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Macroeconomic and Fiscal Deviations

from Plan 1985-87

Patrick Honohan

Policy Paper No. 24

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MACROECONOMIC AND FISCAL DEVIATIONS FROM PLAN 1985–87

by

Patrick Honohan

Following the change of Government, it is now a good time to review the degree to which economic and fiscal developments over the past 2½ years deviated from the outgoing Government's national plan Building on Reality. The object of this paper is quite modest. Rather than exploring the whole question of policy formulation and its success, the paper merely presents a factual statement of the deviations, with some suggestions for the future.

In section I we look at how the economy generally evolved in the thirty months after the publication of the plan in early October 1984, by comparison with expectations. This is a natural stopping point, as the plan was only for three years, and the Government responsible went out of office in mid-March 1987. Armed with this background, section II examines the scale and pattern of deviations in the budgetary aggregates, 1984 to 1987, using the January 1987 budgetary proposals of the outgoing Government as the reference for 1987. Concluding remarks are presented in Section III.
I Macroeconomic deviations

The level of forecast detail available in *Building on Reality* is quite considerable. While there is no full table of National Accounts forecasts for each year in the document, the various tables and charts presented all of the essential features.

The main macroeconomic deviations from the plan are set out in Table 1, which may be compared with Table 1.6 of *Building on Reality*. The latest CSO estimates of the main aggregates are, at the time of writing, for 1985, with a full set of National Accounts available only for 1984. The latest Labour Force Survey figures relate to April 1985. For the later years we use on three main sources, all based on information available about January 1987. First there is some information contained in the *Economic Background to the Budget* and the *Budget Proposals* of January 1987. Secondly, there are the forecasts of the Central Bank, published in their Winter 1984 bulletin, and the December 1986 (Published in February 1987) *Quarterly Economic Commentary* of the ESRI. These forecasts do not differ very widely either in their assumptions about fiscal policy or the international environment. For some of the breakdown of employment and unemployment, and of sectoral growth, I have provided my own estimates as of February 1987, as shown. Of course all of the estimates, even those for 1984 and 1985 are subject to revision, which is sometimes quite substantial. Already by May 1987 they are out of date in some respects. But there seems no better benchmark for the purpose of this paper.

Furthermore, as will be seen, the deviations from plan now appear so large as to be unlikely to be eliminated by subsequent revision of estimates. To avoid undue circumlocutions the discussion is generally presented as if all of these estimates and forecasts were certain.
Despite the more expansionary than planned fiscal stance, cumulative GNP growth in the three years 1985-87 totalled only about 1% per cent or 6 per cent less than hoped for. The shortfall in GDP growth was smaller, but net external factor payments were larger than expected. The shortfall was apparent in all three years.

In contrast to the development of real growth, consumer price inflation was better than expected, with prices rising just over 13 per cent over the three years compared to 21 per cent envisaged in Building on Reality.

The combination of low growth and low inflation left nominal 1987 GNP over £1 billion or six per cent short. (The shortfall would have been greater but for the fact that the GNP deflator did not slow as much as did consumer prices). Helped particularly by weak import demand, the current account deficit in the balance of payments in 1986 and 1987 was well below expectations.

Unemployment clearly overshot the expected figure by a wide margin. In order to examine the pattern here more closely we present, in Table 2, plan and "actual" figures for the breakdown of employment and unemployment (cf. Table 1.1 in Building on Reality). (A difficulty in comparing forecast to actual here is the artificial categories of persons employed attributed to certain government schemes. The main schemes involved are the Enterprise Allowance Scheme and the Social Employment Scheme. While both of these undoubtedly provide employment and not just training, there is some difficulty in assigning the jobs to the appropriate economic sector. This was not done in Building on Reality, and since then statistics on employment have not included a separate category attributable to the schemes. It is thought that most, but not all of the employment is in the service area.)
The most striking deviation in this table is the figure for total at work. *Building on Reality* projected 1.16 million at work, whereas the actual is only 1.04 million, a shortfall of 117,000, or fully ten per cent. Instead of growing, the numbers at work fell by over 60,000.

