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Fiscal Adjustment in Ireland in the 1980s

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Abstract: We examine both the motivation for, and the overall dynamics of, fiscal adjustment from 1981 to 1991. Growing interest costs to meet an ever-expanding debt, combined with the impact of retrenchment on the welfare bill and several adverse exogenous shocks, made fiscal correction a nightmare in the early stages. The benefits of persistence came later with some reversal in all of these factors. In quantitative terms, governments relied much more on tax increases than on expenditure reductions. However, little was done to improve the incentive structure of the tax system. In contrast, some useful efficiency improvements may have been gained on the expenditure side.

I INTRODUCTION

The archetypical fiscal experiment of the 1980s worldwide was adjustment. The Mexican debt crisis of 1982 marked the most conspicuous early case among scores of countries where enforced retrenchment to correct swollen budgets and external deficits was the order of the day. Ireland's experience in the 1980s is thus less unique than it may sometimes appear to the Irish taxpayer, worker or welfare recipient.

The severity of retrenchment in Ireland was not exceptional: nothing like the 30 per cent fall in per capita private consumption in Jamaica, for instance. But there are some characteristics of the process of fiscal correction in Ireland which make it different from most others. For one thing the adjustment was not an enforced one: government foreign debt was rolled over, and indeed substantially increased, during the 1980s without the need for special negotiations or rescheduling. The country did not draw even on the

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unconditional credit lines available to it at the IMF, and there was no externally imposed programme of adjustment measures such as might have been associated with a larger IMF loan or stand-by agreement. Second, the adjustment took place without abandonment or curtailment of an extensive income maintenance programme well beyond the experience of most adjusting developing countries.

Why did Ireland adjust if under no pressure to do so? There are some wrong answers to this question.

> First is the idea that the high inflation experienced in 1980-81 was an important contributory factor. But the inflation was largely an imported one, with the movements of sterling, the US dollar and commodity prices each playing an important rôle (aided and abetted by indirect tax increases brought in to begin to stem the fiscal deficit). When these external factors were reversed in 1985-86 inflation fell to, and even below, the EMS average.
>
> The second mistaken idea is that around 1981 the Irish electorate and Irish policy makers were seized with the free-market doctrines which were then emerging so strongly in Thatcher's Britain and Reagan's United States, and decided that the scope of government activities and spending in the economy should be reduced. It is true that free-market ideas emerged progressively during the 1980s in Ireland as elsewhere, but the heavy reliance on tax increases in the early stages of Ireland's fiscal contraction contrasts sufficiently strongly with the British and US cases to put paid to the idea that the impetus for fiscal restraint came from this ideological basis.

This paper looks at two aspects of the adjustment. First, we examine the basis for and the objectives of fiscal adjustment as they were perceived in Ireland and at the overall dynamics of the fiscal adjustment. We note that measuring the fiscal crisis and establishing feasible targets for its correction were important and non-trivial aspects. Growing interest costs to meet an ever-expanding debt combined with the impact of retrenchment on the welfare bill made fiscal correction a nightmare in the early stages. The benefits of persistence came later with some reversal in both of these factors. The endogenous dynamics of interest and unemployment dominate the interpretation of fiscal aggregates throughout the 1980s.

Secondly, we look behind the overall magnitudes to characterise the policy measures adopted to effect the fiscal correction. Several different types of procedure for cutting spending are possible, and all were tried with differing degrees of success. Though the distinction is not an unambiguous one, both tax and spending measures were utilised. It is clear that reliance was placed on tax increases as a means of increasing government revenue, but little was done to improve the incentive structure of the tax system. In contrast, some useful efficiency improvements may have been gained on the expenditure side.

II SYMBOLS AND REALITY

2.1 *Eliminating the Current Budget Deficit*

In understanding the fiscal correction in Ireland it is important to begin with the reasons for the correction and the objectives underlying this retrenchment. The key word in this context is sustainability. Official statements do not necessarily provide an accurate insight into the motivations of government, but it is worth recalling the uncharacteristic rhetorical flourish with which the July 1981 budget statement opens: the "objective ... has been to ensure that Ireland remains an independent economy. The piling-up of foreign debt to finance daily expenses is the negation of the principle of self-reliance, the principle of Sinn Fein, on which this State is founded." The same document, which heralded almost a decade of fiscal retrenchment, listed a number of reasons for early action to eliminate deficits. These included the avoidance of enforced deflation later on ("we must act if we are to protect essential public and social services"); the removal of "fraud on the young people of this country by piling up debts to be repaid by the workers of the future"; and the consideration that the limits to the extent to which foreign banks are prepared to lend "can be reached suddenly and with little warning".

The perceived reason for fiscal correction was that it was ultimately inevitable and that early correction would leave what we tend to call "future generations" — but which in practice includes ourselves a few years down the road — in a better condition. The prevailing fiscal path was unsustainable.

Ten years ago, the usual way of measuring the sustainability of the fiscal stance was the level and trend of the current budget deficit (CBD). And at that point the deficit was worrying both in regard to level and trend. No doubt this was a useful rule of thumb for a period of economic stability and modest government debt, but it provided an inadequate guide to the policy-maker of the 1970s and 1980s.

Our topic is not the 1970s, so a few words must suffice. The OPEC-I oil shock elicited a similar response in Ireland to that in the UK. Countercyclical fiscal policy was applied, at the cost of a significant breach of the "no-current deficit" rule. The policy, superficially attractive, was associated with accommodation of high inflation, and with a protracted, though somewhat less abrupt, recession than occurred in other industrial countries. By 1977, corrective policies (especially higher taxation) and a buoyant economy had helped to almost halve the CBD. The oil-shock having passed, appeal to the old doctrine would have dictated elimination of the CBD. Carrying that too far too quickly might have been a mistake; but it was a different mistake that was made. Departing from orthodoxy, the new government of 1977 made their colourful bid for full employment; an effort which went so badly wrong that it has tended to overshadow policy mistakes before or since. Unlike France's experience with the ("Mitterand") dash for growth, the financial markets did not penalise the sharp increases in the Irish CBD in 1978 and 1979 (nor the fact that the 1979 deficit came out at almost double the budgeted level). Foreign loans were still easily available, and by 1981 the CBD was heading for 10 per cent of GNP and overall Exchequer borrowing for twice that.

The July 1981 budget was stated to be the first step on the road to elimination of the CBD in four years. This aim was said to be "difficult but not impossible", but proved to be both. The current budget has remained in deficit to the present time, with no immediate prospect for balance in the years ahead.

The decision to target the CBD for elimination had unfortunate consequences. By setting an effectively unattainable goal, the government set the scene for public disillusionment as the failure to reach that goal became apparent. Significant tax increases in the succeeding years were barely sufficient to prevent the deficit from growing, let alone reduce or eliminate it. Not only did this have an adverse political effect on the government itself, but by increasing public anxiety about the nature and scale of an eventual crunch, it may have contributed to the high savings ratio and depressed private investment demand of the mid-1980s.

The truth of the matter is that elimination of the CBD was not a necessary condition for returning to sustainability of budgetary policy. It is true that the homely analogies about living beyond one's means represented a simple message which seemed, after successive election campaigns, to have been understood by every household in the country. But, for the early to mid-1980s, it was a counsel of perfection. The inevitable failure to achieve this target demoralised politicians and electorate alike, and caused the adjustment process to falter mid-way.

Already by early 1984 an advisory body, the National Planning Board,[1] wisely recommended abandonment of the target of eliminating the CBD. The government complied, in its plan *Building on Reality* (October 1984), though

1. Over whose report the government exercised no editorial control.

it did not adopt the particular alternative suggested by the Board.[2] But the damage had already been done. The CBD as a symbol of irresponsible budgetary policy had been too firmly established to be replaced overnight.

