

**A Genuine Economic Recovery-**  
**The Case for Fiscal Stimulus**

Paper presented to FEPS/TASC Seminar on 'Stimulating Recovery'

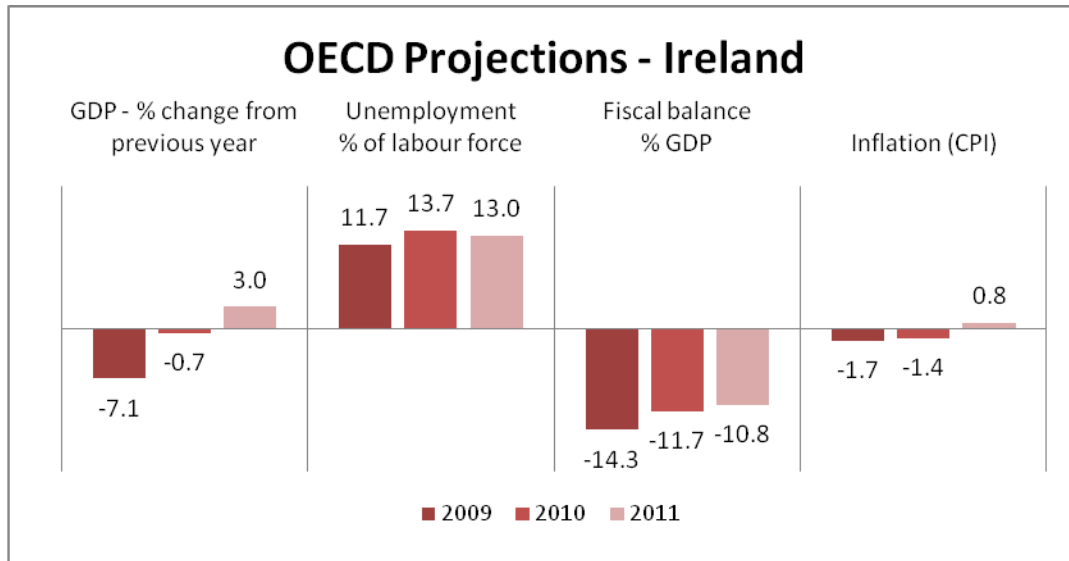
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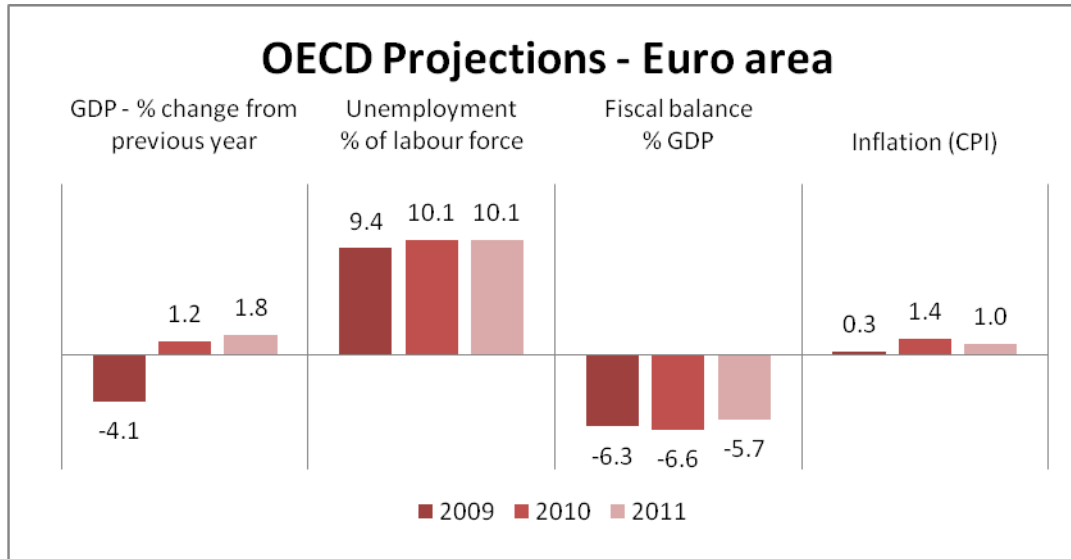
## Behind the Recovery Story

