Chapter 15 A Critical Assessment of the 1989 Budget (Adapted from a paper given by the author to the Student Economic Workshop)

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The predominant reaction among commentators to this year's budget was that it was a bland budget, an opportunity lost, and one totally lacking in any sense of direction. It is a criticism which has been leveled against all Irish budgets within the recent past. In general, it may be countered by claiming that these commentators do not fully appreciate the political, and especially administrative problems associated with radical measures, but such an apology for inaction is not valid on this occasion because of the unique coincidence of factors both requiring and facilitating substantial reform. This budget, I propose to argue, has been an economic non-entity to a degree not fully appreciated even by its more vociferous critics. Its failure to engage in any real reform was in no way due to political or administrative factors beyond a willingness to cave into pressure groups seeking to preserve the *status quo*.

The first heading under which I intend to analyse this budget is that of its fiscal stance; it is here perhaps more than anywhere else, that this budget is over-rated. Table 1 shows the CBD, EBR and PSBR for 1986, 1988 (excluding the tax amnesty) and the 1989 budget forecast, all as percentages of GNP.(1)

Table 1
Borrowing indicators as ratios of G.N.P.

	C.B.D.(%)	E.B.R.(%)	P.S.B.R.(%)
1986	8.5	13.1	15.7
1988 (excluding tax amnesty)	4.5	6.1	8.5
1989 (projection)	4.1	5.3	6.4

The first striking feature is the improvement between 1986 and 1988, one which no-one foresaw in the runup to the 1987 general election; but the second feature is that this year's budget has failed to continue the progress in relation to the debt problem; it has hardly changed the PSBR, and it represents a standstill *viz-a-viz* 1988. It has been observed that the tax yield projections in the budget are rather pessimistic, but in terms of debt stabilisation this is likely to be fully neutralized by the over-optimism of the 6% nominal GNP growth forecast contained in the budget.

Where this standstill leaves the crucial debt to GNP ratio is an issue in the dynamics of debt which I do not propose to analyze in much depth. But a critical condition for debt stabilization is that the deficit should equal the product of outstanding debt and the nominal GNP growth rate. For 1989, using the PSBR as the borrowing indicator, this amounts to a PSBR of about 6.3% of GNP. So the 1989 position is of a debt which is just stabilised. It is a situation in which the problem is contained, but in which nothing is being done to resolve it.

Table 2 shows some debt-GNP ratios for ten years hence on a number of rather strong assumptions with different initial (ie 1989) PSBR's. While the actual figures are rather hypothetical, because of the strength of the assumptions, the underlying idea is not. The compounding effect of changes in the servicing burden amplifies the trend in the debt/GNP ratio, whichever way it is going. A zero PSBR must become a medium term policy objective if the ratio is to be reduced to an acceptable level within the foreseeable future. Merely stabilizing the debt leaves a grave problem hanging, like an albatross, indefinitely, over the Irish economy, until further progress is made.

Table 2
Debt/G.N.P. projections for 1999

P.S.B.R./G.N.P	Debt/G.N.P.
0	0.74
0.03	1.06
0.06	1.3
0.09	1.54
0.12	1.87

Assumptions: (i) 3% inflation
(ii) 2% growth
(iii) No real change in taxation or government spending

Bank of England guidelines consider that lenders should provision for default in relation to debtor nations in which the foreign servicing costs exceed 3 months' export earnings, or in which the debt/GNP ratio exceeds 0.8 (2). Given Ireland's inflated export figures, the Irish debt may well in fact satisfy the first of these conditions; and it certainly satisfies the second one. The 1.33 debt/GNP ratio is unparalleled in the developed world where ratios of 0.3 or 0.4 are nearer the norm. And yet Mr Reynolds saw fit to divest the Exchequer of £150m, and persisted in his ideologically motivated refusal to sell even a minority stake in Irish Life, which would have raised £200m. Indeed not only is privitisation of Irish Life a budgetary necessity; but it is also necessary for the international growth of the company itself, because of the restrictions on state-owned companies, notably in the USA. Had he, in these or other ways, had the vision to see beyond stabilising the debt the PSBR could now be down to 5% of GNP. The failure to do so could be construed as a temporary measure, perhaps for electoral motives. But it would be very typical of this government, having resolved the immediate problem of an exploding debt to revert to their pathological short sightedness, and avoid any further action. This budget is at least consistent with such a scenario.

