The Irish Times,
27/01/ 2009

Income tax rates will need to rise.

By Alan Ahearne

ANALYSIS:The crisis is unprecedented: the solution – a speedy, once-off adjustment – is preferable to the brutality of slowly soaring unemployment. But the public sector did not cause the problem: property did, writes ALAN AHEARNE.

THE IRISH economy is in the midst of an unprecedented economic and financial crisis. Consensus projections for growth imply that, with possibly one exception, this country will record the largest cumulative drop in national income in an advanced economy since the second World War.

Real GDP may fall below 80 per cent of its trend level, meaning the slump would meet the technical definition of an economic depression. The unemployment rate looks likely to revisit levels experienced in the 1980s, though hopefully only temporarily.

A sovereign liquidity crisis, in the sense that the Government finds itself unable to borrow from private investors at tolerable interest rates to finance day-to-day spending, is a growing risk.

The main cause of the crisis that we now face was the turn of the housing cycle. The inevitable bursting of our housing bubble triggered a severe contraction in economic activity, a collapse of housing-related tax revenues and an accompanying rapid deterioration in the public finances, and a marked weakening in the stability of the banking system. The international credit crisis compounded these problems by adding to the stress on the banks, by pushing many of our largest trading partners into recession, and by precipitating a sharp rise in the value of the euro against sterling and the dollar.

As a small open economy, economic recovery will depend on exports. Faster export growth will spur increased employment and greater investment spending in export industries. Rising employment will, in turn, provide support to consumer spending and, along with actions by the Government, will help to strengthen the public finances.

Our economy is home to many outstanding businesses with huge potential for growth. Such firms formed the backbone of our extraordinary export-led growth in the 1990s. Tragically, this success was hijacked by property interests around the turn of the century and exports faltered.

©2008 Bruegel– 33, rue de la charité, 1210 Brussels- Tel: +32 2 227 4210, Fax: +32 2 227 4219

Two conditions are necessary for a revival in exports: a rebound in economic activity abroad and a substantial improvement in cost competitiveness at home. Most forecasters expect some recovery in the global economy in 2010, supported by extraordinary fiscal and monetary stimulus. The question is how do we boost our economy's international competitiveness to take advantage of the global upturn.

In answering this question, the key consideration is our membership of Economic and Monetary Union (EMU). For small European countries like Ireland, the experience of the past decade demonstrates that membership of EMU can bring significant benefits.

At no time have these benefits been more evident than over the last 18 months. Notwithstanding domestic banking problems, membership of a large currency union has provided considerable insulation against the turmoil on global financial markets.

These benefits, however, come at a price. EMU is only for the agile. Not having a separate exchange rate as a tool for coping with the shocks affecting our economy means that internal flexibility is required to reverse the loss of competitiveness that the country experienced during the housing bubble.

As shown in the accompanying chart, prices in Ireland (expressed in a common currency) have soared 25 per cent since 2001 relative to those in our trading partners. Some of the faster pace of increase in prices and wages can probably be justified by improvements in productivity, but there can be little doubt that wages – in both the private and public sectors – overshot their sustainable levels during the bubble years.

Put simply, we are living beyond our means.

With low or even negative inflation projected abroad, and little or no prospect of a strong rebound in sterling and the dollar, the necessary adjustment in competitiveness can only be brought about through declines in prices and wages here. The pull-back in average wages and living standards will occur in any event as the housing bubble deflates.

The choice we have to make as a nation is whether the adjustment happens quickly through a co-ordinated, across-the-board cut in nominal wages, or slowly and brutally through downward pressure on wages stemming from soaring unemployment.

A once-off adjustment is clearly preferable because it will promote a recovery that will eventually restore living standards.

One issue is the difficulties that wage reductions may create for households with large mortgages and personal debts. International evidence shows that the main cause of debt defaults is unemployment. Keeping as many people in employment as possible through wage reductions will minimise financial distress. Reducing average public sector pay will go some way towards addressing the situation in the public finances. But an often overlooked point is that even large-scale public sector pay cuts would only have a moderate effect on the fiscal deficit.

A 10 per cent reduction in public sector pay and pensions, for example, would reduce Government spending by €2 billion. But when account is taken of the associated loss of tax revenues (both direct and indirect), the net reduction in the budget deficit would be a little more than €1 billion.