2.2 *Missed Targets*

The failure to make any apparent inroads on the CBD before 1987-88 is evident in Figure 1.[3] In contrast to the 1975-77 period, where the CBD (6.8 per cent of GNP in 1975) was almost halved in two years, the fiscal restraint

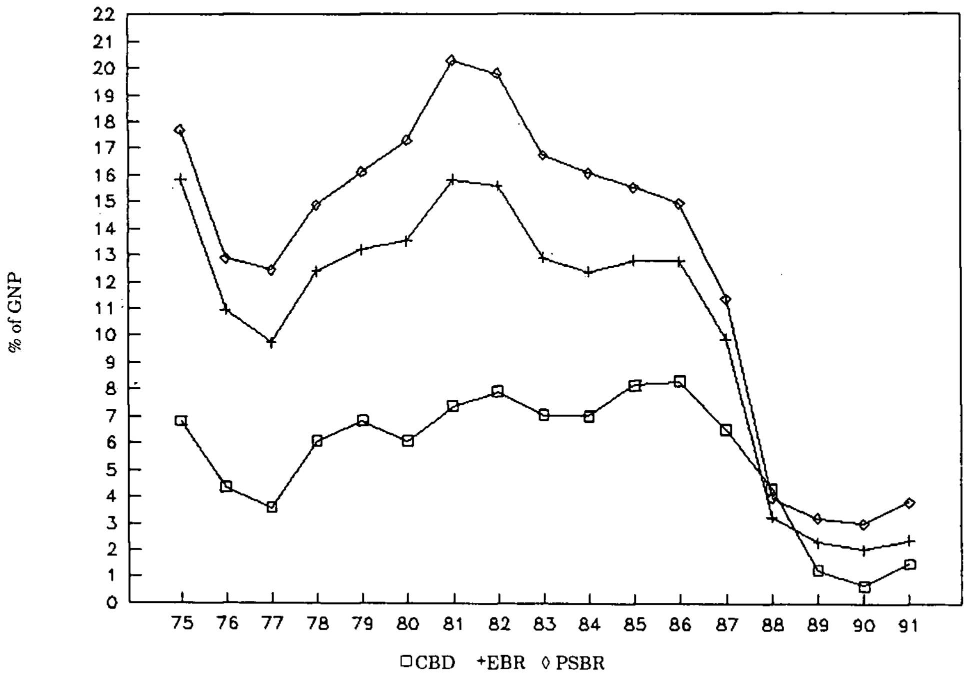

Figure 1: *Deficit and Borrowing — Budget Booklet Format*

2. Though the implications for the current budget deficit in the National Planning Board's proposals coincided with *Building on Reality*'s current budget deficit targets. The new objective of stabilising the debt to GNP ratio was discussed in Honohan, 1985.

3. The quantitative assertions of the paper are based on a detailed analysis of a number of different data series. Among the key differences between the various series is the question of inclusiveness. The "budget book" data, used in Figure 1, focuses on the Exchequer, leaving semi-state bodies, the social insurance fund and local authorities (including the health boards) outside the picture. Though it is an unsuitable source for considering the overall stance of government, it is the most widely used in official statements and press comment, so it is particularly relevant for questions of symbolism, psychology and confidence. The treatment of 1991 varies for technical reasons from figure to figure; Figure 1 uses the official projections contained in *Economic Review and Outlook*, July 1991.

of the early 1980s was unable to bring the CBD below 7 per cent for six years in a row. A small reduction as a per cent of GNP in 1983 and 1984 followed by a resumption of growth in that ratio translates into an increase in the nominal size of the deficit right through to 1986. No wonder the perception at that point was of a failed adjustment.

Official claims that something had been achieved even by 1986 received more tangible support in the figures for the wider definitions of deficit finance, the EBR and PSBR. By 1986 the EBR was more than three percentage points of GNP below its 1982 peak and the PSBR deficit more than five percentage points down. Indeed, as Dornbusch (1989) puts it, this early fiscal retrenchment was dramatic.

Nevertheless, the debt-GNP ratio had not yet stabilised. The rate of borrowing was still far too high to accomplish that. Figure 2 shows that the ratio continued to grow considerably to the end of 1987. Thereafter, as with all the other series, there is a dramatic improvement in 1988.[4] It was largely the reduction in borrowing in 1988 and after that brought the debt ratio down from 128 per cent of GNP at end 1987 to 109 per cent at end 1990.[5]

The sharpest fall in the borrowing figures occurred in 1988, largely as a result of the tax amnesty. However, the CBD even net of the tax amnesty effect[6] fell as a percentage of GNP in 1988, to a greater extent than in any year bar 1976.

After 1988 the rate of improvement in EBR and PSBR slowed,[7] but the CBD continued to improve so that by 1989, at little over 1 per cent of GNP, it had fallen by 5 percentage points in two years.

4. Note that Figure 2 deflates end-year debt by the mean of previous and subsequent years' GNP. This shows a much sharper decline in the ratio at 1988 than do the usual calculations based on previous year's GNP. The debt figures are the official series; after 1982, this series excludes some double entry bookkeeping. Foreign currency debt is valued at end-year exchange rates; however, it is the nominal capital sum due at maturity and not the current market value that is included for marketable debt.

5. Though currency movements also helped, so that (based on the end-1986 portfolio), by end 1990, the Exchequer would have made a capital gain equivalent to 3 per cent of GNP on exchange rate movements alone.

6. The one-off nature of the amnesty suggests that this treatment is appropriate. Official sources were always careful to show two sets of figures for 1988, with and without amnesty. In this they showed an admirable degree of foresight: boasting unduly about declines that would be quickly reversed would have been shortsighted.

7. Considerable data problems bedevil interpretations of timing here, as delays in receiving EC transfers confuse the picture. The National Income and Expenditure figures might, on a superficial reading, appear to suggest that 1989 rather than 1988 was the year of chief budgetary improvement. The conclusion in the text is supported not only by the budget book figures, but by a close interpretation of the NIE figures. Specifically, in our only departure from published statistics, we have (in figures marked "adj") excluded from the NIE data on current spending the large and volatile item "expenses of market intervention less recoupment from EC", which really has more the nature of a fully secured short-term loan than a subsidy.

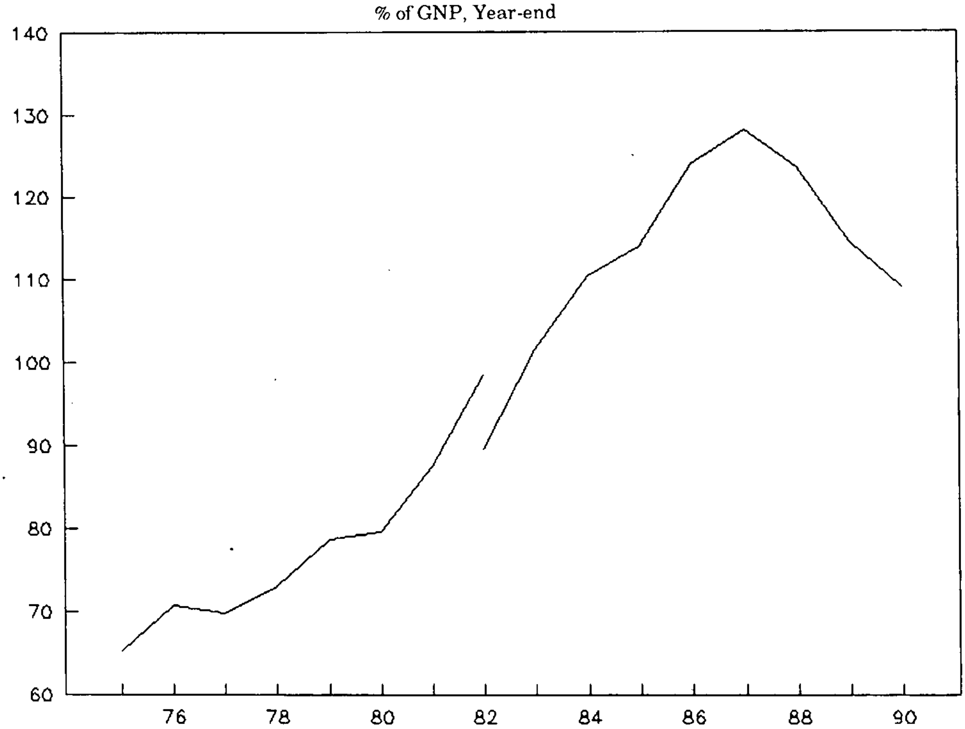

Figure 2: *National Debt 1975-90*

How this improvement was divided between tax and spending changes is reviewed below, but first it is worth examining how far these improvements (and indeed the earlier lack of progress) was reflected in budget proposals, and to what extent it came as a surprise. Figure 3 presents the budget proposal and the outcome for both of the two main current aggregates, spending and tax revenue. Three periods are evident: before 1982; from 1983 to 1987, and from 1988 on.

Before 1982, budget estimates were rather inaccurate on both spending and taxation, with a systematic tendency for budgetary over-optimism on spending after 1978. In 1979 and 1982 also, the tax revenue forecasts in the budget were over-optimistic, while 1981 must be treated with care as the outcome was strongly affected by the July budget of that year.

From 1983 to 1987 budget projections were generally more accurate. Even the deficit slippage in 1986 is not evident in the figure, because it is caused by a cumulation of rather small errors on both sides.

