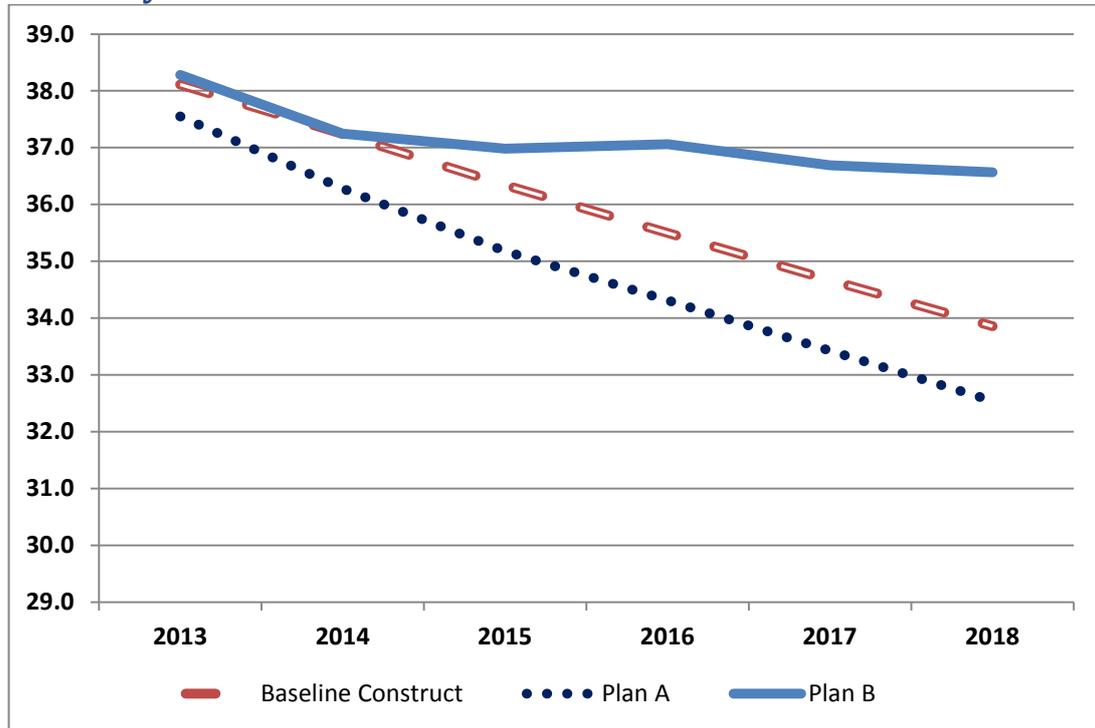
A clear difference emerges between Plan A and Plan B in terms of the public sector deficit which falls more quickly under Plan B given a combination of revenue buoyancy and possibly more efficient fiscal consolidation via tax increases. The relative efficiency of tax increases and spending cuts as a means of fiscal consolidation is a subject to which we will return in a later paper.

Chart 3 Projected general government deficit – slow international recovery scenario



The impact of Plans A and B on 'primary expenditure' (Chart 4) – total general government spending less interest payments on debt – is shown in Chart 4. There is a sharp decline in primary spending under Plan A to a level of under 34% of GDP whereas under Plan it remains close to 36.5-37.0% for most years.

Chart 4 Projected 'primary expenditure' - slow international recovery scenario



5.4 Alternative global scenarios

Instead of using a slow international recovery we could assume another slump or, alternatively, quick recovery. A new and prolonged recession in the key trading partners would have significant impacts on employment, output and government finances. Unemployment could increase sharply under Plan A (to 21%) while it would increase at a slower rate under Plan B (to reach 19% in 2018). Bradley and Untiedt (2012:71) have projected an unemployment rate of approximately 19% in 2014 under a global worse-case scenario. Our results are based on an assumption of no additional net outward migration. To the extent that a large (and unexpected) increase in unemployment occurs, it is very likely that net outward migration would increase further. Further work is required in modelling these impacts.

Under a fast international recovery unemployment remains high for the foreseeable future with a rate of close to 14% under Plan B and a rate of around 17% under Plan A for 2015 to 2018. Bradley and Untiedt (2012) are more

optimistic in projecting a fall from a high of around 16.5% in 2014 to around 9% in 2018. Timing factors are critical to the extent that an investment stimulus under Plan B generates significant additional employment initially but this boost diminishes as the stimulus is gradually withdrawn. A crucial unknown is the extent to which private investment takes off as confidence improves and as the initial boost to domestic demand gives breathing space before a recovery in private investment.

A sense of how projections are impacted by changes in GDP or in underlying circumstances is important⁵. The Department of Finance (2011:43) has estimated how a lower annual GDP growth impacts on the General Government Balance (the government deficit). For example, a lower growth in GDP in 2012 by one percentage point would raise the Balance by 0.5% of GDP.