©2008 Bruegel– 33, rue de la charité, 1210 Brussels- Tel: +32 2 227 4210, Fax: +32 2 227 4219

Comparing that figure to the €16.5 billion in spending and tax revenue adjustments that are required to restore fiscal balance by 2013 underscores the enormity of the task facing the Government. Reducing public sector pay is a necessary part of the effort to improve Ireland's cost competitiveness, but fiscal consolidation will require many other adjustments.

I suspect that much of the rhetoric in the media about public sector pay and reform is an attempt by some of the least well-informed commentators to distract attention from the main source of our economic woes. The mess in which the Irish economy finds itself largely stems from the house price bubble, not from problems in the public sector. It is probably not a coincidence that some of the most vocal critics of the public sector today were among the most conspicuous cheerleaders for the housing boom.

That is not to say that major public sector reforms are unnecessary. During the boom, surging tax revenues from the property sector allowed the Government to meet the increased demand for public services without major improvements in productivity.

The meltdown in the public finances means that a more radical programme of reform is needed if spending cuts are not to translate into excruciatingly painful reductions in services. Parts of the public sector are wedded to archaic structures and systems that act as barriers to improvements in efficiency and sap employee morale. A more agile and entrepreneurial public sector is sorely needed. With our backs against the wall, there is surely no better time for an overhaul of the system. As the new White House chief of staff Rahm Emanuel put it, "One should never let a good crisis go to waste".

The international experience provides evidence about how best to approach fiscal consolidation. Studies suggest that consolidation is unlikely to be successful if it relies on reductions in productive capital spending. Cuts in current spending and transfer payments usually result in a faster escape from the fiscal doldrums.

More specifically, I find compelling the arguments put forward by Jens Henriksson, a former official at Sweden's ministry of finance and colleague of mine at the think-tank Bruegel, in a recent essay. The Swedish government engineered an extraordinary fiscal consolidation following that country's banking and property crisis, shrinking the budget deficit from more than 11 per cent of GDP in 1993 to less than 2 per cent in 1997.

How did Sweden do it? For starters, the government provided unambiguous signals that it was committed to do something about the deficit. The prime minister took the lead and put his job on the line. Goals were set and the government stuck with them. A flat 11 per cent was taken from all government spending categories, with only a few exceptions.

This approach seems to me to be preferable to the complete elimination of some programmes while other expenditures remain untouched.

Second, the consolidation programme was designed as a comprehensive package. Presenting the consolidation measures in one package made it clear to all interest groups that they were not the only ones being asked to make sacrifices.

Third, the government communicated honestly with the public while the programme was running. As a result, the public knew that large sacrifices from everybody in society were required.

©2008 Bruegel– 33, rue de la charité, 1210 Brussels- Tel: +32 2 227 4210, Fax: +32 2 227 4219

Along with spending cuts, substantial increases in taxes will be required to restore fiscal balance.

There is a strong argument for broadening the tax base using a residential property tax, as recommended recently by the National Competitiveness Council. Income tax rates should not have been cut during the boom when the economy was overheating, and will now need to rise. The higher tax band will likely have to be increased to a level well beyond the 48 per cent rate favoured by the Irish Congress of Trade Unions if the current budget deficit is to be eliminated by 2013.

Public acceptance of this painful medicine is critical if we are to avoid the social unrest that is occurring in Greece and Iceland. The public will presumably not be willing to put their shoulders to the wheel unless the burden-sharing associated with the fiscal consolidation is perceived as equitable. That means requiring those who benefited most from the property bubble to make the largest contribution.

Extraordinary gestures of sacrifice from our political leaders and other figures of authority who oversaw the bubble and whose misguided policies contributed to the current crisis would be helpful in securing social solidarity. Finally, a line cannot be drawn in the sand in relation to the behaviour of property interests and bankers during the boom. Those who are responsible for the horrible economic morass in which we find ourselves must be held to account.

Alan Ahearne lectures in economics at NUI Galway and is a former senior economist at the Federal Reserve Board in Washington DC

©2008 Bruegel– 33, rue de la charité, 1210 Brussels- Tel: +32 2 227 4210, Fax: +32 2 227 4219