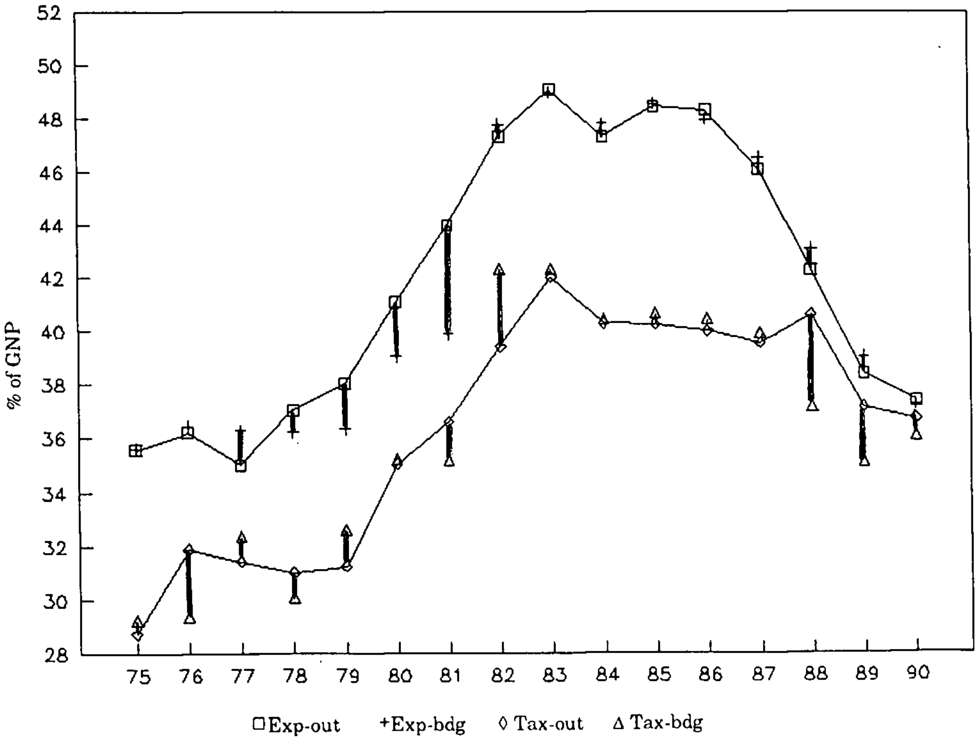

Figure 3: *Budget and Out-turn: Current*

The years 1988-90 present an entirely different picture. Once again budget projections are inaccurate, but now the errors are chiefly on the tax side, and are in the sense of under-optimism. The very substantial fiscal improvements of 1988 and 1989 were not forecast in the budget proposals of those years. The 1988 budget proposed a current deficit of over £1.1 billion compared with an outcome of just over £0.8 billion before amnesty. The 1989 budget proposed holding to the previous year's outcome, but eventual outcome was less than £0.3 billion.

Two conclusions may be suggested. First, by 1983 public scepticism with regard to budgetary over-optimism had become endemic. There was no longer much to be gained by presenting unrealistic figures. Indeed the opposite may have been the case. Second, the idea that the private sector responded vigorously to an improved fiscal situation needs to be reviewed carefully in light of the fact that it was the private sector's economic recovery that generated what was an unexpected degree of fiscal improvement in 1988-89.

2.3 *The Scramble to Boost Revenue*

Tax increases were the chief means of effecting a reduction in borrowing. As a share of GNP, taxation was static from 1977 to 1979 at below 31 per cent; it grew rapidly from 1979 to 1984, jumping to over 41 per cent (see Figure 4).[8] Since 1984 the ratio to GNP has been comparatively static (apart from the one-off amnesty jump in 1988), with the 1991 budget figure still at 41 per cent.

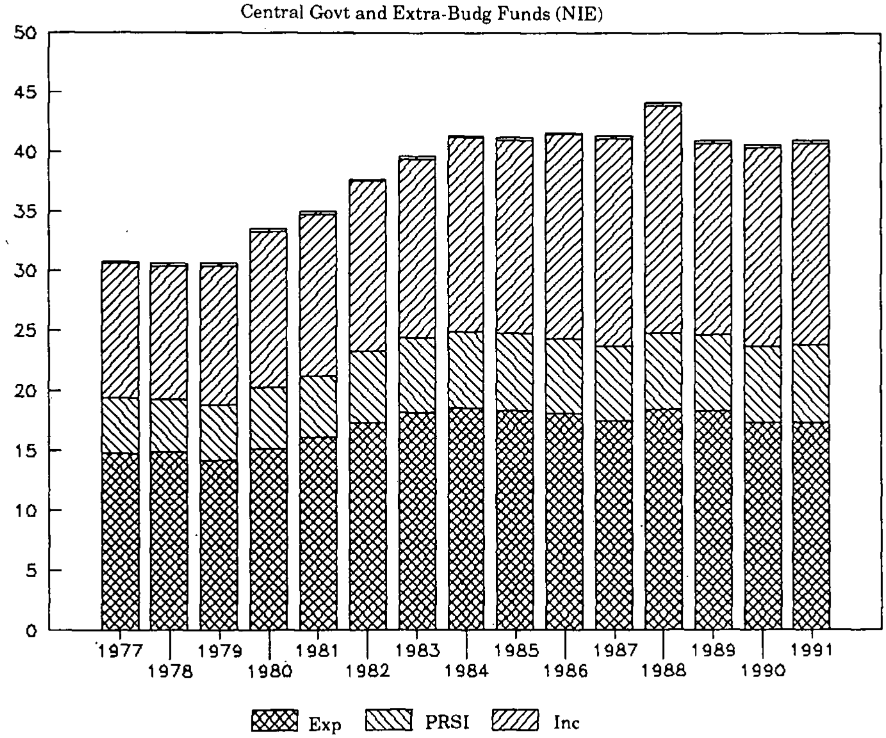

Figure 4: *Taxation as a Percent of GNP 1977-91*

The almost inexorable growth in tax revenues is even more evident if we do not express them as a percentage of GNP. In real purchasing power terms (Figure 5),[9] tax revenue has grown rapidly in every year bar 1985 and 1986 (again neglecting the amnesty year effect), from a 1977 figure of £('91)5.4 billion to £9.7 billion in 1991. Thus, it was rapid economic growth in 1978-79 and again in 1987-90 that allowed the tax share to remain static despite

8. Figure 4 is from the NIE accounts for Central Government and Extra-Budgetary Funds, and thus includes the Social Insurance contributions as tax revenue. Budget data is used for 1991, though the differences from mid-year projections would be hard to detect visually.

9. All "real" fiscal data in this paper are deflated by general purchasing power (GNP deflator) and not by factor cost. Both measures are important, but the purchasing power one seems more relevant for the present context.

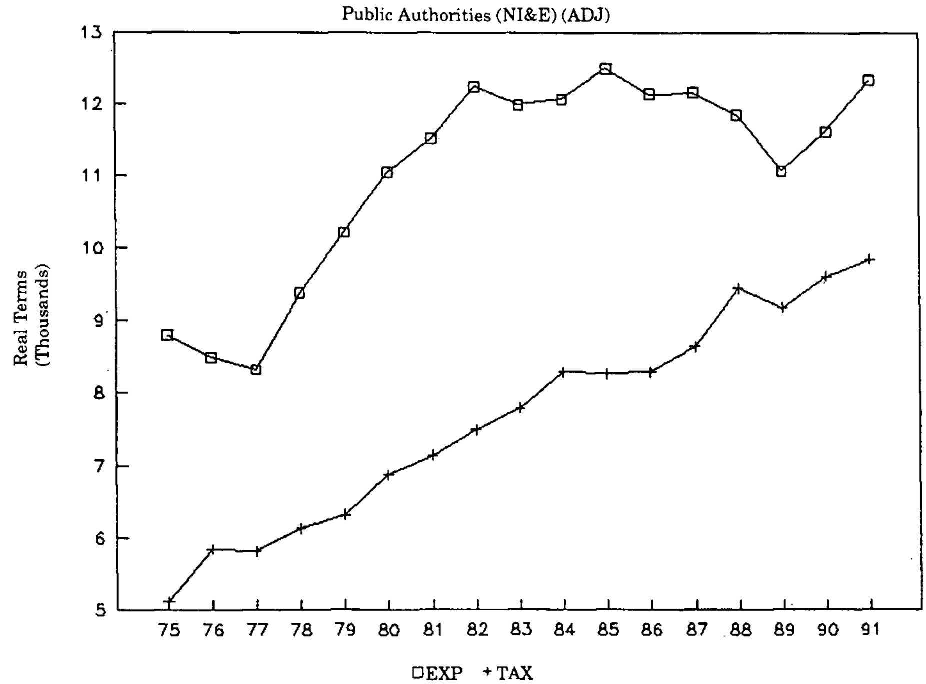

Figure 5: *Total Spending and Taxation*

growth in the real tax take; in contrast, slow growth in 1985-86 had meant no increase in the real tax take when the tax share was held constant.