5.4 The impact of an investment stimulus in isolation

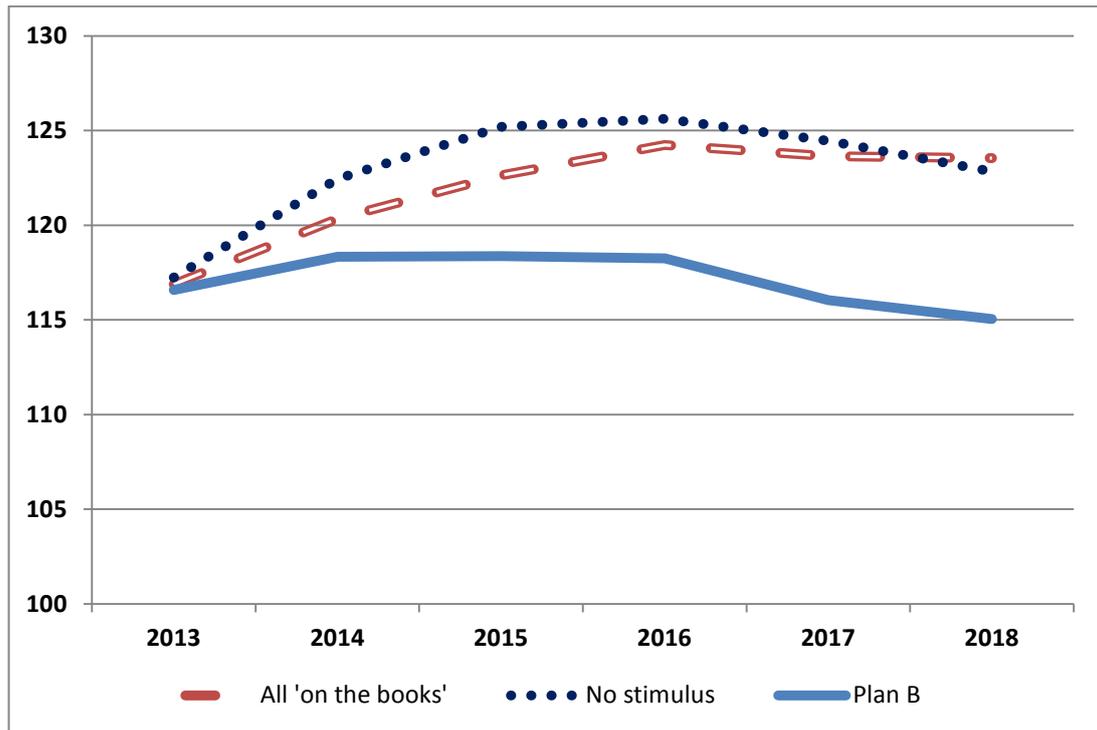
A key feature of Plan B is the proposal for a graduated investment stimulus over six years phased in after appropriate cost-benefit analysis and phased out as economic activity picks up again. Underlying this plan is the proposal that any additional investment would be financed entirely 'off-balance sheet' implying no additions to general government debt. Off-balance sheet borrowing or financing can happen in a number of ways including borrowing by public enterprises (outside the general government sector), some public-private partnerships and commercial financing by the European Investment Bank (EIB).

If it were assumed that some of this additional investment were to be financed by additional borrowing then, clearly, general government debt would increase as is evident from Chart 5. However, even if the investment stimulus were to be

⁵ 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) in the first year. For example a cut of €1bn (=0.6% of GDP) arising from lower public sector 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 0.1-0.3% (with the proviso that this is likely to be an under-estimate as supply-side impacts are not accounted for). A cut of €1 billion in public sector wage rates would lower GDP by between 0.2-0.3%. A similar overall negative impact is likely for the same level of adjustment on the revenue side. All of these estimates are based on static conditions with regard to markets and credit conditions and reflect pre-2008 relationships.

entirely financed 'on-the-books' Plan B still performs better than Plan A in terms of a lower debt to GDP ratio and reaches the 3% deficit target earlier (in 2017 rather than 2018).

Chart 5 Projected general government debt with and without 'off-the-books' borrowing (slow international recovery)



5.5 Overview of outcomes under Plan A and Plan B

Table 5 summarises the outcomes under the Baseline, Plan A and Plan B.

