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WHAT IS THE WAY FORWARD?

Brendan M. Walsh

Policy Paper No. 4

April 1983

An earlier version of this paper was read to the Marketing Society, 18 February 1983.

The Policy Paper series of the Centre for Economic Research consists of preliminary reports on policy-oriented research carried out by members or associates of the Department of Political Economy, University College Dublin. All opinions expressed are those of the contributors and do not necessarily reflect the views of other members of the Department. A list of other publications of the Centre is given at the end of this paper.
It is at the moment difficult to find grounds for optimism in the Irish economy. On the other hand, it is all too easy to find reasons for continuing to "croak like a Cassandra", as Keynes described his commentaries on the events of the inter-war years in Britain.

The recent Budget has reinforced the pessimism that was already prevalent. No other budget since the 1950s has taken as much out of the economy through increased taxation and reduced spending. I estimate that the Budget (including the January excise tax increases) will reduce expenditure on GNP by about 4 per cent. While this should bring about a long-overdue reduction in the amount that has to be borrowed to finance government spending, its implications for the level of activity in the Irish economy are deflationary in the extreme.

It is natural to compare this year's Budget with that of 1976. In both, a similar percentage of GNP was removed from the opening current deficit by tax increases and current spending cuts. But this year cuts in capital spending were also announced during the Budget. While axing the 120 million "global contingency provision" from the published Public Capital Programme may represent something of a window-dressing exercise, the remaining cuts of 100 million will be real enough. There will be no growth in the level of capital spending by the government this year, which implies a decline of over 10 per cent in the volume of spending.

In 1976, by contrast, the deflationary effects of the current Budget were partially offset by a planned increase of 27.6 per cent in the level of the Public Capital Programme, which represented an increase of about 7 per cent in real terms.

However much we fear the deflationary implications of this year's budget, criticism of its overall strategy requires very detailed justification, especially when it comes from those who have for some years now criticised the reckless policy of growing net indebtedness by the public sector. Nonetheless, there are two grounds on which the budget may legitimately be criticised even by those who deplored our descent into debt.
The first is that budgets should be judged not against how much spending and revenue they will generate in the actual state of the economy, but rather in terms of what the outcome might be at some more normal level of economic activity. It is obvious that our present tax structures would generate much more revenue for the exchequer if the economy were to recover more rapidly than is assumed in the revenue forecasts underlying the budget. Similarly, a lower level of unemployment would significantly moderate the rise in government transfer payments. It could be argued that on a more optimistic reading of our economic prospects for the year ahead than that on which the pre-budgetary projections of revenue were based the deficit for 1983 may be much smaller than that projected in the budget document. This certainly proved to be the case in 1976, when the post-budget deficit forecast was £327 million, but the outturn was a deficit of £201 million. A radical extension of this line of reasoning might lead us to the conclusion that if by some miracle the economy could be moved to "full employment" (and I hesitate even to try to define what is meant by this concept), the present tax structure would generate so much revenue for the exchequer that the projected current budget deficit would be transformed into a sizeable surplus.

I believe these points have some force, but regrettably it is hard to see that they can be used to justify raising the projected Public Sector Borrowing Requirement. Despite the harshness of the recent budget, it implies an Exchequer Borrowing Requirement of over 13 per cent of GNP, to which must be added a few more points for borrowing by the semi-state sector. It is sobering to compare this with the situation facing the Chancellor of the Exchequer in Britain in framing his budget, namely a projected PSBR of less than 3 per cent of GNP.

The state of the public finances in this country dictates that we impose harsh measures now and use any unforeseen improvement in revenue or reduction in expenditure during the year not to relax the discipline that has been imposed,
but to achieve faster than expected progress towards the restoration of a sustainable level of borrowing.

