# What Should We Do With the Surpluses?

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## Introduction

Future historians will record 1999 as a pivotal year in Irish economic and social development. In recent months, we have witnessed a lively, and increasingly fractious, media interchange about the future of: social partnership; public sector pay; the national infrastructure; poverty reduction; the tax burden; privatisation; a proposed state pension fund; and regional development. At the end of the millennium, Ireland faces serious choices about its future direction and these options dictate the answer to the question of "what to do with the surpluses".

In this paper, I address some of the fundamental issues that are at the heart of the current debate: whether the social consensus model is genuinely sustainable in its current form; the evolution of public sector pay; comprehensive reform of the tax system; and the optimal design of a state pension fund. The final section lays out conclusions and recommendations.

## Is Social Consensus Sustainable?

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The social partnership arrangements that have guided economic and social policy in recent years were formed during a period of genuine national crisis in the mid-1980s (see also Lane 1999a). In the context of an explosive national debt, oppressive taxation, high emigration and rising unemployment, the major actors in the economy recognised that it was in their individual self-interest to participate in a national programme of economic regeneration. Moreover, in view of the dire economic and social conditions, there was a heavy moral responsibility to act on behalf of the "common good", rather than to advance purely private or sectoral objectives[1].

In the intervening years, the country has been radically transformed by rapid output and employment growth. In terms of the public finances, booming tax revenues have led to the emergence of a budget surplus, despite very substantial recent increases in government spending. Moreover, high output growth and low interest rates have sharply reversed the dynamics of the debt-output ratio, leading to a spectacular improvement in fiscal sustainability. Finally, the ongoing privatisation programme is transforming the "national balance sheet", converting state-owned assets into cash[2].

It is natural that the relaxation of external constraints on fiscal policy (initially the need to restore fiscal stability in the mid-1980s, then the fulfillment of the Maastricht conditions in the run-up to EMU, now the achievement of actual budget surpluses) should erode the level of support for the social consensus model[3]. Moreover, this trend is reinforced by fading memories of the pre-Tiger days and the rise of a new cohort of decisionmakers in

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[1] The self-sacrificing "Tallaght Strategy" of the Fine Gael leader Alan Dukes well illustrates this point.

[2] To the extent that such assets are more productive in private hands, privatisation improves the "net worth" of the state. However, the privatisation process also incurs significant underwriting and marketing costs. The cash realisation from privatisation is also diminished to the extent that the discounted share allocation to workers exceeds the value of new productivity/flexibility/incentive agreements. In this regard, it is remarkable that very similar worker deals have been negotiated across the pool of privatisation candidates, despite large differences in initial conditions (civil service versus semi-state, monopoly versus competitive environments) and in the scale of concessions that have been obtained. Just as in the public sector pay arena, the "parity" principle appears to dominate all other factors.

[3] It is ironic that EMU itself further weakens fiscal discipline. Pre-EMU, a lax fiscal policy would have been punished by an increase in the interest rate premium and a weakening in the exchange rate. In a common currency zone, a loose national fiscal stance does not induce a similar response --- only in the case of actual default risk will the government experience a increase in its interest rate premium. Moreover, in a common capital market, private borrowers no longer must share in a higher cost of public borrowing. Finally, the exchange rate effect is no longer operative.

the social partnership apparatus. Long-suppressed differences in goals and world-views are now re-emerging: individual groups now recognise that the government can "afford" to make fiscal concessions in selected areas and the race is on to secure some of the gains.

In these circumstances, the ranking of spending and tax priorities is inherently a political process --- in contrast to the crisis conditions of the mid-1980s, there is unlikely to be agreement even on the correct *direction* for overall public spending, let alone on the details about the precise composition of an expenditure/taxation package. This places a heavy burden on the political and budgetary systems that must filter and reconcile the many claims on the public purse.

It is unclear that the Irish political system is currently well placed to cope with this allocation problem. A byproduct of the social consensus model has been that the large questions concerning economic and social priorities have been delegated by the political process to "neutral" institutions such as the National Economic and Social Council or to direct negotiation between the government and union and business federation leaders. In the absence of consensus, the formation of fiscal policy is necessarily re-politicised in the sense that it is the responsibility of the political system to ensure that the entire economic and social spectrum is adequately represented, including the interests of non-unionised workers, the non-organised poor and young or unborn firms. Moreover, the budgetary process must ensure that allocations to individual claimants do not threaten current or future fiscal viability. International evidence suggests that this is better achieved by a transparent system that places ultimate responsibility for fiscal policy on the finance minister than by a collegial and secretive system in which lines of responsibility are not clearly designated[4]. Improving transparency in the fiscal process can also help eliminate perceptions of a "democratic deficit" in the discussion, analysis and evaluation of alternative spending proposals.