The central bank has recently added its voice to the more optimistic projections on the economy for the second half of this year. Below are the recent OECD projections for Ireland. On the face of it all 2011 indicators are pointing in a positive direction, GDP up, unemployment down and the fiscal deficit narrowing. [http://www.oecd.org/document/9/0,3343,en\\_2649\\_34573\\_45269961\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/9/0,3343,en_2649_34573_45269961_1_1_1_1,00.html)

Chart 1.



In assessing the relative strength of the economy and the role of policy it is important to note that the recovery in the Euro Area as a whole began in mid-2009, a full year before Governor Honohan's current forecast, and the recession also began here a year earlier. Therefore this recession will have lasted precisely 2 years longer than for the Euro Area as a whole, even if current forecasts prove correct. Below are the OECD's comparable forecasts for the Euro Area in Chart 2.



2009 is the decisive year regarding policy divergence, with the overwhelming majority of the Euro Area economies then adopting fiscal stimulus while the FF-led government adopted fiscal contraction. The cumulative effects of that policy divergence are shown in the table below.

**Table 1. Ireland Versus Euro Area, End 2008-2011, Based on OECD Projections**

	Ireland	Euro Area
Cumulative change in real GDP, %	-5.0	-1.2
Cumulative change in nominal GDP, %	-10.1	+1.1
Rise to peak in unemployment, %	+7.7	+2.6
Cumulative addition to fiscal deficits, % GDP	+36.8	+18.6
Cumulative change in price level (GDP deflator), %	-5.4	+2.3

Source: Calculated from OECD projections

There is too an important difference in the components of growth. While domestic demand rises in the Euro Area, in the OECD’s projection for Irish domestic demand is a further contraction over the next 2 years, so that GDP growth is entirely dependent on net exports. Based on these OECD forecasts, it is possible to calculate that nominal GNP will contract by a further 5.5% in 2010 and rise by just 0.8% in 2011- to leave it 22.5% below its peak in 2007. This is an Irish Depression.

The impact of changes to the price level is an important factor in both growth and the deficit. In Ireland’s data the decline in real GDP is masked by outright deflation. Therefore, while inflation

modestly reduces the cumulative rise in Euro Area deficits, here the debt burden piles up because of deflation. If all private incomes, both household and corporate fall via deflation, so too government income (taxes) will be deflated. Yet the nominal debt burden for all sectors will be unchanged, thereby increasing the real debt burden for all.

**Debt & Deficits**

The tax regime policy in this state is almost exclusively aimed at domestic activity, not export activity. At the same time bond markets, are dependent above all on the continuity of cash flows. Therefore a continued decline in the government cash flows, predominantly the taxes derived from GNP will only serve to increase the debt burden and tend to undermine its sustainability. Whereas the cumulative addition in the fiscal deficits is 36.8% of GDP using OECD projections to 2008-2011, the cumulative addition to the deficits rises to 49.1% of GNP.

There are a number of risk factors associated with this path of government finances. These include, but are not confined to:

- Nominal interest rates on government debt exceed the growth rate of taxation revenues
- The volume of government debt interest payments plus government spending exceeds taxation revenues plus borrowing capacity
- The growth rate of government debt (deficits) exceeds the prospective growth rate of taxation revenues

In the course of the Depression here all of these factors have appeared at one time or another. It is only NTMA’s recent bond issuance which has prevented all three factors occurring simultaneously.

However, the focus of policy has been on just one of those variables- government spending. That has been with disastrous results. It begins with the double-bookkeeping assumption that cuts in government spending equal savings. There is no recognition of the fact that government spending is a component of GDP and a portion of investment. Policymaking works from the assumption that spending can be cut spending depressing activity and the tax revenues which flow from it. Likewise it is assumed that cutting welfare payment levels will produce savings even as the numbers entitled to welfare payments rises.