I would propose that three turning points can be identified in the tax trends of the past fifteen years: 1979 when the tax take began to increase as a share of GNP, 1984 when this ceased (Figure 4) and 1987, when the take resumed its upward path in real terms (Figure 5).

The broad composition of taxation has also changed over the same period (Figure 4), with a fairly steady decline in the share of expenditure taxes (down from 48 per cent in 1978 to below 42 per cent ten years later, with a temporary interruption in 1989). Increased administrative effectiveness of income tax as well as a perception that international tax competition was more severe for expenditure taxes than for income taxes both contributed to this change.

Political scientists have wondered whether governments spend because the tax revenue is there, or whether they look for tax revenue to cover their spending needs. Like most economists I would reject this formulation of decision making as being too remote from an optimising framework, but it may not be too bad as a heuristic device. If so, I think that it is fair to say that the early years of adjustment 1981-84 saw a scramble to raise enough tax revenue to meet spending needs and to cut borrowing. For the next two years political exigencies prevented any increase in tax rates; a revulsion had set in and the *Building on Reality* commitment to a freeze in tax/GNP ratio established what may prove to be a firm ceiling. Unhappily, macroeconomic stagnation transmitted this into no growth in revenue and a resulting failure to make any further inroads into borrowing before 1987. The tax revenue buoyancy of 1987-90 was of a different character: macroeconomic recovery filled the coffers, allowing an uncovenanted fall in borrowing.

Tax is only one side of the story, but it is quantitatively by far the most important. In 1982 public authorities net borrowing was equivalent to £('91)3.4 billion, compared with £0.8 billion for 1991. This improvement was matched by an increase in tax revenue, which grew from £('91)7.5 billion to £11.2 billion in 1991. Total spending (current and capital) has, by 1991, returned to the same real level it had reached in 1982, i.e., £12.2 billion; while real current spending was at a record level in 1991.

Here too is a failure to meet symbolic requirements. Public consciousness was that the fiscal crisis was created by overspending. Not only was the current deficit never eliminated, but progress was apparently entirely on the tax side. Before turning to the spending side to see why this was so, it should be pointed out that this distinction between tax and expenditure in local usage (i.e., broadly between legislation that involves the private sector writing cheques and programmes which involve the government writing cheques) is one that though of great symbolic importance, sits most uneasily with economic theory. Indeed, national income accountants have for years attempted to distinguish between expenditure by government on goods and services and other forms of government disbursement such as subsidies and transfers. In Ireland, only about one-fifth of current government spending is on goods and services, a share which fell during the 1980s. The remainder can be regarded as closely analogous to negative taxes. But in a fiscal crisis it is often the symbol that matters.

2.4 *Why the Turnaround Was So Slow: Endogenous Factors*

We have already mentioned the important rôle of unemployment and interest in influencing trends in the Irish public finances during the 1980s. The prompt payment of all debt servicing together with an income support system for the unemployed (that alone was, by 1987, transferring some five per cent of national income) were two of the distinguishing hallmarks of the Irish fiscal adjustment. The dynamics of unemployment and interest were affected by, and in turn fed back on, the fiscal adjustment in an important manner.

At the beginning of the adjustment, Exchequer borrowing was adding about ten percentage points to the annual debt/GNP ratio. As each successive year began with a larger debt, non-interest spending net of taxation would have had to be lower than before even to maintain the same budgetary deficit. It was like trying to walk down an up-escalator.

The second point is a link between the level of borrowing and the interest rate paid on those borrowings. This is somewhat controversial, and I am relying on the authority of the OECD for this idea. In their recent (1990-91) report on the Irish economy, they note that the years of high borrowing have been associated with high domestic interest rates. If this relationship is valid, then each three percentage points (of GNP) increase in the EBR is associated with a one percentage point increase in long-term interest rates. Thus, a failure to stem an acceleration in borrowing has consequences not only for the volume of debt to be serviced in the future but also for the rate at which the servicing must be made.

A few remarks are in order about this relationship proposed by the OECD. First, it is not the overall cost of borrowing but only the domestic interest rate that is affected by shifts in the EBR. That is reasonable, in that the holder of Irish pounds may reasonably fear a devaluation of the currency as one possible consequence of a situation in which the debt to GNP ratio is growing in an apparently unsustainable way. That particular fear does not affect the holder of debt denominated in foreign exchange; the eventuality of some drastic action reducing the value of foreign currency claims (such as delays in servicing or forced rescheduling) have never been likely in the Irish context. Second, the estimated relationship is not couched in terms of real interest rates as one might expect: instead the OECD find that inflation differentials between Ireland and Germany have only a slight impact on nominal interest rate differentials. Third, note that the current EBR may be a very imperfect indicator of the likelihood of a servicing crisis: the level of debt should also be important, but the OECD have not discovered any level of debt effect. I would like to accept the OECD relationship only on a provisional basis: work in progress should help elucidate the determination of Irish interest rates.

On unemployment one has to take account of the fact that the familiar automatic stabiliser function of income support programmes is transformed from a benefit to a problem when the objective of fiscal stabilisation has supplanted that of income and employment stabilisation as happened in Ireland in the early 1980s. There can be no doubt that the fiscal contraction of 1982-84 contributed to unemployment, triggering additional spending on income maintenance, and thereby impeding progress in reducing borrowing.

Just as the OECD theory about interest rates adds a new twist, however, the close linkage between the Irish labour market and that in the UK provides further important links in the story. As I argued in my 1984 paper, based on data running to 1982, there is a strong causal relationship between

UK and Irish unemployment rates. A negative shock to Irish employment conditions sets in train a process of migration which takes some time, and which depends on UK labour market conditions. Recently, I have made a preliminary review of the more recent data running up to 1991 (Honohan, 1992). This review concludes that UK-Irish unemployment links continued to be close for male unemployment throughout the 1980s. That overall Irish unemployment trended upwards to a much greater extent than that in the UK is, on this reading, attributable mainly to the growth in female unemployment. I suspect that this growth in female unemployment is only partly attributable to business-cycle conditions.

Combining these two mechanisms we can explain why fiscal restraint necessarily yields a slow turnaround in the deficit. Starting from a situation where debt and debt servicing are increasing, a tightening of fiscal policy is not enough to cause the deficit to fall, because of the up-escalator effect. Unemployment rises, making it almost impossible, when combined with the growing interest bill, to reduce total spending. But the seeds of success are being sown. Unemployment will gradually return to its former level as part of the labour force escapes through the safety valve of emigration. A further tightening of the fiscal screws is sufficient to halt and even reverse the growth in the debt ratio. Now the interest escalator has moved into reverse and, just as unemployment also begins to fall, reductions in borrowing become progressively easier.

This simple model has other messages. Because the endogenous process is an unstable one, fiscal adjustment needs to be energetic. Stabilisation of the EBR at its ultimate target rate is not enough: there must be a temporary reduction in the EBR below its long-term level if the economy is to be brought back from an unstable or unsustainable path to a stable one.

Not all of these mechanisms were fully appreciated when policy was being formulated in the early 1980s. But that they are among the most important determining the time path of the fiscal aggregates in Ireland can be seen from a breakdown of current spending trends in those years. Of a total increase of £('91)1.75 billion in the real value of current Exchequer spending from 1981 to peak year 1984, over £('91)1.5 billion was accounted for by increases in interest and social welfare payments.[10] While real social welfare spending stabilised between 1985 and the trough of total current spending in 1989, interest payments accounted for over one-third of the real decline of £('91)0.65 billion.

10. Cf. Table 1. Not all of the increase in social welfare was related to unemployment in view of the significant increases in the real rates of benefit. However, by 1985 payments for unemployment were more than 2 per cent of GNP higher than if unemployment had remained at its 1980 level.

Table 1: *Changes in Real Government Expenditure, 1981-91*

	1981-85	*1985-89*	*1989-91*	*1981-91*
		In 1991£		
Social Welfare	687	–7	195	876
Interest	832	–234	143	741
Health	–33	–73	137	31
Education	68	121	54	243
Other Current	198	–455	453	196
Total Current	1,753	–648	982	2,087
PubCapPgm	–1,143	–658	374	–1,426
EBR for Capital	–767	–667	312	–1,122
Total*	986	–1,314	1,293	965

*Current plus EBR for Capital.
Note: Brought to real terms by GNP deflator.
Source: Budget booklet.