The second point in attack on the government's budgetary strategy concerns the manner in which it is hoped to reduce the public sector's borrowing. Despite the glare of adverse publicity about public sector spending cuts, the main contribution to reduced borrowing will come from increased taxes. Last February's budget envisages an increase in tax receipts of about 18 per cent in a year when GNP is expected to grow by about 13 per cent in money terms. Thus the share of taxes in national income will rise sharply. As may be seen from Chart 1, this share has risen from about 40 per cent in the early 1970s to over 57 per cent this year.

It is interesting to note that the recession of 1974/75 and harsh budget of 1976 caused a sudden increase in this ratio, but renewed economic growth resulted in a gradual decline in the years 1976/79. The increase in the share of taxes in national income since 1979—i.e. 37 per cent to 57 per cent—is without precedent in our economic history. Although there are still some countries in Europe that are more heavily taxed than we are, there are none in which the share of taxes in income has risen as rapidly as in Ireland in the last four years, and this year's budget accelerated the recent upward trend.

Related to this point is the nature of the budget to achieve a marked reduction in the ratio of public spending to GNP: it is disappointing to see that it contained virtually no attempt to show any of the undesirable features of our tax system that could be adjusted for—i.e. essentially reducing the revenue obtained from taxation. The gloomy implications of the overall budgetary strategy have not been mitigated by any imaginative measures such as a restructuring of the system of direct taxation. This is surprising, in view of the priority assigned to this task by the previous Coalition government, and the detailed research into this topic undertaken by the Commission on Taxation.
The urgency of this restructuring has increased with the rise in the burden of direct taxation implied by the budget. As we have seen, the overall burden of taxation will increase sharply this year. Much of this increase will be due to a continuation of the upward trend in direct taxation, as is clear from Chart 2. The new maximum income tax rate of 65 per cent, when added to the 7.5 per cent PRSI levy, and the special
per cent levy, implies that taxpayers can reach a marginal tax rate of 73.5 per cent in additional income in excess of a relatively modest threshold. The extreme case is that of a single PAYE taxpayer, who could be liable to this penal rate of marginal tax with a gross income of £12,376 which corresponds to a take-home income of less than £50 a week. The new tax structure intensifies the problem that has existed for some time now, of excessively high marginal tax rates reached at low income thresholds.

These high marginal tax rates do not, however, correspond to exceptionally high average tax rates. Our single PAYE worker in the illustration above would be paying an average tax rate of less than 40 per cent. We must now face up to the task of raising this much money from taxpayers without pushing them into the sort of marginal tax rates that serve primarily to encourage the growth of the unrecorded economy.

It is easy to pinpoint the problems of excessive taxation relative to national income, but very difficult to suggest practical measures to improve the situation. By definition there are two ways in which the share of taxes in income can be reduced: either taxes can be reduced or income increased. Any call for a reduction in taxation should be linked to specific suggestions for reducing public spending if it is not to be tantamount to a plea for increased borrowing.

Professor Laffer succeeded in selling the Reagan administration during its first year in office the appealing message that a generous tax cut would so stimulate the level of economic activity that tax revenues would actually increase and the government deficit fall at the same time. This rosy vision has long since been supplanted by a more sober view as the administration tries to grapple with a federal deficit that risks growing to Irish proportions! While the much higher level of taxation in Ireland might tempt
s into believing that the Laffer doctrine has greater relevance here than in its own country of origin, at the end of the day the conclusion seems inescapable that only through a rigorous policy of curbing public spending can we hope to reverse the alarming upward trend in taxation relative to national income [1].

The need to curtail spending is, of course, widely acknowledged in principle. Indeed it has become something of a test of a commentator’s mettle to see how vigorously he/she denounces government spending and how colourful are the examples of waste that are adduced to support this case. But the time is now for decision and action, rather than talk. The Minister for Finance acknowledged the need for further cuts in spending in his budget speech, and mentioned the need to examine the public capital programme with a view to eliminating programmes that yield very little if anything by way of a financial or social return to the community. The credibility of the government’s commitment to this course of action was, however, enhanced by its announcement during budget week of its agreement to purchase another bankrupt industrial enterprise [2].