The table below demonstrates that this proposition, that cuts equal savings, is false. It shows the relationship between economic growth and the key variables of government finances as reported in the Exchequer Statements. Although these are not comprehensive, they highlight the key relationships.

**Table 2. Fiscal Variables 2008-2009**

	€bn
Decline in tax revenues (a)	14.3

Increase in Govt. spending (b)	3.2
Govt. tax increases (c)	5.9
Govt. spending cuts (d)	4.6
Total (= a+b+c+d)	28
% of nominal GDP decline (€26.3bn)	106%
% of nominal GNP decline (€29.8bn)	94%

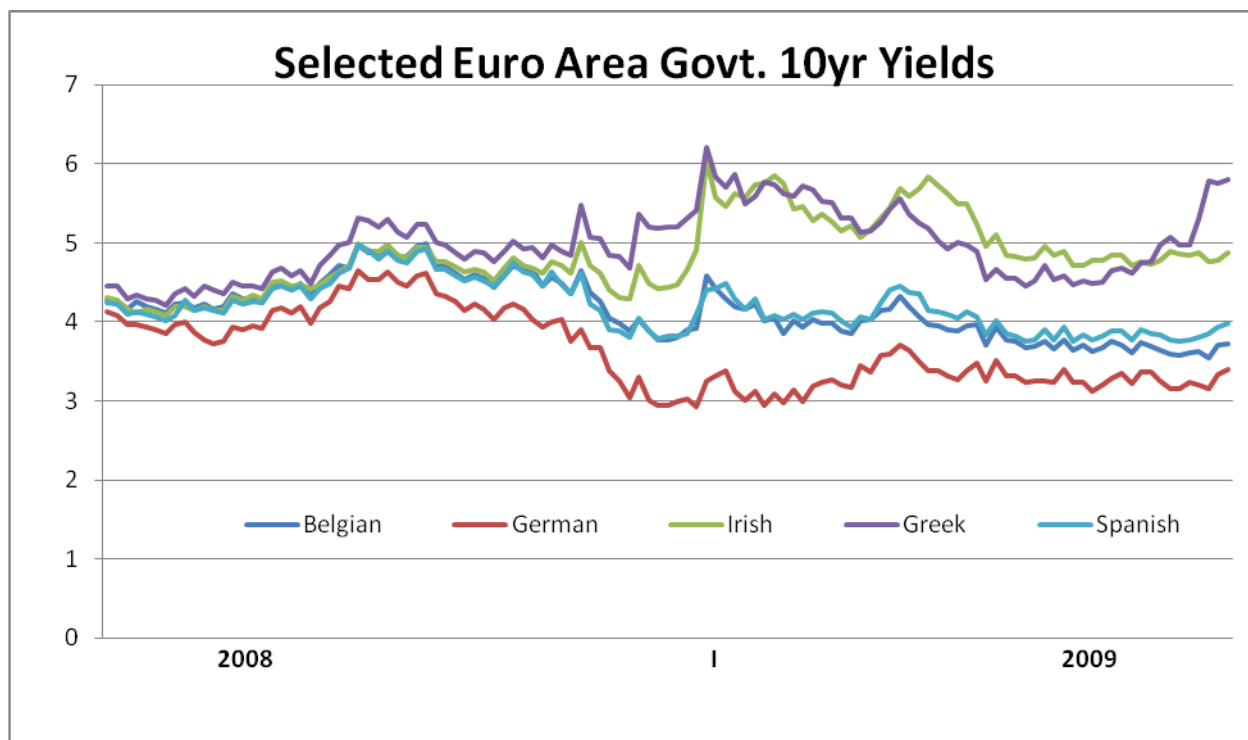
Source: calculated from DoF, CSO data

In the period 2008 to 2009 government finances deteriorated by €17.5bn overwhelmingly through lower tax receipts. At the same time Government spending cuts and tax increases amounted to €10.5bn. If fiscal tightening amounted to savings, then the deterioration in the deficit would otherwise have amounted to €28bn. But then we arrive at the ludicrous situation where a deterioration of €28bn exceeds the total decline in GDP of €26.3bn, which is literally incredible.