2.5 *Exogenous Disturbances to Fiscal Costs*

In addition to the endogenous dynamics of unemployment and interest, there have been important exogenous swings in these quantities. Previous studies (Fitz Gerald, 1986 and McAleese and McCarthy, 1988) have documented the impact on Ireland of the worldwide interest rate jumps in 1979 and again towards the end of 1982. These, together with the lower world interest rates prevailing in the second half of the 1980s, are an important part of the historical evolution of the fiscal crisis.[11]

As with interest rates, the first part of the 1980s experienced a negative labour market shock in the form of the massive rise in UK unemployment associated with the Thatcher adjustment. This shock led to rising unemployment in Ireland even before fiscal correction began. The impact of this and other external shocks of Irish unemployment has been studied by Barry and Bradley (1991). Improving labour market conditions in the UK in the second half of the decade eased the exogenous pressure on Irish unemployment.

A third exogenous factor was the unexpectedly sharp reduction in the rate of CPI inflation. The best example of this is seen from the explicit inflation forecasts published in *Building on Reality*. Table 2 compares these with the outcome and shows that cumulative inflation over the three years 1985-87 came to less than 13 per cent compared with a forecast of over 20 per cent. There were several consequences. The detailed fiscal plan based on these

11. We may also note the evolution of exchange rates, which (given the currency composition of foreign debt) had an unfavourable effect on the size of total debt from 1980 to 1984, favourable from 1984 to 1986 and again from 1988 to 1990. However, only part of these exchange rate effects can be treated as exogenous as some are linked to the inflation-competitiveness nexus.

forecasts included cash limits on public sector pay and provisions for social welfare increases which were expressed in nominal terms, but pitched just below the forecast rate of inflation in order to offset some of the real increases that had occurred because of unintentional over-indexation in the immediately preceding years. That inflation came out lower than intended eroded the bite of these provisions. It would have been hard to revise cash limits downwards as the actual inflation proved lower than expected (especially considering that, even as they stood, the cash limits were not achieved). Public sector wage settlements were made to cover periods in which price inflation was expected (by both sides in the negotiation) to be higher than it worked out. Debt instruments that had been sold at modest expected real yields proved to have exceedingly high *ex-post* real yields. With negative buoyancy impacting nominal tax revenues, the budget was the loser all round in this faster than expected disinflation. This experience casts doubt on the view that elimination of inflation was a central aim of the Irish fiscal retrenchment.

Table 2: *CPI Inflation: Forecasts and Outcome*

	1984	*1985*	*1986*	*1987*
Proposals for Plan*	9.3	6.5	6.0	6.0
Building on Reality^	9	7	6½	6
Budget 1985		6		
Budget 1986			4½	
Budget 1987				3
Actual	8.6	5.4	3.9	3.2

*April 1984.
^October 1984.

It would be easy to argue that these exogenous effects, when combined with the endogenous dynamics discussed above, are enough to explain much of the early delay, and the late speed of current spending reduction. With direct unemployment payments alone of close to one per cent of GNP for 50,000 unemployed and with every one hundred basis points adding one per cent of GNP to debt servicing costs, the magnitudes are large enough.[12] Furthermore, when emigration picked up, not only were unemployment payments reduced, but with shrinking waiting lists, the costly local authority house-building programme became unnecessary, and demand for other social services was also reduced.

12. To average interest costs. The servicing of fixed interest long-term debt is not sensitive to these movements.

2.6 *Turning Points in Spending Aggregates*

Just when the turning points in spending occurred is somewhat controversial. It is clear that they do not always coincide with the turning points for taxation. All series agree that, after some fall from 1975 to 1977, spending increased rapidly to 1982. A definite turning point is seen at 1982. In the data for total spending (current and capital) this begins a period of stability in real terms (see, for example, Figure 5), and of reduction as a share of GNP.

Current spending continues to grow in real terms, though at a slower rate, until about 1985 (Figure 6), followed by stagnation until 1987.[13] After 1987 there is a reduction in real current spending, though whether this occurs mainly in 1988 or 1989 depends on interpretation. The official statistics have most of the fall in 1989, but they include spending on the Public Servants early retirement scheme as a current item. This spending, which was mainly in 1988, should arguably be treated as capital: doing so serves to distribute the fall in real current spending more or less equally between 1988 and 1989. It seems best to regard 1988 as the key turning point. Growth at or above the 1983-85 rate is resumed from 1990. This all suggests turning points at 1983,

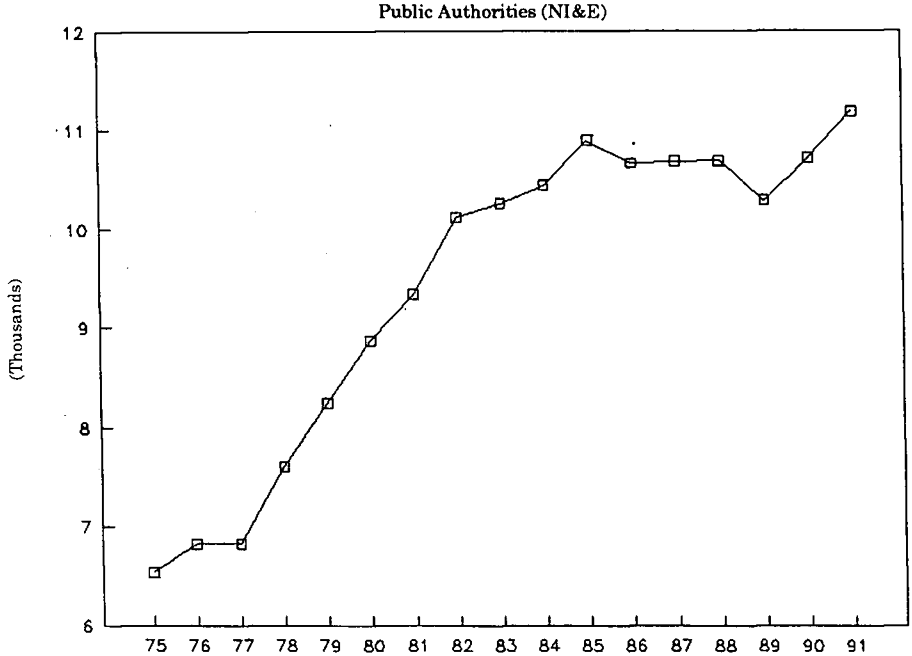

Figure 6: *Current Spending (Real Terms) (ADJ)*

13. The NIE data shows spending increasing until 1987, but this is because they include as a current subsidy substantial but variable sums effectively lent by the Exchequer to the Agricultural Intervention Agency, and subsequently recouped from the EC. As already mentioned, Figures 5 and 6 exclude these items.

Table 3: *Public Authorities Accounts in Real Terms*

Year	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
						In 1991 £											
Total Taxes	5114	5839	5809	6126	6317	6864	7128	7495	7797	8293	8278	8293	8649	9444	9190	9612	9845
Total Current Receipts	5397	6171	6231	6621	6980	7531	7719	8272	8645	9051	9142	8965	9417	10096	9708	10157	10613
Total Current Taxes	5053	5802	5774	6085	6278	6827	7097	7461	7762	8254	8240	8256	8606	9378	9133	9545	9763
Capital Taxes	61	37	35	41	39	37	31	34	35	39	38	37	43	66	57	68	82
Other Capital Receipts	997	384	234	327	437	387	380	533	376	392	483	376	511	676	472	520	842
Current Expenditure	6546	6831	6820	7613	8254	8884	9347	10128	10272	10452	10903	10706	10966	11120	10119	10695	11044
Subsidies	601	620	595	712	778	783	804	782	792	748	737	661	865	1005	398	564	430
National Debt Interest	744	889	972	1160	1277	1351	1535	1882	1951	2049	2282	2117	2196	2225	2131	2223	2220
Transfers (Residents)	2141	2229	2179	2337	2478	2658	2878	3328	3473	3582	3755	3816	3864	3921	3728	3798	3998
Wages, etc.	3060	3093	3072	3403	3721	4092	4130	4136	4056	4073	4128	4113	4040	3969	3862	4110	4396
Capital Expenditure	2246	1657	1492	1769	1979	2180	2178	2126	1736	1626	1606	1479	1474	1158	785	915	1150
GFCF	944	805	827	945	1092	1217	1182	1099	978	879	889	805	652	486			
Grants to Enterprises	213	258	250	253	281	389	351	314	248	185	194	185	150	138			
Net Dis-saving	1145	661	589	992	1274	1353	1628	1855	1627	1401	1761	1741	1549	1024	411	538	431
Net Borrowing	2333	1897	1812	2393	2777	3109	3395	3414	2952	2596	2846	2807	2469	1440	668	866	657
Primary Deficit	1589	1008	839	1233	1501	1758	1860	1532	1001	547	564	690	273	–785	–1463	–1357	–1563

Source: 1983-88: National Income and Expenditure 1989; 1982; NI&E 1988; 1977-81; NI&E 1985;
1970-76: NI&E Revision published February 1985, (except details of capital account and transfer payments for 1975-76: NI&E 1979);
1989-91: ESRI Medium-Term Review, 1991.

