Meeting borrowing targets by accident could prove fatal

Aidan Kane *

Sunday Business Post 28th August 1994

As the annual round of public expenditure decisions gets underway, the capacity of the government to strike the right fiscal balance will be tested as never before. A real worry must be that the recent drift in public finances will continue, leading to higher taxation and spending.

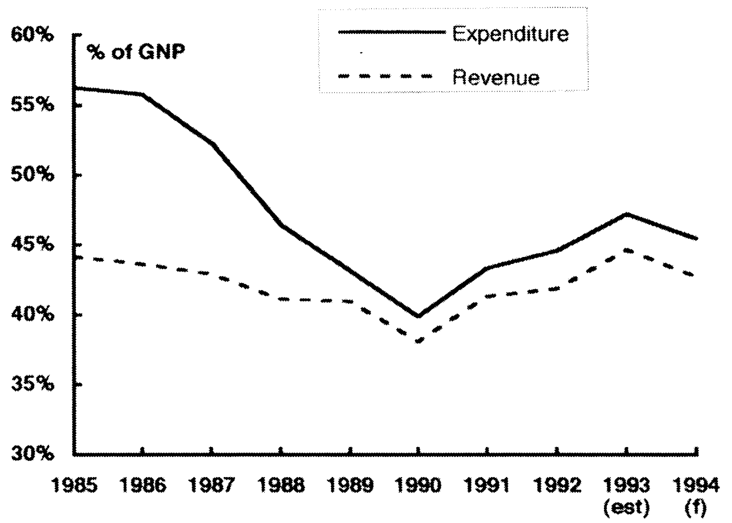
Such a concern is not confined to the "slash and burn 'em" school of economics. The Department of Finance's *Economic Review and Outlook 1994* commented: 'the way in which fiscal consolidation is achieved can have an important impact on the economy's growth potential; in this regard the levels of taxation and expenditure merit careful attention'.

It remains to be seen whether this official but understated view will be reflected in policy.

The accompanying graph gives the essential background. Government borrowing, successfully reduced through the period 1987–90, has remained low and sustainable. Since 1990, however, governments have met their borrowing targets only by increasing expenditure and taxation. The dip in the government share of national income in 1994 forecast by the Department of Finance reflects optimistic expectations of growth for this year.

If this is not a crisis, it certainly is a cause for some concern. If public expenditure control continues to slip and taxation is raised in tandem, we risk further burdening the market sector and limiting its capacity to deliver increased living standards and more jobs. The policy problem can appear

*Department of Economics, NUI Galway.



Note: Data (on budgetary basis) derived from Table 9 in 'Economic Review and Outlook 1994', Dept. of Finance.

Figure 1: Revenue and Expenditure as % of GNP 1985–94

more or less acute by measuring the public sector in different ways. The graph here does not reflect the fact that prices in the public sector (essentially wages) differ from those in the economy generally.

Making this adjustment, one can find that the public sector has been growing at the same rate or more slowly than the rest of the economy, and so its share has been roughly stable or even falling.

This raises two important points. First, should costs in the public sector be growing so rapidly? In the period 1989–93, they rose by 25 per cent, compared to a general inflation rate of about 5 per cent.

This in part reflects the impact of postponed pay increases, as well as subsequent awards. It could only be continued if such increases reflected productivity improvements. Otherwise, (and more likely) we have a truly dysfunctional public expenditure process.

The second issue for policy makers is that the public finance numbers expressed as a share of GNP are clearly sensitive to revisions in GNP estimates. A government overspends in cash terms, but growth is revised up and so it meets its target share of expenditure without meeting either of its components.

Meeting targets by accident rather than design is better than not meeting them, but doesn't give much confidence in future policy commitments. This is a serious issue in Ireland, given the problems with our GNP data, and the vagaries of economic growth forecasts generally.

Budgetary discipline: whence it came, where it went

Table 1: How to make budget 1987–93 (not)

Overruns(+)/underruns(−) £million

	1 Central Fund Services	2 Other Current Expenditure	3 Current Revenue	4 Current Budget Deficit = 1 + 2 − 3	5 Borrowing for Capital Purposes	6 Total EBR = 4 + 5
1987	−42	−44	−66	−20	−52	−72
1988	−69	−84	+655	−808	−30	−838
1989	−102	−29	+425	−556	−20	−576
1990	−51	+85	+139	−105	+118	+13
1991	−74	+131	+1	−56	−285	−229
1992	−82	+240	+48	+110	+13	+123
1993	−34	+70	+182	−146	+70	−76

Source: Budget Booklets

Note: 1988 includes tax amnesty receipts: 1991 includes Irish Life Flotation receipts.