Instead, €10.5bn amounts to 35.25 per cent of the decline in GNP, and is therefore likely to have a direct impact of accounting for the same proportion of the deterioration in government finances, equivalent to €6.2bn. However, we have already seen that the damage done to government finances will persist long after the recovery is officially declared. So too will the fiscal damage done from the policy of fiscal tightening, thus negating any 'savings' whatsoever.

Unsurprisingly, and contrary to widespread claims none of this has reassured financial markets. At the end of May 2010 Ireland's benchmark 10-year government bond yield was 4.9 per cent. In early 2008 this yield was just 4.3 per cent. At the same time, the cumulative decline in the price level has been 5.4% with the result that real 10yr yields have risen by 6 per cent. To refer to one of the earlier metrics of unsustainable debt, the nominal 10-year yield has been above the growth rate of taxation revenues continuously since 2007. Ireland's yields are among the highest in the Euro Area, below only Greece and Portugal, ahead of Spain, Italy and the rest.

Chart 3.



Irish yields started 2008 as part of the core group just above the German benchmark. They began to diverge in July 2008 as tax revenues weakened. The austerity measures of October 2008 and in early 2009 were greeted by a surge in yields, helped on the by the size of the bank bailout and its blanket terms. In mid-February 2009 Irish yields surged past Greek yields under the impact of austerity measures in March and stayed above Greece until its own crisis in November last year. They remain above all the other crisis-hit countries except Greece.

(For Spain, Italy and Portugal this recent crisis is not directly related to their deficits, or debt levels. There has been no sudden deterioration of either in 2010, compared to 2008 and 2009. In a forthcoming paper it will be shown that the 2010 crisis is a crisis of European banks, reflected in their rising inter-bank borrowing costs and falling share prices, and that their €750bn bailout is transfer of capital to them from European taxpayers, the poor and public sector workers. This is a multinational and multilateral version of NAMA).

### Case Against Stimulus

Greece, Spain, Portugal and Italy have all had austerity measures forced on them. The *Wall Street Journal* recently commended the Dublin government for showing the way, writing a riches to rags story for the Euro Area periphery in their role as boosters for neo-liberalism. However, this is not the remedy that the Euro Area 'core' has acted upon, nor the US, China or Japan. They have all adopted fiscal stimulus packages, with varying degree of success dependent on the scope and content of the measures. In contrast, the policy of the Dublin government is fostering deflation and is clearly not reducing the deficit to manageable levels. Ireland has the highest deficit in the Euro Area. Without

taking account of the negative impact of the latest austerity measures, the OECD forecast for 2011 is a deficit here equal to 10.8 per cent of GDP, nearly double the Euro Area deficit of 5.7 per cent. It is also considerably higher than the 2008 deficit of 7.3 per cent of GDP, which policy was supposed to reduce.

The most authoritative recent work on the effects of fiscal stimulus brings together seven different econometric models from the Fed (2), OECD, IMF, European Commission, ECB and Bank of Canada, (*The Effects of Fiscal Stimulus in Structural Models*, IMF WP/10/73). The main conclusion was that “the multipliers from government investment and government consumption [general government spending]...are clearly larger than...” all types of tax cuts and only “...targeted transfers [to the poor] come close to having the same multipliers as government spending” (p.16). The researchers found that the fiscal multiplier from government investment was a cumulative 3:1 over 2 years.

Yet the case for fiscal stimulus remains a controversial one across Ireland, for whatever reason. The list of objections includes (but is not exhausted by) the following: we are a Small Open Economy, there will be ‘leakage’ in the form of increased import demand, there are no shovel-ready projects, fiscal multipliers do not exist, do not exist/are very low in Ireland, and so on.

There is not space here to examine each of these claims in detail. But there is a practical critique of them which can be summarised with the following acronym: NDP.