Note: Current subsidies include subvention to the agricultural intervention agency subsequently recouped with payments from EC FEOGA.

1988 and 1990. The controversial part of this conclusion is that it implies that significant inroads were made in the 1988 fiscal year and not earlier. Of course, this depends to some extent on the choice of real spending, rather than per cent of GNP, as our main measure.

The same turning points are suggested by the data on capital spending financed by exchequer borrowing. This actually falls in real terms in 1983, then remains fairly static until further falls in 1988 and 1989; growth is resumed in 1990.[14] Unlike the situation with current spending, capital spending has remained well below its peak both in real terms and as a share of GNP. Public authorities capital spending was running at over £('91)2.1 billion per annum before 1983; the 1991 figure is not much more than one-half of that.

III THE FORMULATION OF FISCAL POLICY

The statistical aggregates represent only a bland summary of a complex and difficult process of underlying policy measures. If the attempt to reduce overall spending was only a modest success, that must be understood against an institutional and political background that has not been favourable to cuts. This section examines some aspects of fiscal policy-making in Ireland over the past decade.

3.1 *Procedures for Cutting Spending*

Broadly speaking, there are only a limited number of ways in which the cost of government spending in a given year can be cut. Spending can be postponed; real rates of subsidy or the salaries of public servants can be reduced; services can be terminated or privatised. For the longer term, other options are available: procedures can be established that limit growth and promote improved management; public servants can be offered early retirement.[15]

(a) Immediate Cuts

Postponement. The most important manner in which cuts were achieved in the period under review was through postponement. I am speaking here of the cutbacks in capital spending and especially in public fixed capital formation. Probably most of the capital projects that were deferred will eventually be built (though there are notable exceptions). But they will not be built until much later than they would have been had there been no fiscal

14. Cf. Table 3, based mainly on NIE data. The latest years in this table draw from the ESRI Medium-Term Review, June 1991.

15. Early retirement schemes have an immediate cash cost, but may result in net savings in the long run if the retired staff are not replaced directly or through the use of consultants.

retrenchment. Roads are a good example: a comparison of successive roads programme documents over the past dozen years shows many projects that remain on the stocks but with repeatedly postponed completion dates. Likewise with housing. The 7-8,000 unit rate at which local authority houses were being built in the mid-1980s has collapsed to about 1,000 in the past three years. There will be more public, or public-assisted housing in the future.

There is a cost to delaying capital spending.[16] Road congestion and travel times are worse than they would have been. House waiting lists are longer than they would have been (though shorter than they were at some points in the past) and are growing. Unless the eventual spending is higher because of the postponement — and that is rarer than is commonly supposed — there is a genuine and lasting improvement in the fiscal position.

During 1983-91 capital spending fell below its 1982 peak by a cumulative total of almost £8 billion in 1991 prices. It is easy to see why postponement of capital spending has been politically the preferred option. The hope of eventually getting the capital improvement remains present and losing what you never had cannot hurt too much.

Public Service salaries. Another form of postponement is in public service pay rates. Public service pay rates could be cut on either a permanent or a temporary basis, but for reasons to be mentioned, temporary cuts are more likely. Cutting public service pay relative to rates prevailing in the private sector is a sure way of reducing the deficit; it is also guaranteed to create industrial relations problems and depress morale in the public service. Both of these characteristics became central to the failure of *Building on Reality* to reach its budgetary targets in the mid-decade. Heavy reliance in that fiscal plan on cash limits for public service pay which would have reduced pay relativities in the plan were not matched by adherence in subsequent budgets to those limits.[17] As I pointed out in my 1987 paper, the government's capitulation to the teachers' strike of 1986 set the seal on the plan's targets. But at a deeper level it is clear that any cutback in public service pay rates can only be a postponement so long as the government continue to adhere to the procedure of accepting the recommendations of the public service pay arbitrator. The jump in pay costs in 1991 following the expiry of the Programme for National Recovery is an example of that. The arbitrator will continue to preserve relativities: but, broadly speaking, only by breaking the relativities can pay be used to lower the budget deficit. Lower wage inflation

16. Though in some cases, like local authority housing in the mid-1980s (given the short waiting lists then) and the Dublin Airport runway, the costs of delay are small. Though the well-developed technique of cost-benefit analysis is available to make this sort of evaluation, it is greatly underused in official circles in Ireland.

17. Even though the limits had become less severe than expected in real terms.

all round tends not to help the budget by much because of the loss of tax revenues. If, as is often the case, the arbitrator's award includes a retrospective element, then little or nothing has been gained for the budget in the end.

A relative cut in public service pay rates is appropriate mainly as an emergency measure. The public service needs staff of calibre just as much as the private sector, and while the rôle of pay, in causing some of the more able civil servants to move to the private sector, may not be as great in the short run as some argue, there can be no doubt that a severe and permanent downgrading of the status and rewards of a public service career would tend over time to result in a worsening of the performance of the public service more than the cost savings would warrant.

Rates of transfer payments and subsidies. Cutting real rates of transfer payments or of subsidies is a very simple way of helping the budget. It often does not involve administrative complexity, it can be concealed by inflation, the losers cannot normally take industrial action. Yet it was not extensively used during the 1980s. Indeed, Table 4 shows the substantial real increases in the weekly social welfare payments during the decade.[18] This determination to maintain and even increase income maintenance payments was a hallmark of the fiscal adjustment in Ireland. Persisting, as it did, through a

Table 4: *Real Value of Social Welfare Payments*

	Short-term	*Long-term*	*Long-term unemployed*
1980	100.0	100.0	100.0
1981	100.5	106.0	100.4
1982	106.1	112.1	105.6
1983	106.1	114.1	110.9
1984	105.3	113.1	111.0
1985	105.8	114.2	112.2
1986	105.8	114.3	113.0
1987	105.5	114.1	112.7
1988	106.5	115.0	118.5
1989	105.1	113.5	121.7
1990	108.5	115.9	128.0
1991	110.2	117.7	131.9

Notes: Based on married couple with two children.
Second semester figures deflated by August CPI.

18. This contradicts the misleading table in the OECD 1990-91 report for Ireland which is based on average unemployment payments, and disregards the increasing share in the total of those entitled only to the lower rates of unemployment assistance.

time of falling or static per capita income generally, and when a considerable tightening of welfare entitlements was happening in Britain, this strategy was criticised on efficiency grounds (higher replacement ratio for the unemployed and incentive for return migration) and as a perverse response to rising numbers of claimants. On the other hand, the mitigation of poverty was probably significant.

The one area where rates of subsidy were reduced, and eventually eliminated was that of food subsidies. The sums involved were significant, as the subsidy attached to the commodity and was not in any way means-tested. Actually, the food subsidies were very like negative excise taxes. Seen as such, they might not have been regarded as notably egregious. After all, we have been well used to extraordinarily high excises on certain goods, and zero rates on others: what is magic about zero that we cannot set negative excise rates? However, this reasoning was not applied to food subsidies. These subsidies (on bread, butter and milk) had risen to over one per cent of current government spending by 1984. Since they were treated in the budget accounts as an expenditure and not as a (negative) tax, they were scrutinised on a different set of criteria. It was pointed out by those who advocated their abolition that they represented an inefficient, because untargeted, way of alleviating poverty. It was especially stressed that although the poor spend a higher proportion of their income on food, the rich spend higher absolute amounts and thus get higher absolute amounts of subsidy. These arguments were valid, so far as they went, and I do not want to defend the food subsidies. But the food subsidies became a totem in the debate over spending cuts far beyond their real importance.

The argument over food subsidies was ultimately a destructive one. Indeed, the social welfare increases in the January 1982 budget were calculated on the basis that the poor would be especially hit by the planned abolition of food subsidies; these increases were not modified when, at a late stage, it was decided not to touch the food subsidies and instead to resort to an increase in the main VAT rate. The issue re-emerged in the Summer of 1984 when the government decided to announce a scaling back of food subsidies which was being built into the public finance profile of the draft plan *Building on Reality*. This proved so politically difficult that the announcement, made just before the Summer break, only involved a halving of the subsidies. The poor public reception of this announcement sealed the rate of further spending cuts that were being contemplated for the fiscal plan. In the event, food subsidies proved to be the biggest single spending cut effected by the 1983-87 government. Arguably more would have been achieved if the expenditure hawks had chosen a different ground on which to make their stand.