Were it not for the fact that the labour force (including the unemployed) actually declined by some 27,000, instead of growing by 45,000, the unemployment figure, already 29,000 or 14 per cent above target, would have been even worse.

The decline in the labour force is partly explained by higher than anticipated emigration: the plan used an assumption that net emigration would amount to about 17,500 in three years, while the outturn may be as high as 80,000. Emigration and unemployment are not independent variables: the deterioration in job availability was presumably an important factor in inducing emigration.

The poor employment performance was not concentrated in any one sector. *Agricultural* employment, starting from a lower base in 1984 than was realised, fell by 26,000 instead of the 9,000 planned for. Even *service* employment, which had continued to grow throughout the 1980-84 recession, peaked in 1984 and slipped by about one per cent in the following three years: *Building on Reality* had envisaged 17,000 new service jobs not counting the service sector's share of the 22,000 jobs on the "schemes". (A puzzling feature of the 1985 Labour Force Survey figures was the sharp drop recorded in public sector service employment: this figure must be regarded as somewhat suspect). *Building* employment showed the largest percentage drop – 20 per cent – even though it was expected to remain roughly stable. *Manufacturing* failed to deliver the bounceback in jobs that was hoped for in 1984: employment in this sector continued its slide from the 1980 peak and slipped below 200,000 in 1987, some 14 per cent below the planned figure.
These discrepancies are very large. Although the employment projections had been pitched at the optimistic end of a range, the outturn was well below the pessimists' view. Admittedly, some independent experts did not accept the bounce-back thesis and forecast that, even with rapid output growth in manufacturing employment would stagnate there because of projected rapid productivity growth. But to balance this, the modest growth planned for in private services was regarded by many in 1984 as being too pessimistic. Furthermore it is of interest to compare the Building on Reality forecasts with those contained in two other official documents, one more optimistic, the other less so. The previous plan The Way Forward was published by the Fianna Fail Government at the end of 1982 to cover the period 1982 to 1987. Although it envisaged a much tougher fiscal stance than Building on Reality, The Way Forward projected total employment at around 1.24 million by 1987. The National Planning Board's medium term forecast, published in April 1984 was more pessimistic with total employment forecast at 1.11 million. Even this overestimated the outturn by some seven per cent. Why was the employment shortfall so broadly based and so large?

It is too early to attempt an exhaustive analysis of the macroeconomic divergences between the plan and the outturn, but it is useful to highlight a few of the major discrepancies. In some cases the causes are fairly obvious even at this stage, but in many others the explanation must await more detailed analysis when full data become available.

Table 3 shows actual and planned cumulative growth in agriculture, industry and services. It can be seen that output growth fell far short of target in agriculture and industry, but was roughly on target for services. Employment broadly reflected the shortfall of output in agriculture and industry, but declined in services despite the output forecast being reached.
The poor performance of agriculture can largely be explained by the very poor weather in 1985 and 1986, which restricted gross output and necessitated increased food imports. The external environment, operating through the CAP, was also more difficult than had been allowed for in the plan, with quotas tighter and some prices lower than had been expected.

The causes of the major shortfall in industrial output are complex, and only tentative conclusions can be offered at this stage. Although it is not clear exactly with what to compare the Plan's assumed growth rate of 4½ per cent per annum in world trade and in Ireland's export markets, the volume growth of imports of OECD countries in the three years in question was (OECD December 1986) 5¼ per cent, 7½ per cent and 5½ per cent respectively. While other measures could be provided which show a lower trend, it does not appear that weaker than expected aggregate world trade can be a major explanation of the shortfall in industrial output. International trading difficulties in specific products could have held back the growth of the modern industries, where the plan had extrapolated a continuation of the rapid growth of 1983 and 1984. More generally, industrial exports and output could have been affected by a loss of competitiveness resulting from currency movements in 1985 and 1986. The devaluation of August 1986 only partially reversed the earlier trend, so that by 1987 competitiveness had been restored to at least the 1984 level in regard to the continental currencies and the yen, but not with regard to sterling or the US dollar, and not against the average of our trading partners.