Insofar as any of the claims has some merit, their net effects are rebutted by all evaluations of the impact of the National Development Plans. These have tended to focus both on infrastructure projects and education, increasing the effectiveness of both, and to which we could add health care investment. All the objections to fiscal stimulus cited above must have been in force when the NDPs were implemented, if at all. Yet all evaluations of the NDP show that the multipliers are extremely large. The same is true for the multipliers attached to EU Community Structural Funds. Below is a compilation of some of the research on the NDPs, CSF and others, all of it specifically relating to investment in this economy.

**Table 3. Irish Evaluations/Assessments of Multipliers Attached to Government Investment**

Source	Multiplier	Time Horizon
ESRI, Ex-Ante Evaluation of the Investment Priorities of the NDP, 2007-2013	1: 2.4 a	14 years
Fitzgerald & Morgenroth, Mid-Term Evaluation of NDP, 2003	1: 2.4 b	15 years
Lane & Benetrix, ESRI, Vol. 40.4, Autumn 2009	1: 2.2 c	6 years
ESRI, WP 287, April 2009	1: 2 d	7 years
Bradley, Morgenroth, Untiedt, Macro-Regional Evaluation	1: 2.8 e	16 years

of the Structural Funds Using the HERMIN modelling framework, 2003		
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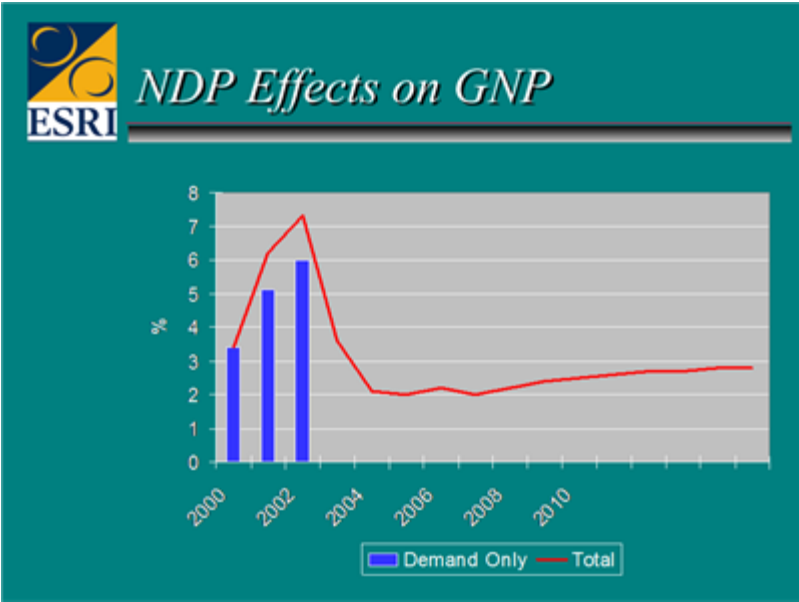
- a. Average annual multiplier over 14 years. Based on assumptions of capacity constraints, notably in the labour market. Supply-side effects increasing once more after 14 years
- b. Average annual.
- c. Cumulative from a one-off permanent increase in government investment. Rises to 1: 4 if the one-off increase is later reversed.
- d. Cumulative multiplier from one-off change in investment. Does not include long-term supply-side effects, which might be expected to double the multiplier to 1: 4
- e. Average multiplier over 16 years.

The average multiplier in these estimates just under 1: 2.4. In addition, the Mid-Term Evaluation places the average annual return on investment at between 14 and 18 per cent, depending on the composition of the investment. These returns are net of any effects arising from being a SOE, leakage, etc.

On the issue of import leakage, the multipliers associated with this economy are higher than for Greece, Spain, Portugal and the north of Ireland. The authors of the HERMIN analysis suggest this may be associated with the degree of openness. The lowest multipliers arise in Greece and NI, the two most closed economies examined, whereas this economy is the most open in Europe. Participation in the international division of labour is a key factor determining productivity and growth. Logically, the higher degree of participation would tend to increase the effects of all investment, and therefore tend raise the level of the multipliers. Multiplier effects rise with openness, not decline as is frequently assumed.