Abolishing programmes: Abolition of current spending programmes presented different problems. Most programmes had been introduced in quite recent times and supported on a cross-party basis. It was not easy for politicians to reverse their earlier decisions and destroy schemes which they had argued for and had boasted about. Here it is important to stress the relative absence of ideological commitment in Ireland to a reduced rôle for government. Even most politicians who are committed to fiscal retrenchment are also sympathetic to the objectives and methods of public spending programmes; they simply think that their scale has got out of hand and out of proportion to the nation's capacity. That is why spending cuts are generally proposed in such an apologetic way. It would be easier for politicians who were ideologically unsympathetic to the spending programmes. Ireland is by no means unique in this respect. Indeed, the worst-designed and most wasteful public spending programmes affecting Ireland are those of the CAP for which Ireland can accept only a limited degree of responsibility.

Particular spending programmes are defended not only by the scruples of politicians. Each programme accumulates its own interest group of individuals who benefit disproportionately from that programme. Usually well-organised and vocal, they make abrupt programme cancellation extremely difficult. Explicit abolition of programmes has played a surprisingly small part in spending restraint during the decade.

Indeed, under the pressure of high unemployment and depressed economic activity, new programmes were introduced. The Social Employment Scheme: designed to give the long-term unemployed a chance to get back to work, if only on a temporary and low-paid basis, was the largest of a number of new labour market spending initiatives, some of which have been co-financed by the European Social Fund. Another large scheme was the house improvement grants scheme of 1985, designed to boost the building industry which had been severely weakened by the recession.[19]

All-in-all, the most significant cutbacks in current spending have been achieved through more indirect and long-term means to which we now turn.

(b) Indirect Methods of Controlling Spending

Three indirect methods of expenditure restraint have been employed with considerable success. These were the recruitment freeze for public servants, later combined with an early retirement plan; the imposition of cash limits on semi-autonomous agencies; and the promotion of budgetary responsibility at a less centralised level. Their political costs were also, for the most part, smaller than was the case for direct cuts. Inevitably, some of these indirect

19. A flaw in the design of this scheme was its open-ended nature: no ceiling was imposed on the overall cost, which soared to well over £100 million before the scheme was terminated.

methods have taken time to bear fruit, but their success is likely to be a lasting one.

Recruitment embargo. The recruitment embargo was an ingenious tool. Obviously, it was an extremely blunt instrument, resulting in managerial nightmares and an uneven and unpredictable impact. However, it was fairly easy to monitor, it forced managerial innovation and promoted efficient practices and it reduced current budgetary costs significantly. Although those hit by the freeze could complain, the uniformity of the freeze and the fact that, though there were exceptions they were comparatively few and well-defined, helped secure its acceptance as a kind of rough justice. When first introduced in 1981, the embargo did allow the filling of a proportion of vacancies arising. The net effect was a fall of 2 per cent in Exchequer-financed employment in the following four years, compared with an increase of 15 per cent in the previous four. From 1987 the embargo was tightened considerably, with effectively no recruitment. The early retirement plan accelerated the reduction in employment so that numbers are now close to their 1978 level. Including local authority employment, this means a fall in numbers employed of some 24,000 since 1982 yielding a gross saving in pay costs of the order of 2 per cent of GNP.

To the extent that pubic service managers were able to deploy available staff as effectively as possible to deliver prescribed services it may be assumed that the fall in staff numbers was not accompanied by a commensurate fall in services provided. This decentralisation of efficiency improving measures is a key advantage, both politically and practically, of the indirect approach to expenditure reduction.

The same is true, though perhaps to a lesser extent, of cash limits. Cash limits are of limited effectiveness in the central civil service where managers do not have effective budgetary control. A cash limit on, say, the total Social Welfare vote cannot be met by administrative action alone if the number of eligible claimants is too large. Progress towards defining decentralised budgetary responsibility where this is feasible (for example over the administrative budget of the Department of Social Welfare) has begun, as foreshadowed in the White Paper, *Reform of the Public Service*. The process is a slow one but likely to be increasingly effective. Where autonomous agencies already existed, as with the semi-state bodies, cash limits appear to have been quite effective. Indeed, an examination of the estimates volumes for 1988 and 1989 suggest that cutbacks in the grant-in-aid to non-commercial semi-state bodies were among the main explicit measures in achieving the considerable expenditure restraint of those years.

Cash limits can be challenged by such tricks as overspending through the year in order to create a visible and publicly embarrassing crisis at year-end, or by borrowing from private financial institutions to cover the shortfall in one year in the hope that it will be made up by a more lax Exchequer stance in the following year. These tricks were used during the 1980s, but an increasing recognition by local authorities and semi-state bodies, both commercial and non-commercial, that they were going to have to face up to a hard budget constraint appears to have resulted in a more responsible and sober approach.[20] This must have contributed to the substantial efficiency improvements that I believe to have been achieved especially in the commercial semi-state sector.

(c) Spending Policy and Outcome

Table 1 shows a breakdown of the real (purchasing power) change in government current spending in three different periods, 1981-85, 1985-89 and 1989-91.[21] I choose 1985 and 1989 because they are the peak and trough years. Of the five categories, only health falls in each of the first two sub-periods; only education grows in each. Against a background of increasing health costs worldwide, the steady reduction in health spending is remarkable. Increases in education reflect a definite policy decision to improve teacher-pupil ratios, despite the fiscal stringency, and, in the second sub-period, the effect of the payment of the controversial special award to the teachers is obviously taking its toll. But the changes in these two large categories of spending are rather small. The big increases in 1981-85 are in interest and social welfare which, as already mentioned, between them explain the vast bulk of the net change. In the second sub-period interest costs fall in response mainly to reductions in interest rates, and there is a stabilisation of social welfare costs as the numbers unemployed fall. The table reveals the heavy reliance on capital spending cuts throughout the first two sub-periods.

It is necessary to delve a little further to interpret the substantial turnaround in the category "other current" between 1981-85 and 1985-89. The modest growth in this category 1981-85 reflects mainly increases in payments for industry and labour (including ANCO — now FÁS) and agriculture, together with an increase in the housing subsidies paid to local authorities and in the compulsory payment to the EC budget, offset by the reduction in food subsidies. The further reduction in food subsidies and in the rates relief grant to local authorities, together with a reversal in the growth of spending on industry, labour and agriculture, provide the main explanation for the fall

20. The demonstration effect of the Irish Shipping Limited disaster may have been an important factor for the semi-state bodies — and for their bankers.

21. The source here is the functional classificatiion of the budget book. Budget figures are thus included for 1991.

in the second sub-period.[22] Note how many of these cuts appear in the category of cash limits to semi-state agencies.

Improvements in efficiency can go some distance in reducing public spending. Central government can only achieve such improvements by indirect means: devolving managerial responsibility and establishing clear budgetary targets and incentives for improvements in efficiency. With rapid economic growth the modest restraint on spending that this implies may be almost enough. But the attempt to push this indirect approach too far inevitably bumps up against real policy decisions. At a certain point further savings can only be achieved with reductions in services provided. Some of this has already occurred, as witness the reported growth in hospital queues. Surely, government should not allow the decision on elimination or curtailment of services to occur in a haphazard way without ensuring that the burden is shared evenly throughout the country and across categories of need.

Though governments have admittedly been reluctant to take tough decisions, it has to be said that they have not been assisted very effectively by existing administrative procedures. What are known as the "spending departments" have not taken a lead in designing coherent programmes of expenditure restraint for their ministers to evaluate, modify and eventually propose to the government. The administrative burden of proposing cuts has fallen largely on the much maligned Department of Finance, the importance of whose work is widely underestimated. Combining as it does, an audit and approval function together with policy formulation, the expenditure side of that Department is, in my view, as understaffed as its economic and taxation function. As a result, its contribution to spending reduction has been piecemeal and of more limited effectiveness than it should be. Its famous hit-list of impractical spending cuts is still, I understand, reheated and served at the annual estimates campaign. The urgency of the immediate budget task results in the focus of its proposals being too often confined to the next budget year, without enough regard to slow-yielding but potentially more effective methods of spending restraint. A coherent approach to spending cuts may appear less urgent now than it did when spending seemed to be spiralling inexorably, but such an attitude underestimates the loose ends and distortions that have inevitably resulted from the period of restraint itself. As the experience of the National Planning Board and the Commission on Social

22. This data needs to be treated with care. Note in particular that some of the reductions in Exchequer spending relate to the move off-budget of substantial EC-financed programmes in training and employment. This move does not affect the overall public authorities spending figures already discussed above and shown in Figure 6. Note also that timing effects of EC receipts in agriculture also tend to exaggerate the degree to which there were public spending cuts in these categories in 1988 and 1989.