Moving on to the question of direct taxation, a major issue here is one of definition. The approach of the Commission on Taxation to extend the definition of income tax beyond the core PAYE income tax to cover PRSI, is widely accepted. The reasons for this extension were especially highlighted when, in the book of estimates, an increase in employers' PRSI contributions was calculated as a cut in the input from the Central fund into the social welfare budget, and hence as a cut in government spending. In other words an increase in taxation came through the contortions of the Irish budgeting system as a cut in government spending. It would follow from the inclusion of PRSI as an income tax; that Youth Employment and Health levies are too.

But I go further than this in extending the definition of income taxation. Although tax and social welfare systems are politically and administratively independent, they are economically integrated in the distortions they create. A nominal cut in taxation financed by means testing benefits in such a way that no-one's net income is changed cannot reasonably be construed as representing a change in any economic variable. So I define income taxation as the net sum of all income related transfers from individuals to Government; nominal taxes less social welfare spending. Analytically if net income is plotted against gross income, this is the difference between the 45° line and the net income function. This difference may be plotted against gross income, and average and marginal effective tax rates may be hence derived. Table 3 shows such rates calculated for the UK in 1981 by Brown and Jackson.(3)

Table 3
U.K. marginal effective tax rates, 1981

Income/week(£)	Tax rates(%)
45	93
75	117
90	60
100	51
120	41

Assumption: Married, two children

It is at this point that the importance of looking at welfare and taxation together is clear; because the rapid withdrawal of benefits ensures that the highest tax rates in any economy occur in the poverty trap. This not a pattern which many would seek to defend, but one which simply arises out of the confused and haphazard disjointed evolution of the taxation and social welfare systems.

It is, moreover, a system providing a massive distortion of factor markets. Its disincentive effects to work effort are likely, at a theoretical level to be strongest in the poverty trap, most obviously, because it is here that the highest marginal rates occur; but also, and perhaps more significantly, because providing benefits and then withdrawing them has an unambiguous net disincentive effect, as both income and substitution effects tend to lessen work effort. Net taxation, on the other hand, has an income effect and substitution effect operating in different directions, so the overall effect is unclear. This theoretical argument has strong empirical backing; there is no solid evidence of a disincentive effect is caused by nominal taxation; but there is a substantial body of evidence suggesting that the rapid withdrawal of benefits does have such an effect; notably in Ireland, the study by Walsh in 1977. (4).

At first sight, the budget made some attempt to remove some anomalies and lower marginal rates. This is an illusion created for electoral motives. The budget actually worsened the situation in three key ways, neutralizing any positive changes .

Firstly, it introduced and increased tax exemptions. These exemptions seem to be a feature peculiar to the Irish tax system. The problem with them is that at the point at which the exemption is lost, in the absence of a compensating provision, the marginal rate is infinite. Such a compensating provisions exists, in the form of tapering relief; but this still leads to a 60% marginal PAYE rate over a wide band of income.

Secondly, it proposed means-testing child benefit, This is, and must be seen as, economically equivalent to an extra income tax positively related to family size. I imagine that many supporters of this feature of the budget would oppose such an income tax, in which case they are guilty of the muddled thinking which has caused the Irish public financial system to degenerate into the state in which it lies.

Thirdly, failure to index tax free allowances effectively increased the marginal tax rates for many of those whose incomes are around the threshold figure.

The proposal for a negative income tax system is often criticised on the grounds that it would entail excessive marginal rates to preserve the present social welfare system. But the negative income tax is already, from an economic point of view, the system in operation; the marginal rates it entails are in the poverty trap. The first step in direct taxation reform is to make this explicit in the political and administrative system; if necessary, with all its anomalies and all its absurdities. From there the momentum for rationalisation would be irresistable.

The administrative tax and welfare dichotomy may cloud the thinking of politicians, like in the doublespeak of Mrs. Thatcher where she justifies top rate tax cuts as "necessary for efficiency" while praising the most stringent means testing of benefits, effectively taxation at at least 100%, as "targeting"; but it ought not to cloud the thinking of economists, who should see this budget as failing to take any overall stance on the question of direct taxation.