As I said earlier, it is natural to compare our present predicament with the situation that occurred in 1976. Then, as now, the economy was in recession and a harsh budget had been introduced. Then as now there were signs of recovery in the international economy. In 1976 we participated fully in the international recovery, tax revenue rose, and the deficit fell, much more rapidly than projected, the balance of payments deficit disappeared, and the stage was set for a period of significant economic growth. Can we hope for a repeat of this experience in 1983/4?

[1] Mr Dukes might however have pondered Adam Smith’s views on the effects of high taxation: “High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to the government than what might be drawn from more moderate taxes.” The Wealth of Nations, Book V, Chapter II, Part II, Art. IV.
To evaluate this question we should recall the important role that is assigned by all commentators to competitiveness as an engine of growth in our economy. For years the Central Bank and the Department of Finance have enthroned unit labour costs in Ireland relative to our trading partners as a major determinant of our economic performance. This emphasis was heightened by the previous Coalition government when they set up the Committee on Costs and Competitiveness, and the last Fianna Fail government maintained continuity with this approach by assigning competitiveness a central role in the strategy for economic recovery outlined in The Way Forward. In fact an improvement in competitiveness was the only mechanism identified in the "national economic plan" by which Ireland's ability to participate in the world economic recovery could be enhanced.

I believe that competitiveness fully merits the prominence it has been given in most recent commentaries on the Irish economy. Its importance can be illustrated by looking once again at our experience during 1976. In that year there was a rapid fall in the external value of sterling, which resulted in a 10 per cent decline in the effective exchange rate of the Irish pound. This depreciation of our currency was not immediately offset by higher domestic costs, and consequently in both 1976 and 1977 we experienced an important gain in international competitiveness. I think the contribution of this factor to the economic recovery that we experienced in these years is often overlooked.

There are important differences between our present situation and the one we faced in 1976, due in no small measure to the consequences of our decision to join the EMS in 1979. Replacing the sterling link with a commitment to an EMS currency peg was a radical change in policy that had far-reaching implications for our ability to maintain, let alone improve, competitiveness. I believe there is now an inconsistency between official exhortations on pay moderation as a means of maintaining or improving competitiveness and our rigid adherence to the exchange rate at which we joined the EMS. Commentators tend to equate an improvement in competitiveness with moderation in the rate of increase in domestic labour costs expressed in Irish pounds, ignoring the fact
that an upswing in our exchange rate can cancel the gains that might have followed from a moderation in the rate of increase in domestic labour costs. While there was some excuse for the Committee on Costs and Competitiveness not placing sufficient emphasis on the difficulties of defining appropriate wage norms in the face of fluctuating exchange rates, neglect of this issue is less excusable in the case of The Way Forward, which after all should have built on the lessons that could have been drawn from the earlier discussion of competitiveness.

The importance of the exchange rate as a factor in our trading competitiveness over recent years can be illustrated by considering the behaviour of prices in Ireland and West Germany in recent years. Chart 3 illustrates the behaviour of (a) Irish inflation relative to German inflation and (b) the DM/Irish pound exchange rate since 1978. The much higher rate of inflation in Ireland than in Germany shows as a decline in the price curve: German goods becoming cheaper in terms of German marks compared with Irish goods in Irish pounds. This would not be too significant if Irish pounds were becoming correspondingly cheaper in terms of DM, that is, if our exchange rate were falling by about as much as our inflation outpaced German inflation. But as may be seen from the exchange rate line, this has not occurred. We have remained passively at our original central rate within the EMS, and the only change relative to the DM that has occurred has been due to the revaluations of the DM. The result has been a progressive real appreciation of the Irish pound, measured in this Chart by the growing gap between the exchange rate curve and the inflation ratio curve.

While the use of consumer prices in this comparison undoubtedly overstates the competitive deterioration that has occurred, it highlights the contrast between Ireland and Germany since the formation of EMS, and the role of the exchange rate in this development.