Generally speaking, the implied forecasts of average productivity in the plan proved fairly accurate with regard to manufacturing industry, so that the shortfall in employment was similar to that of output. However given the weakness of the modern sector, one might have hoped for a higher ratio of jobs to output.

- 6 -
In the building industry, higher than expected productivity exacerbated the major shortfall of perhaps 15 per cent in output. The immediate cause of this output shortfall would appear to have been the weakness of private investment. How far this, in turn, was due to high real interest rates, how far to a general lack of confidence, how far to uncertainty about the direction of future taxation policy and how far it reflected the impact of the changed demographic situation on the housing market cannot yet be established.

Service output appears to have increased roughly in line with plan, although with public services taking a higher share of the total. The unexpected feature here is that employment fell as output rose. It is hard to explain this development, the opposite to what the plan, relying on special employment schemes, had expected, particularly in a sector where measured productivity growth in the past had been minimal.

Overall, a 1½ per cent growth in GNP accompanied a fall of 5½ per cent in numbers at work in three years. This was a historically rapid decline in the employment to output ratio, the reasons for which require further study.

By 1987, the expenditure structure of the economy was substantially different to plan: Table 4 gives the figures. Though private consumption represented a lower share of GNP this was more than compensated for by the much higher share of public consumption. The share of investment was down, relative to plan. This cannot be attributed directly to lower spending in the public capital programme inasmuch as the PCP's share in GNP in 1986 was only 1¾ lower than planned (and the January 1987 proposals would actually have left it somewhat above the planned share). Finally lower world prices together with the external weakness of data processing and chemicals resulted in the foreign sector being much smaller in gross terms, though exports of goods and services fell less than imports. In my
view the lower than planned exports figure is less serious than it looks: the forecasts assumed a very rapid growth in activity in the pharmaceuticals and computer sectors where exports and imports are extremely high compared with domestic value added. When this did not materialise, the loss of value added was accordingly modest.

Looking behind the gross shortfall in employment and output, therefore, the most striking macroeconomic deviations were: lower investment reflected in low building output and employment, poor agricultural performance, a lower than planned employment/output ratio in services and building, and much lower labour force participation, not all of which reflects higher emigration.

Some, but not all, of the macroeconomic deviations can be attributed to bad weather and other identified external influences. For the remainder, a difficult issue is whether they reflected a failure of analysis or a failure of policy: was it unrealistic for economists to expect a better outcome, or could the Government have done something about it? Either way there are lessons to be learnt. The figures presented here pose questions to which the answers are not yet clear.
II Fiscal Discrepancies

Building on Reality established six targets in the fiscal area. These were set out in paragraph 7.9:

- a reduction or at least a stabilisation of Exchequer foreign debt and foreign debt servicing, both as a proportion of GNP;
- a halt to the growth of the overall National Debt/GNP ratio;
- a reduction in the balance of payments deficit to a manageable 3 per cent of GNP;
- a reduction of the Exchequer borrowing requirement to less than 10 per cent, a level last attained in 1977;
- a reduction of the total public sector borrowing requirement from 17 per cent to just over 11 per cent of GNP;
- a reduction of the current budget deficit to 5 per cent of GNP.

In interpreting the outcome in this area one must distinguish between the stock objectives (i.e. those relating to debt), and the flow objectives (i.e. those relating to deficits and borrowing requirements). Basically the flow objectives are the operational targets; they are derived in such a way as to allow an expectation that, unexpected shocks aside, the debt/GNP ratio may be stabilised. Thus, (as explained in my 1985 paper in the Irish Banking Review) the purpose of using stock objectives is to make operational the concept of sustainability; working from the requirement of at least stabilising the expected value of the debt/GNP ratio in the medium term, and an assumption regarding GNP growth, interest rates and exchange rates one draws conclusions about the maximum rate of borrowing which is tolerable. But the debt/GNP ratio is not so useful as an ex post measure of performance. The main reason is that exchange rate fluctuations can cause large variations in the Irish pound value of foreign debt. A windfall gain to the Exchequer caused, for example, by a fall in the value of the main currency of debt, i.e. the US dollar, can seriously mislead as to the sustainability of an improvement. Not only can the fluctuation be reversed, but even if it is not, the value of debt will resume its upward
trend if borrowing is not brought under control. Thus the virtual stabilisation of the foreign debt/GNP ratio in 1985 - it grew from 0.549 only to 0.553 - was followed by a rapid increase in that ratio during 1986 to 0.590. There are other, technical, reasons relating to the timing of borrowings and the valuation conventions for low-coupon stocks which can make year-to-year changes in measured debt/GNP ratios misleading. Not too much weight should therefore be attached to the jump during 1986 in this ratio from 1.34 to 1.47 (instead of the planned 1.32).