The budget did make some attempt to broaden the tax base, but in the face of the pressures for this and circumstances favouring it; it was so grudging and half-hearted that it cannot even be considered as piecemeal reform in the direction of the proposals of the Commission on Taxation. Residential Property Tax is currently levied at 1.5%, a little below the standard rate rate income tax on imputed rental income. It exempts properties rented to another. In the rising property market its extension would have represented an excellent means of effectively taxing imputed rental income and moving towards fiscal neutrality, without causing taxpayers capital losses in absolute terms; yet it was left unchanged. With falling interest rates, reduction of mortgage interest relief could not have been better timed; yet only a 10% cut was introduced. Life assurance tax relief dates back to the introduction of income tax; but the transformation of life assurance into a savings industry leaves this relief as an anachronism. The budget barely scratched the surface on this issue.

The twin of the narrow base present in all ill-conceived tax systems is double taxation. While the Irish system is more to be faulted in relation to its narrow base than in relation to double taxation; there is one important case of the latter. Corporate profits not distributed in dividends may be liable for Corporation tax; while the rise in share prices these profits cause may be liable to Capital Gains Tax. I say *may* advisedly, because both Corporation and Capital Gains taxes are easy to avoid and evade in this sense the element of double taxation may approximately compensate for the inadequacies of both these taxes. But this approximate 'rough justice' is not the basis for a rational tax system. The taxation of all capital gains as income and the abolition of separate corporation taxation is a pre-requisite for a level playing field in terms of taxation policy. Yet the budget avoided all mention of capital and corporate taxes apart from some loose commitment to contemplate changes in the finance bill.

On indirect taxation, the key issue is E.C. harmonisation, due only three years from now. The arguments for having a separate indirect taxation system as well as a direct system imply the desirability of a narrow base (e.g. this is necessary for it to constitute a 'voluntary tax' or to compensate for externalities). It is hard to justify two complete broad-based tax systems; one on income, one on expenditure. (5). Yet this is precisely what the Commission on Taxation proposes, and, more significantly, it is what will inevitably happen as a result of the completion of the single European market. Given this inevitability of this, the budget should have entailed some adjustment to prepare for the revenue loss it will cause. But the Minister chose to go in exactly the opposite direction by raising excises. This is very ironic, because the extension of V.A.T. to gas in the 1988 budget was justified on the grounds that it prepared for V.A.T. harmonisation. The strategy of the government is, hence, to prepare for increasing indirect taxes by increasing them; but simultaneously to prepare for reducing other indirect taxes by increasing them too. The government will then cap all this by having the brazenness to demand compensation from the E.C. for the revenue loss harmonisation will entail.

Rationalisation of the tax system along the lines I have suggested does not entail any specific level of government intervention; it only seeks to make the chosen level of government intervention coherent, clear to all, and within the means of the economy. Contrary to some interpretations the Commission on Taxation did not recommend any particular level of taxation; it merely proposed rationalising the system and then simply estimated the tax rate necessary to meet certain objectives. Almost any level of intervention can be conducted within a coherent framework. It is in failing to offer such a framework that the budget was especially unsatisfactory.

The optimum level of intervention is an ideological question which I do not wish to discuss in this paper. But I would comment that not only does the openness of the Irish economy severely restrict the power of domestic government to affect output and employment levels; but it even limits the scope of domestic government to tackle distributional questions. Egalitarian policies, whatever about their ideological desirability, cannot be implemented given the integration of British and Irish labour markets, because of the flows of professional and entrepreneurial persons they would cause. It seems to me that the openness of the Irish economy greatly limits domestic government's role, even in allocative questions. In the context of this year's budget the ideal of the state recognising the limitations of its own potential remains as far away as ever.

It would be kind to say of this budget that it was one of piecemeal reform, albeit reform in so many directions that it made no substantial change in any one respect. My assessment of it is even more critical; the piecemeal reform was in no case sufficient to show any commitment to change or provide any radical momentum, and in most cases was actually neutralized by measure further compounding the inadequacies of the Irish public financial system. On a political level, it may well represent a shrewd electoral strategy but on an economic level it is yet another testimony to the underlying lack of commitment of Irish politicians to run sound fiscal policies and engage in real tax reform.

Footnotes

1. Irish Times,26.1.89.
2. Financial Times,22.7.87.

3. Brown and Jackson, "Public Sector Economics", p.116.
4. Walsh, "A Labour market survey", in "Irish economic policy", E.S.R.I.
5. O'Hagan, "Economy of Ireland", p.88.