Table 5 Two Fiscal Adjustments Compared

	Baseline (2012)	Baseline (2013)	Plan A (2013)	Plan B (2013)	Plan A (2015)	Plan B (2015)
GDP nominal values (€bn)	164.2	168.6	164.8	167.2	166.4	173.9
Employment ('000s)	1827.4	1840.3	1800.4	1822.4	1755.3	1825.7
Unemployment rate (% Labour Force)	14.4	13.8	15.7	14.7	17.8	14.5
General Government Balance (% GDP)	7.7	8.3	7.1	7.2	4.7	1.9
Government Expenditure	43.1	43.8	43.3	44.0	41.4	42.7
Government Revenue	35.5	35.6	36.2	36.8	36.7	40.8

Note: Baseline corresponds to the actual estimated outcome in 2012 and in 2013 without any fiscal adjustment whatsoever.
Plan A entails an adjustment of €3.5 billion of which €2.25 billion is from expenditure
Plan B entails an adjustment of €2.7 billion of which €2.3 bn is accounted for by revenue.
The Baseline differs from that of the NERI Autumn QEO in that it is based on modelled projections rather than Stability Programme Update estimates.

Table 6 Plan B would be better for growth and jobs

	Plan A relative to baseline 2013	Plan B relative to Plan A 2013	Plan A relative to baseline 2015	Plan B relative to Plan A 2015
GDP real growth rate difference	-2.2%	+1.4%	-1.1%	+0.3%
Employment	-39,900	+22,000	-94,300	+70,400
Unemployment rate (% Labour Force)	+1.9%	-1.0%	+4.4%	-3.3%
General Government Balance (% GDP)	-1.1%	0.0%	-2.6%	-2.8%
Government Expenditure difference	-€2.484bn	+€2.132bn	-€6.037bn	+€5.462bn
Government Revenue difference	-€0.314bn	+€1.836bn	-€1.330bn	+€10.008bn

Note: See notes to Table 5 above.
Under Plan A GDP is lower by 2.2% and unemployment is higher and these factors in combination with others lead to lower revenue than under the baseline scenario.
The Baseline differs from that of the NERI Autumn QEO in that it is based on modelled projections rather than Stability Programme Update estimates. It accounts for reported overspending in the Department of Health.

There is a negligible difference in outcomes between Plan A and Plan B in 2013 with regard to the government deficit and overall level of gross debt expressed as a percentage of GDP. The key difference is the targeted level of 'primary public

expenditure' as a percentage of GDP. Under Plan A the *intention* is to reduce the level of primary public spending from an estimated 40.0% in 2012 to 37.9% of GDP (according the Stability Programme Update) – a drop of 2.1 percentage points or, approximately, €1.5 billion in total primary expenditure.

Under Plan B the proposal is to reduce the level of primary public spending as a proportion of GDP by a smaller magnitude – a drop of 1.7 percentage points - from 40.0% in 2010 down to 38.3%. The wedge between overall target spending at 44.0% in 2013 and total primary spending is total payments of interest on general government debt projected for 2013 (5.5%⁶). This latter amount is similar under both Plans A and B. In the event of an agreement at European Union level to reduce the interest payment burden it would be possible to reduce the total interest by up to one percentage point (lowering the interest bill from 5.6% of GDP to approximately 4.6% in 2013). In this event we would concur with a much smaller contraction in primary spending as a proportion of GDP. Given the positive impact of an ambitious investment programme it should be possible to conserve the real value of primary expenditure including current and capital voted exchequer expenditure and direct savings arising from lower unemployment to priority areas.

A 'no further overall non-pay cuts' stance such as proposed in Plan B does not mean that savings could not be made across a range of programmes. A rigorous, continuous and in-depth investigation of every area of public spending with a view to achieving cost reductions where these are possible and desirable on economic and social grounds. The results of a periodic review of spending such as are summarised in the Comprehensive Review of Expenditure and published in December 2011 (Department of Public Expenditure and Reform, 2011) should be made available along with the detailed and unedited briefing material prepared by each Department. Where savings can be achieved in various areas the amount realised should be diverted into priority areas of public support. Mention here is made of the following three areas in particular where Ireland needs to catch up on many other European countries and where the benefits are likely to be significant:

- Investment in early childhood education and care;

⁶ After adjustment for higher GDP due to a Plan B fiscal package.

- Mental health services for young people; and
- A youth guarantee to extend training and work opportunities for school leavers.

6 Conclusion

In this paper we have explored fiscal choices and options and some possible macro-economic impacts. Political economy explores choices and allows for a complex interaction of economic agents. Public finances sit within a large economic and social context. Regulating public finances can never be a simple exercise in accountancy. It must allow for the dynamic relationship between government and the rest of the economic world.

The wheels of the fiscal car continue to spin in the mud as additional pressure on the accelerator of fiscal austerity leaves little impression on employment, output or consumer confidence. Instead we need a rubber mat of an investment stimulus under the fiscal wheels to allow a lift off from the recessionary mud. An export-led recovery towing van would certainly help if such were available but such outside help alone is not enough.

Overall, the proposed Plan B performs better in terms of deficit reduction, unemployment, and debt/GDP ratio. Plan B complies with targets as set by the Troika (under both the fast and slow recovery scenarios). Which plan is followed is a matter of choice for the Government.

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