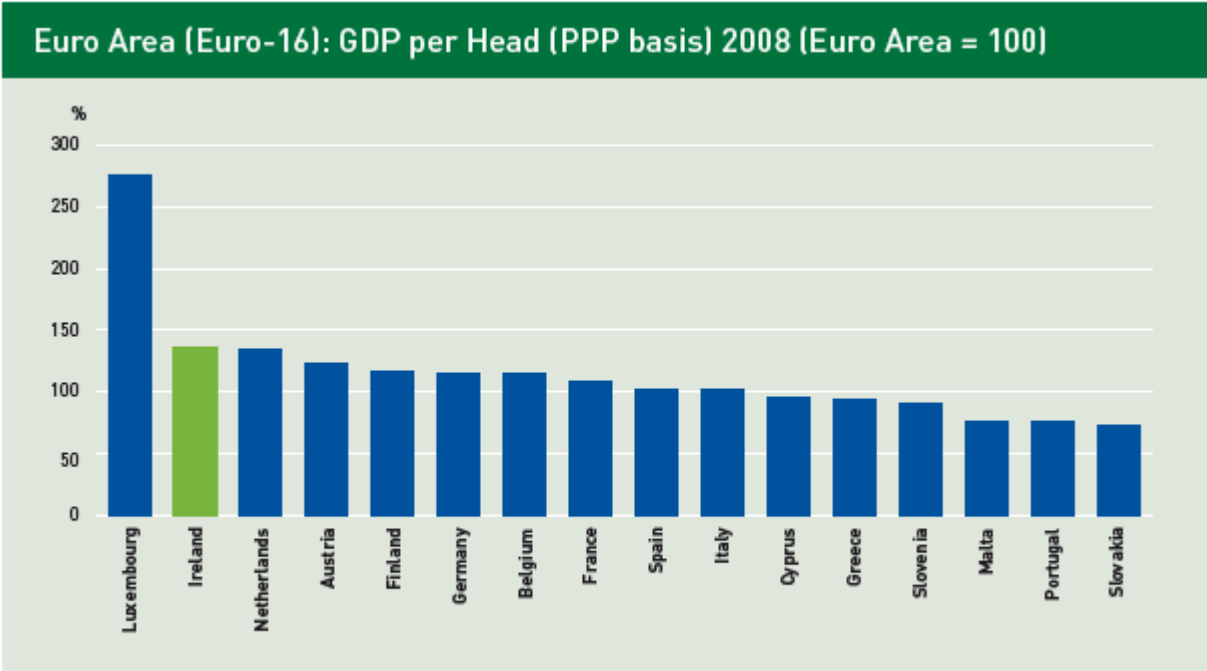
To reiterate, all these evaluations are of the actual effects of state investment, including the NDP and CSF. The characteristic effects are shown in the chart below, from the Mid-Term Evaluation of the NDP.

Chart 4. **Total Effects on GNP from the NDP, %**



**Funding Investment**

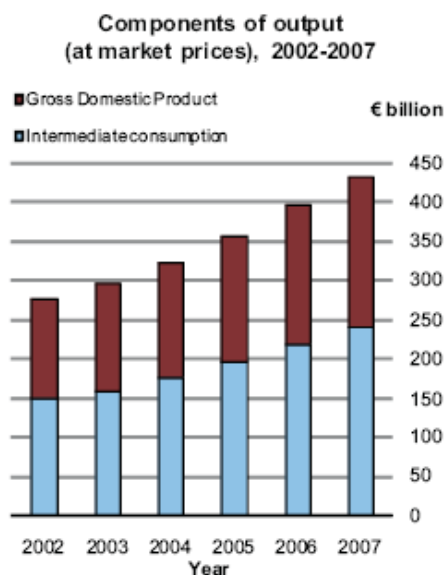
The final argument against stimulus is that, while it might be fine in principle, it is simply unaffordable- ‘we’re broke’. In Chart 5 below, taken from the central bank’s latest report, Ireland’s relative poverty is put into some perspective.



Source: Eurostat.