It is important to recognise how the apparent overall drift has arisen. The accompanying table looks behind the broad numbers and compares budget targets and actual results since 1987. A negative number in the last column indicates the government borrowed less than envisaged at the start of that fiscal year.

Overall, the borrowing record has been a success story: errors have been in the 'right' direction. But this has not meant that all of the components of the budget that give these results have moved as policy makers might wish.

The first column of the table relates to 'Central Fund Services' —mainly service of the national debt and contributions to the EU budget. Expenditure here has been consistently less than forecast, in part due to the successes of the National Treasury Management Agency. There were also savings on the rest of the government's current expenditure up to 1990, when a series of overruns began (column 2).

It is certainly tempting to infer that since 1990 savings on debt service have been used to fund part of the increased day-to-day spending. If this is an accurate interpretation, then we are seeing a classic case of expenditure slippage. The key distinction between the two types of spending is that the first is broadly less open to control by government than is the second.

Savings on debt service might be more usefully 'banked' so that the government reaches its borrowing targets more quickly and/or with a lower level of taxation.

Current revenue—mainly taxes—has usually been higher than expected because of greater than forecast economic growth (and in 1988 because of the tax amnesty). The capital side of the budget is erratic and this might reflect problems in the timing of EU receipts.

The central idea is that borrowing numbers alone conceal the worrying trend explained above on the current side of the budget. To stretch a point, the Department of Finance makes stately progress keeping to the Maastricht limits on borrowing, swanlike, while beneath the waterline, expenditure and taxation paddle furiously to keep up.

It is fair to concede that some of he variations are small (a few Beef Tribunals a year) in the context of the annual budget each year of some £12 billion. The real problem is the cumulative effect of this drift and the missed opportunities it represents.

While it is possible to overstate the case for corrective action in the future, a cynic might argue that it is necessary to do so, given an inbuilt bias towards increased public expenditure apparent from recent fiscal history.

The link to tax reform

A specific concern is that slippage on the expenditure side will postpone indefinitely the programme of tax reform still necessary to make the Irish labour market function properly. Tax reform has been rhetorically embraced and practically ignored.

Part of the official resistance to it has been the fear that major tax reform would lead to reduced revenue, at least in the short term, thus throwing fiscal policy off the low borrowing path so recently achieved. In general it is true that the more radical the reform the more unpredictable are the consequences for revenue.

Economic models which are used to predict the effects of reform are based on the present structure of the economy: radical tax reform would change that structure and so the models are of limited value.

The problem is that if one postpones reform because of this uncertainty, one foregoes the benefits of a more rational tax system e.g., a better match between the supply and demand for labour if the 'tax wedge' were reduced. These gains are long-term in nature and those who would benefit under reform are politically invisible; they are those who otherwise emigrate or are excluded from the labour market here by a perverse tax system.

This all boils down to a question of risk for policy makers: they could take the risk that there would be an initial revenue loss under reform in exchange for the long-term gains in the wider economy. The revenue loss would later be made good by a combination of increased long-term growth and if necessary, adjusting the tax rate under the reformed system of allowances and exemptions. Irish policy makers could rationally take this risk

If they could assure themselves (and financial markets) that any post-reform increase in borrowing was temporary in nature. They could only credibly do this if their credentials on the expenditure side were unimpeachable, which they are not. Thus, no radical tax reform. QED. Furthermore, overall tax reductions, as opposed to tax reform, are self-evidently not sustainable without expenditure restraint.

More to the point, the economy would not respond to any given tax reform in the beneficial way hoped for if companies and individuals believe that the new system will eventually be used to simply extract more revenue. The government and others were mystified by the vehemence of opposition to the changes in property tax, and concluded that this meant no one really wants tax reform.

A more plausible explanation is simply that people do not believe the tax rate will stay at current levels and they have no reason to, when public expenditure drifts upwards. The same argument will apply to any further reform measures aimed at broadening the tax base in order to reduce tax rates. In this way the policy problem is more acute than the relatively small current expenditure overruns in each year might seem to imply.

All is not gloom, if only because issues such as these are being highlighted by IBEC and the Small Firms Association among others as they attempt to influence this year's budget round. On the other hand, many more interest groups are concerned with the overall budget as being distinctly anti-social. Ministers know that even those budget submissions calling for expenditure restraint in general typically seek expenditure increases in particular— 'in the national interest' of course. Ministers then have to make choices. Which is what they are elected to do.

http://www.aidankane.net/writingsetc/1994_kane_borrowing.html