Nevertheless it is clear that the fiscal objectives were being missed by a fairly wide margin by the time the Government left office in early 1987. For the purpose of this exercise it seems appropriate to take the January 1987 budget proposals of the outgoing Government to represent the 1987 "outturn" or "actual". The incoming Government's somewhat different measures should not be brought into consideration, as they were not explicitly guided by Building on Reality. Looking then at Tables 1 and 5, we see that only one of the fiscal objectives was satisfied, namely the current account of the balance of payments, at about two per cent of GNP in 1986 and 87. This target is less a fiscal than a financial one: lower private spending contributed to its achievement.

The widest measure of borrowing, the PSBR, did decline, but not as quickly as planned (Table 5). The 1984 outturn of 16% per cent of GNP was followed by about 16 per cent and just over 15 per cent in the following two years, with about 13% per cent budgeted for 1987. However the planned percentage for 1987 was only 11% per cent. The narrower deficit figures, the EBR and the CBD exceeded their planned percentages by about the same margin - 2 to 2% per cent of GNP.

**Excesses in the Exchequer paybill**
It is instructive to look at the cash figures (Table 6), as well as the GNP shares, to see how these discrepancies evolved.
The cash figures for the major budgetary aggregates in the 1985 budget were almost exactly in line with the plan, as was the outturn for total current spending and Exchequer borrowing. But these aggregates concealed a very significant shift in the share of current spending was absorbed by public sector pay. Moreover as mentioned above, GNP values were lower than projected, and the same cash amount for the EBR translated into an overrun of 0.4 percentage points when expressed as a percentage of GNP. In particular, public sector pay came out at 16.2 per cent of GNP instead of the planned 15.3. It was payment of the arbitrator's award, announced on budget day 1985, which caused this excess. Public sector pay in 1985 reached £2.48 billion, or £79 million above the cash limit set out explicitly in paragraph 7.21 of the plan. This excess absorbed savings in non-pay current expenditure and in borrowing for capital purposes, which could otherwise have been used to limit the EBR to the planned share of GNP.

The decision to pay the arbitrator's award in early 1985 had even heavier consequences for the 1986 budgetary arithmetic. Largely because of that decision, pay in 1986 was budgeted to exceed the plan's cash limit by the much larger figure of £127 million. In the event, special awards to teachers and other groups further exacerbated the outcome in 1986, so that pay exceeded the plan limit by £145 million. The 1985 savings (relative to plan) in non-pay current expenditure could not be repeated, and though borrowing for capital purposes was again restrained below the plan level, it was not far enough below to offset the excess on pay. Accordingly the budgeted EBR for 1986 was already more than £100 million above the plan - and that translated into a much larger deviation in the percentage of GNP.

The plan had envisaged a reasonably generous pay award in 1987, after two years of restraint. Instead, by January 1987, the softer-than-planned line on pay adopted by the Government left the paybill £140 million above the plan cash limit with nothing
left in the kitty for an election year pay award. The 
paybill's share of GNP rose again to a record 16.4 per cent in 
the 1987 proposals instead of falling as planned to 14.6 per 
cent. In an accounting sense, therefore, the excess on pay 
accounts for almost all of the overrun on the EBR.