Although our experience relative to Germany is representative of what has happened in other "narrow-band" EMS currencies, we should not exaggerate the importance of these countries to us. Trade with the members of the System remains relatively unimportant
to this country, and we continue to be dominated by developments in the United Kingdom. On this front, recent trends have been far from encouraging. The extraordinary spectacle of a weak pound sterling and plummeting British inflation dominates the prospects for Irish competitiveness in the immediate future. Chart 4 shows what has happened since we broke the link with sterling. From late 1979 to mid-1981 we experienced a massive competitive gain relative to sterling: the exchange rate fell, which British inflation remained high. Late in 1981, things began to change dramatically: our exchange rate strengthened against sterling and British inflation began to fall. These trends accelerated towards the end of last year, and by the start of this year the entire competitive gain that opened up in 1980 had disappeared.

To achieve the competitive gain hoped for in The Way Forward in the face of the rise in our exchange rate would require not just wage moderation, but actual cuts in money wages. This unpalatable fact may not have been clear at the time when The Way Forward was being drafted, as the fall in sterling occurred after the research behind this document was completed. It is, however, disturbing to see the Economic Background to the Budget retaining the assumption that unit labour costs in our competitors will rise by as much as 8 per cent during 1983. In fact the rate of increase will be much less in the markets that really matter to us, and it will be still lower when measured in a common currency, unless sterling rises relative to the EMS currencies during the year.

The original version of this paper was written in mid-February, before the March realignment at EMS currencies. What happened on that occasion was seen by many as a new departure in Irish exchange rate policy, and in a way it was such an historic event. For the first time ever we consciously devalued our currency. In fact, the effects at the downward adjustment at our ECU central rate were not very dramatic for two reasons: (i) day-to-day movements around ECU central rates immediately after the realignment offset some of the effects of the devaluation and (ii) sterling continued to weaken against the EMS currencies, during early April. The second factor
proved short-lived and the more recent rise of sterling has resulted in a substantial depreciation of the Irish pound: by mid-April on a trade-weighted basis, our currency had fallen about 7 per cent below the peak reached earlier in 1983. The gain in competitiveness that this decline in our exchange rate could harbinge owes more to the renewed strength of sterling than to the decision to devalue in EMS.

This recent experience highlights once more the peculiar effects of maintaining an exchange rate peg to the EMS currencies, whose weight in our trade is relatively minor. There is no prospect of the United Kingdom participating in the exchange rate mechanisms of the EMS, so the prospect continues to be that the value of our currency will fluctuate widely relative to that of our main trading partner. The long-run prospects for the EMS have been called into question by the difficulty with which French and German interests were reconciled this time round.

Renewed growth of output calls for a favourable ratio of domestic costs to export prices. We cannot afford to relent on the headway that is being made in curbing the rate of increase in domestic costs, but we have also to pursue exchange rate policies that reinforce any progress made on the domestic front. Recent experience shows that even a more "active" policy at EMS realignments does not ensure this objective will be achieved. There is no obvious alternative policy to put in place of the approach that has been pursued, but we need to consider options such as a return to a modified sterling link in the event of a collapse of the EMS. It would be foolhardy to assume that the policies of the last four years will prove appropriate on the road that lies ahead.
CHART 2  SHARE OF DIRECT TAXES IN NATIONAL INCOME
CHART 3: DEUTSCHE MARK/IRISH POUND EXCHANGE RATE AND INFLATION RATES

EXCHANGE RATE

RATIO OF INFLATION RATES

YEAR

CHART 4: STERLING/IRISH POUND EXCHANGE RATE AND INFLATION RATES

- **INDEX**
  - 90.00
  - 80.00
  - 70.00
  - 60.00
  - 50.00
  - 40.00

- **YEAR**
  - 1978
  - 1980

- **EXCHANGE RATE**

- **RATIO OF INFLATION RATES**

- **YEAR**
  - 198