The chart alongside is from the CSO's recently published *National Accounts and Value Added* data. It shows the relationship between Intermediate Consumption and final output, measured by GDP.

Chart 5.



Published by the Central Statistics Office, Ireland.

In any modern advanced economy, this intermediate production usually exceeds final production by some way. In 2007 in this economy GDP amounted to €192bn, by intermediate consumption amounted to €240bn.

This underlies the process by which fiscal multipliers work. A final output determined by government investment, say, construction of a new hospital, will require inputs, mainly from the private sector. These inputs will in turn require other inputs, and so on.

This is especially true of public sector investment since it automatically generates intermediate consumption in the private sector for most types of investment. The same process does not work in reverse- the public sector is not always obliged to increase its activity because of increased investment by the private sector. However, it may do so by

virtue of increased taxation revenues arising from that investment activity.

But here is a key aspect of the problem. Taxes are too low in this jurisdiction. Below is a table setting out the uses and resources table in the recent CSO national accounts already cited.

Table 4. Resources and Uses in the National Accounts

	€ million		
	2006	2007	
<b>Resources</b>			
P.1	<b>Output</b>		
P.11	Market output	328,897	359,414
P.12	Output for own final use	12,340	13,260
P.13	Other non-market output	32,840	36,319
P.1	<b>Total Output</b>	<b>374,076</b>	<b>408,992</b>
D.21	Taxes on products	23,388	23,997
-D.31	less Subsidies on products	-1,052	-1,029
	<b>Total resources (output at market prices)</b>	<b>396,412</b>	<b>431,960</b>
<b>Uses</b>			
P.2	Intermediate consumption	216,384	239,895
B.1*g	<b>Gross Domestic Product</b>	<b>180,028</b>	<b>192,065</b>
	<b>Total uses</b>	<b>396,412</b>	<b>431,960</b>

Note: In this table Gross Domestic Product is given at market prices.

Taxes on products (less subsidies) as a proportion of GDP were just 12 per cent in 2007. Over the course of 2007, total output rose by 9 per cent and GDP rose by 6.7 per cent, yet taxes were barely changed. There are enormous flows in this economy which are not touched by taxation. A 1 per cent increase in the taxation on total output would have yielded €4.3bn in 2007, although that would be somewhat less in 2010.

The structure of the tax system is not simply unjust, it is damaging growth. In 2009 income taxes and VAT accounted for €22.5bn, more than two-thirds of total tax revenues. Yet wages and salaries account for just over half of net national income. By contrast, profits and rents account for 45 per cent of national income, yet together with the huge multinational sector they directly contribute just 15 per cent of total taxation revenues.

Rebalancing the tax system would both provide some of the necessary funds for government investment and stimulate the economy, given the higher propensity to consume of the poor compared to the rentier and the rich. TASC itself has produced *Failed Design* which is replete with examples of tax-raising measures that would not depress demand.

Total government revenues here have averaged 36.1 per cent of GDP in the period 1992-2009, whereas the average for the Euro Area is 45.3 per cent (source; European Commission). Finance Minister Lenihan has argued that the 12.5 per cent corporate tax rate “is our international brand”. The equity in this brand is limited; the next lowest rate in the OECD is Iceland’s 15 per cent. The OECD weighted average corporate tax rate is over 35%, with Germany at 30%, France at 34% and the US and Japan both over 39%. An increase in the corporate tax rate to just 20 per cent would yield an additional €3.1bn at 2009’s Depression-level of activity, a return towards 2007 levels of output yielding an additional €5.1bn.

Applying just this additional source of revenue to government investment would yield a boost to growth equivalent to between €7.4bn and €12.2bn based on the average multiplier of 1:2.4 previously identified in Table 3. These are equivalent to between 4.5 per cent and 7.5 per cent of 2009 GDP and 5.6 per cent and 9.3 per cent of GNP respectively.