*Non-pay spending brought back on target*

The biggest excess in non-pay spending referred to Social 
Welfare, despite the savings of £34 million from structural 
changes in the schemes proposed in January 1987. Of course the 
higher than expected unemployment contributed to this - perhaps 
by something of the order of £80 million. But it is not 
possible to disentangle fully the causes of variations in net 
Social Welfare expenditure. In such a large spending block 
there were inevitably some estimating errors; the real value of 
basic payments slipped over planned levels; unplanned Christmas 
bonuses were paid in both 1985 and 1986. Some of these factors 
must be regarded as unexpected and outside the control of 
Government. (In looking at the published plan figures for Social 
Welfare, account must be taken of the fact that these figures 
include a portion of the funding of the Social Employment 
Scheme which was later accounted for under Labour.)

Although the 1986 budget still envisaged non-pay current 
spending at or below the planned share of GNP, slippage from a 
variety of sources (some of which were indirectly pay-related 
as bodies financed by block grants granted pay increases to 
their staff) also left non-pay spending £82 million over budget 
by the end of the year. The prospect of this slippage 
continuing explains why it was necessary to introduce a wide 
range of specific cuts for 1987 to bring non-pay current 
(supply service) spending back almost to its planned share of 
GNP.

It is interesting to observe that the cash figure for supply 
services in 1987 is lower than the plan. This suggests that 
the faster than expected slowdown in inflation was damaging for
the public finances. Of course lower inflation made it easier for Departments to stay within a given cash budget; but one cannot help feeling that it would have been possible to stay close to these figures even if inflation had been higher.

Though one must be careful not to exaggerate this point, the announcement of cash allocations, as opposed to percentage shares or constant price allocations, for each Department in each year was to prove counterproductive in achieving spending restraint in the face of falling inflation.

As already mentioned, the emerging pressure on plan borrowing targets resulted in restraint on capital spending which took a smaller share of GNP than planned (if we ignore the unplanned provision for Aer Lingus aircraft in 1987) and by 1987 was contributing much less to Exchequer borrowing than planned. This was partly due to weak investment demand from industry, and the easing of pressure on local authority housing. A €50 million contingency fund included in the plan for 1987 capital spending was not used. But the reduction in spending was not all spontaneous. There was a squeeze on, for instance, sanitary services and educational investment and even the roads programme, though greatly expanded, did not quite build up to the planned extent, despite the great importance which the Government attached to it.

**Other sources of deviation**

Other unexpected developments outside government control also buffeted the fiscal arithmetic. Non-tax revenue proved volatile, exceeding its planned figure by % per cent of GNP in 1985, and falling short by a comparable percentage in each of the following years. This item comprises mainly certain interest receipts, transfers from the EEC, and the surplus income of the Central Bank and Bord Gáis Éireann. Some of these items are hard to forecast: a substantial part of the 1986 and 1987 shortfall is attributable to the failure of the Dublin Gas Company and its inability to pay EGB. Interest payments, as a share of GNP, were about on target in 1985, and
fell below plan in 1986. Higher domestic interest rates, together with the higher 1986 borrowing, put the 1987 budgetted interest bill well above the planned percentage.

There were many deviations in budgetary components from what was embodied in the plan. Unexpected factors effectively outside of the Government's control certainly played a part, particularly on unemployment, interest costs and non-tax revenue. But in my view it is not a misleading simplification to single out the major concessions on pay as the key source of fiscal deviations in the plan. By 1987 not only were real pay rates and the share of pay in GNP well above target, but the cash limits had been breached by a wide margin. Pay was the largest single deviation from the planned spending pattern and the excesses on pay were not nearly offset by permanent savings elsewhere.

Alternative views are possible. Some may say that the cash shortfall in taxation was even larger than the overrun on pay. Arithmetically this is true, but it neglects the fact that average tax rates were actually higher to achieve even this low revenue figure, and that the share of tax in GNP was somewhat higher than planned. The shortfall of tax revenue was a consequence of the much lower growth of nominal GNP, and it is hard to see how it could be directly attributed to a policy deviation from plan.

Some take a different view, saying that there were no policy instruments at the Government's disposal to achieve the planned restrictions in the paybill (or that any such policy instruments would have caused unacceptably destructive industrial action. Others point to instruments not employed, such as termination of the public service arbitration procedures, or tripartite national discussions in search of consensus in the corporatist tradition.
III Concluding Remarks

Need for planning

The risk that plans will not achieve their targets poses a severe problem for the credibility of government. If the government does not plan its budgetary and structural economic policy formulation over a period of years, then the only measures adopted will be those that show good results within twelve months or so. Not only will good measures with a longer-term payoff be passed-over, but the sting in the tail of many superficially attractive but fundamentally flawed short-term measures will be neglected until it is too late.