Welfare has shown, only fiscal planning that is well integrated into the administrative process is likely to achieve the balance of practical and political feasibility. If fiscal adjustment means an improvement in the structure as well as in the level of government spending, Ireland's budgetary procedures have been even less equal to the former task than to the latter.

3.2 *Tax Policy*

Tax policy is left to the end because the main issues here are, I believe, straightforward and well-known. The high level and rapid growth of tax revenues already discussed amply illustrate that Ireland has an effective mechanism for achieving a high tax revenue. The revenue yields would be the envy of many a developing country. The shortcomings of the tax system in Ireland have not been so much how to raise sufficient revenue (though that is how it is often perceived by the Minister for Finance as budget day approaches) but how to do so in a manner which is fair and conducive to efficient economic performance and growth.[23] Popular dissatisfaction with the level of taxation is well-known; there may also be dissatisfaction with its structure going beyond narrow self-interest. As Irvine and myself have shown elsewhere (1987) the high rates of tax imposed on a narrow base can be very costly in terms of economic distortion.

The Commission on Taxation proposed a blueprint for tax reform which satisfied most criteria. Not only did it analyse many detailed issues in tax reform but it presented a conceptual framework within which future questions could also be answered. Thus, adoption of the Commission's framework as a basis for progress would have created an atmosphere of relative stability and certainty. It was unfortunate that the value of such certainty in taxation was widely unappreciated in Ireland.

As successive governments scrambled to expand the tax take during the 1980s the prospect of indefinite increases in the tax burden must have been a factor contributing to reduced consumer and investor confidence. Not only was the scale of future taxation uncertain, so long as the path of debt accumulation seemed unsustainable, but no-one knew just what would be taxed. The precise incidence of the taxation that would have to be levied was unclear and potentially very severe. Even tax measures that were clear improvements on the previous system (and moved in the direction mapped out by the Commission on Taxation) added to the fear.

The Department of Finance has earned a reputation of being opposed to tax reform. Basically, its position appears to be that announced reforms, however

23. I do not overstress distributional objectives here, as it is the spending side of the fiscal accounts that normally make most impact on distributional issues. It might be different if we were considering a fully integrated income tax and social welfare regime.

rational, are likely to be watered down by concessions to the worst affected, and thereby ultimately result in a net loss of revenue — potentially serious. This is not an irrational fear; fundamentally new taxes have tended to take-off less quickly in revenue terms than fundamentally new spending programmes.[24]

Without a clear and accepted framework for tax reform, major tax initiatives have been haphazard and partly contradictory. Public debate on these issues has tended to be confused. Advocacy of a wider tax base has been accompanied, in the same breath, with proposals for extending the scope of such tax breaks as the International Financial Services Centre. Though top tax rates have been reduced (the top VAT rate has come down from 35 to 21 per cent) remaining distortions are large, especially in the poverty-trap range.

Perhaps it is not surprising that comparatively little has been achieved in reforming the structure of income tax at a time of stringency. As with expenditure reform, the rising tide may be needed to allow adjustments. Increasingly, tax competition from Europe will erode the biggest distortions and place pressure on taxes that are considerably out of line. Tax regimes in other countries are not ideal either, and part of the focus of the tax debate in Ireland will be to contribute to the intellectual debate on harmonisation of the tax base at EC-level, to avoid the worst side-effects of tax competition.

IV CONCLUDING REMARKS

By 1990, the fiscal crisis was over, at least for the time being. It had lasted for a decade, but at one stage looked unlikely to be resolved this century. It was accompanied by a much deeper recession than economists had foreseen. Would stronger action early on have been more effective or would it have worsened unemployment too much? I have argued that the disappointing early outcome was to be expected from both the endogenous dynamics of unemployment and debt interest, and from the adverse exogenous shocks early in the decade. Conversely, the late improvement was helped by a reversal of these factors. The fiscal adjustment was not accompanied, as current doctrine says it should be, by a substantial improvement in the incentive structure of government spending and regulation. Important reforms remain on the agenda to which Government policy must now increasingly be addressed.

Most of the improvement in the fiscal balance was achieved through

24. Compare the residential property tax with the 1985 house improvement grants. But there are exceptions: the retention tax on deposit interest has been a real money-spinner, albeit one whose shelf-life is now limited by the apparent decision of other EC countries to abandon any idea of a co-ordinated interest withholding tax.

increases in tax revenues rather than expenditure cuts. Would action on spending more than on tax have been desirable? I now think that this may be so, though more because the scramble for revenue may have generated considerable uncertainty, and raised the option value of remaining liquid (Pindyck, 1991) and of waiting before investing in Ireland.

Was the emphasis on cutting capital spending wrong? Despite the new vogue for theories of growth which emphasise the external economies associated with capital accumulation (Romer, 1986), I do not think so. Establishing mechanisms for cutting current spending takes time: it was necessary to act quickly. We have also been lucky to have the expansion in EC structural funds come forward just when local spending had been pared back.

Luck has played a part in our experience, but bad luck can and has been countered. It was bad luck to have inherited the current budget deficit as the main symbol of fiscal rectitude. It was very difficult to establish credibility by reference to the unattainable target of current fiscal balance. It took time to replace it by a more relevant indicator and a more attainable goal. Meanwhile political demoralisation had set in, so that the steam ran out of the fiscal correction programme. By October 1986, financial markets could see this and were apprehensive given the stated policy intentions of the main opposition party. This was the low point in the fiscal adjustment, the point at which Dornbusch was persuaded that the process had been a failure (Dornbusch, 1989).

The 1987 government resumed the programme that the previous coalition had been unable to carry out. With support from the parliamentary opposition, and benefiting from the reversal of the previous negative factors,[25] it successfully accomplished the correction.

Impact of Fiscal Adjustment on the Rest of the Economy

A number of questions surrounding the private sector response to the fiscal adjustment are the subject of other papers in this volume. They present some of the most interesting and unresolved questions about the Irish economy in the 1980s. Let me conclude by briefly enumerating some of them:

— Did the wage deal in the 1987 *Programme for National Recovery* really effect wage restraint, or can wage behaviour in 1988-90 be explained by the record level of unemployment in 1987. The ESRI's model suggests that the relationship between wages, productivity and unemployment did not change in the period, but it leaves open the possibility that wage rates were affected by the agreement, and that productivity responded.

25. With lower interest rates resulting from the financial markets' sense of relief that they had not persisted with their stated policy intentions.

— How far did the fiscal contraction help inflation? In my view this linkage could be overstated. The weak labour market undoubtedly helped avoid overheating. But exogenous factors were clearly important, and the fall in inflation had been accomplished by 1986, despite a generally weak exchange rate policy in the EMS.

— How much of the unemployment was due to the fiscal contraction, and how much to exogenous factors? Despite the key rôle of UK labour market conditions, the short-run impact of the fiscal contraction in 1983-87 was definitely important. The above discussion of endogenous factors implies that the fiscal contraction added to unemployment at first. The fall in unemployment from mid-1987 was strongly influenced by UK conditions, and by the competitive position which had been secured by the realignment of August 1986.

— What led Irish interest rates to be so high on average 1981-87 and so low thereafter? Here I believe that the OECD equation is not the last word on the matter. It ignores the rôle of sterling rates, of the choice between domestic and foreign borrowing by the government, of exchange rate realignments and of confidence factors. More work is needed here.

— Why was the savings ratio so high in the early 1980s and why did it fall in 1988 and remain low through 1990? How far did the tax amnesty play a rôle, both in terms of affecting savings directly through the decision of former tax evaders to pass funds to the Exchequer, and through a confidence factor?[26] It may be that the boost to revenues from this single source was enough to trigger the main return of confidence discussed by McAleese (1990). The timing — mid-1988 — is right when compared with the movement of sub-annual economic activity series.

26. More generally, what is the link between government and private savings? We know that it does not rigorously follow the Barro-Ricardo model. (This is clear from the work of Moore, 1988 and Whelan, 1991, and above all from the fact that the fiscal contraction of 1982-83 was accompanied by a rise in savings, whereas there was a fall in 1988-89.) But there are regularities, especially seen in the financial flows data (O'Connell, 1987; Honohan, 1987).

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