This rebound in activity would impact government finances positively. Previously the DoF had assumed that the elasticity of taxation was 1:1.1, that is a 1 per cent decline in activity would lead to a 1.1 per cent decline in taxation revenues. We have previously seen in Table 2 that a €29.8bn decline in GNP led to an actual €14.3bn decline in tax revenues plus a €3.2bn increase in government spending (despite both tax increases and spending cuts). Assuming the same tax elasticity a €7.4bn/€12.2bn increase in activity would lead to an improvement in government finances of between €4.3bn and €7.2bn. These new funds could either be used for additional investment, or to pay down the deficit, or some combination of the two.

In addition, there are stocks of assets in the NPRF and at NTMA, both over-borrowing and holdings of foreign debt securities which could be used in a temporary measure to provide a one-off boost to government investment. Finally, with bond investors fixated on cash flows, there is no borrowing restraint whatsoever on any investments which yielded between 14per cent and 18 per cent, as

estimated in the *Mid-Term Evaluation of the NDP*. Indeed, any business which repeatedly refused an approximate 16 per return when it can borrow at 5 per cent would soon go out of business, or more likely would sweep aside its current management.

Furthermore, a revival of investment is precisely what is required to overcome the recession. The Depression is entirely accounted for by the collapse in private sector investment. In real terms gross fixed capital formation has fallen by over €20bn, whereas the aggregate decline in GDP is less than €19bn.

The reflationists, like the US, China, Japan, Germany, France and others now have 10yr yields between 1 and 3 per cent below Irish yields. That there is no borrowing constraint on government engaged in stimulus measures is demonstrated in the table below.

Table 5. **Impact of Fiscal Policy on Borrowing Costs**

Stimulus	%	%	Contraction	%	%
	2 year yields	10 year yields		2 year yields	10 year yields
Belgium	0.98	3.49	Greece	8.35	8.30
France	0.55	3.00	Ireland	3.55	5.13
Germany	0.48	2.57	Italy	2.26	4.24
Japan	0.15	1.27	Portugal	3.28	5.29
Netherlands	0.47	2.90	Spain	2.82	4.59
US	0.72	3.20	-		

Source: data from Financial Times, Benchmark Government Bonds, June 4

## Conclusion

The current policy is not working. Even if there is a statistical recovery in H2 2010, it will not generate either increased jobs or additional taxes. As a result, the fiscal position will remain a growth-sapping one, with potentially disastrous consequences. Fiscal stimulus works here, as the NDP and CSF show. Their effectiveness demonstrates the mechanism for creating jobs, raising tax revenues and reducing the deficit. It is fiscal contraction that is unaffordable.

The private sector investment collapse is responsible for the crisis. Only government investment is capable of leading a genuine recovery.

## Appendix.

### Which Investments?

The areas for investment should be derived from an analysis both of their effectiveness and their desirability. There is not scope here to explore these issues, but the table below provides an excellent summary of certain aspects of these for specific types of investment and could be a productive starting-point for any investment decisions.

The table is taken from the ESRI evaluation of the NDP, cited above, p.28. While this was compiled in 2003, and priorities change over time, the basic starting-point is a constructive one. Health care investment has the highest average score on these assessments, followed by housing then jointly by childcare and regional development.

Table 6.

**Table 3.1: Classification of Investments**

	Public Good	Corrective	Targeted	Redistribution	Average Score
Public Physical Infrastructure	%	%	%	%	
Transport (incl. Ports, Harbours, Airports)	80	20			0.59
Environmental Infrastructure	50	50			0.50
Housing	10			90	0.76
Sport & Arts	30	30	30	10	0.53
Human Resources					
Education	90	10			0.65
Training	10		70	20	0.58
R&D	30	10	60		0.47
Productive Sector					
Energy	20	70	10		0.50
Telecommunications	20	80			0.40
Agriculture, Forestry, Fishing	10	40	40	10	0.26
Tourism	40		60		0.24
Enterprise/Industry	10	10	80		0.43
Equality/Social Inclusion			50	50	0.62
Health	100				0.80
Childcare				100	0.70
Regional Urban and Rural Development	10		80	10	0.70

Source: Fitz Gerald *et al.* (2003).