Private sector planning, and planning within the semi-autonomous parts of the public sector cannot be successful without some indications of the government's medium term intentions. These considerations dictate that good policy will be publicly announced and embodied in a credible medium-term framework or plan. But if nobody believes that what is announced in the plan bears any relation to what will actually happen, then it might as well not be announced.

That is why it is important to understand why deviations from planning objectives occur. Did the Government do what it said it would? Did those actions have the intended impact? Did the forecasts embody the most realistic assumptions about the outside world or about the response of the domestic economy to the external environment that were available?

Even if all of these had happened the outcome would have deviated from target to the extent that shocks to the economic system caused deviations from what had seemed the most likely course.

Our analysis has revealed both unexpected shocks (low world inflation, weather), and policy deviations from plan (most
conspicuously on public sector pay) during the period of
Building on Reality. Several unresolved problems await a
definitive answer: in particular, why was private investment
so low?; why was the employment/output ratio so much below
target?

Planning for revisions.

Unexpected shocks prevent the simultaneous achievement of all
of a plan's objectives. Government must respond by choosing
which objectives are to be pursued most assiduously in spite of
the shock. Some objectives will become more easy to achieve,
some more difficult; the appropriate government response will
depend on their relative importance.

A plan for the Government finances such as is contained in
Building on Reality requires the establishment of a target
ceiling for borrowing determined with a view to solvency and
other long term objectives, but also constrained in its
severity by the need to avoid damaging the economy in the short
run through an excessive fiscal squeeze. Thus the figures for
Exchequer borrowing in the plan should be regarded as targets,
or intermediate objectives; the figures for output, employment,
inflation and other macroeconomic variables have more the
status of forecasts. Of course a macroeconomic outturn
deviating from the forecast may call for a feedback response in
Government policy even during the course of a plan. However, a
shortfall in employment, for example, may well suggest the need
for a change in taxation policy or the structure of Government
spending rather than in the overall borrowing target,
especially when that is pitched as high as it was in Building
on Reality.

However this kind of prescription for policy response to shocks
has not been worked out explicitly in advance for Government
planning in Ireland. This is an omission which should be rectified in the next plan.

* * *

Medium term policy involves more than getting the public finances right, and the focus of this paper should not obscure the important structural aspects of planning. The need for a stable, long term tax strategy has already been mentioned. There are many other aims, such as the progressive elimination of restrictive practices and improvements in the efficiency of industrial relations and incentive contracts which can only be addressed in a medium term context. That is another reason why discrepancies between target and outcome in the Building on Reality period should not discourage us from future plans.
Table 1: Main Macroeconomic Indicators 1985 to 1987. Planned and "Actual"

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Notes:
2. 1984: Plan 14.6, Actual 14.4; Source for 1985 and 87 figures; implicit in the January 1987 budgetary proposals.
4. Figures refer to April. 1987 is authors estimate as of March 1987 (date of change of Government).
Table 2: Employment and Unemployment 1984 to 1987, Planned and "Actual" (mid-April)

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Note: Sources: Labour Force Survey, ESRI Quarterly Economic Commentary December 1986 and, where needed, author's estimates.
Table 3: Cumulative Growth by Sector, 1984-87, Planned versus "Actual"

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<th>Sector</th>
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Source: Author's estimates

Table 4: Expenditure Shares in GNP 1987, Planned versus "Actual"

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<td>Net Factor Income</td>
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Source: Central Bank Quarterly Bulletin Winter 1986
Table 5  Budgetary Aggregates 1984-87: Plan, Budget and "Actual" (%GNP)

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University College Dublin

Working Papers


*Asterisked items are no longer available, either because they have been published or are out of stock.


47. J. Peter Neary: 'Tariffs, Quotas and VER's When Capital is Internationally Mobile,' March 1987.


Policy Papers