[4] See Poterba and von Hagen (1999).

What about the role of the economics profession? In the midst of committed advocates proferring competing visions concerning future fiscal strategy, an informed and open public debate can only be enhanced by honest and dispassionate analysis of the economic costs and benefits of alternative options. Economists may vary greatly in their political opinions but it is to be hoped that some degree of consensus could be obtained concerning the likely economic consequences of the various fiscal proposals that have been advanced. Of course, economic advice is only one input into political decisions, since the social and moral dimensions of public policy decisions cannot be "priced".

A second role for economists is to highlight risk factors. It is a part of "boom psychology" to discount the possibility of a reversal of fortune --- the economist must be Cassandra-like in raising the possibility of negative scenarios and subjecting policy proposals to relevant stress tests, such as the risks of a housing crash, a European interest rate hike or a slowdown in the US economy and stockmarket.

## The Evolution of Public Sector Pay

Claims for significant increases in public sector pay represent the biggest pressure on current fiscal policy. In the absence of direct market forces, it is notoriously difficult to pin down the appropriate growth rate for wages and salaries for government employees. Moreover, a high degree of unionisation and their role in the provision of essential services means that key public sector groups (teachers, healthcare professionals, gardai) exert significant bargaining power in pay negotiations.

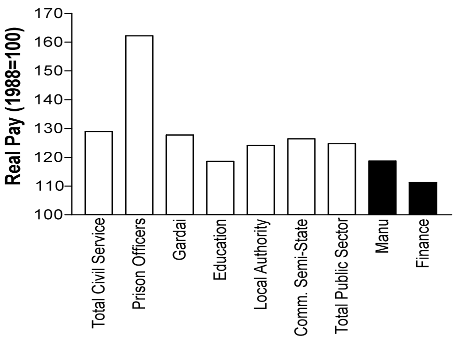
A central plank in the social partnership arrangements has been a structured approach to public sector pay determination. The "blue flu" deal with the gardai and the current nursing dispute have placed this structured approach under serious strain. The government response in dealing with the public sector pay problem is critically important, both in terms of budgetary strategy and in managing the labour market pressures that are evident throughout the economy.

Unfortunately, claims by individual groups of public sector workers, however deserving, cannot be evaluated solely "on their merits". The spillover effects on other public sector pay negotiations and on the private labour market are simply too large for case-by-case settlements. This requires leadership by the heads of public sector unions to ensure that a structured, collective approach is maintained[5]. Equally, the government must resist the temptation to place short-term convenience above the long-term importance of maintaining a consistent, disciplined approach to public sector pay determination.

Figure 1 and Table 1 shows the real (inflation-adjusted) improvement in average weekly earnings over 1988-98 for various public sector groups. For comparison purposes, average earnings in the manufacturing and financial sectors are also included. The evolution of average earnings depends on age structures, changes in skill levels, increments and overtime patterns in addition to the rise in "headline" pay. These considerations notwithstanding, it is clear that public sector pay has sharply improved in the last decade and trends compare favourably to *average* pay dynamics in the private sector. If pension rights were included in these data, the positive public sector differential would be even more extreme. Of course, income growth among the highest-skilled private sector workers, the self-employed and owners of capital may have outstripped public sector pay but, putting redistributive considerations to one side, differences in risk and other characteristics make these groups a less valid comparator group for public sector workers.

[5] In this regard, it is interesting to note that the most severe strains on public sector pay have emanated from those sectors with the weakest links to the national union movements (the gardai and the nurses).

**Figure 1: Pay Dynamics, 1988-1998**




## Table 1

| Year | Total Civil Service | Prison Officers | Gardai | Education | Local Authorities | Comm. Semi-States | Total Public Sector | Finance | Manufacturing |
|---|---|---|---|---|---|---|---|---|---|
| 1988 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| 1989 | 104.6 | 98.9 | 106.8 | 104.6 | 102.0 | 103.5 | 104.2 | 102.3 | 104.1 |
| 1990 | 107.3 | 112.5 | 98.0 | 100.7 | 100.0 | 104.9 | 104.1 | 99.3 | 102.1 |
| 1991 | 110.3 | 112.0 | 101.5 | 104.5 | 104.3 | 107.4 | 107.5 | 100.3 | 103.7 |
| 1992 | 112.1 | 115.1 | 110.1 | 109.3 | 104.1 | 109.8 | 109.3 | 103.5 | 106.3 |
| 1993 | 114.4 | 121.4 | 116.7 | 111.0 | 111.3 | 115.8 | 114.3 | 107.9 | 110.9 |
| 1994 | 114.8 | 125.7 | 117.8 | 114.1 | 111.0 | 113.2 | 114.8 | 105.4 | 110.5 |
| 1995 | 114.3 | 120.8 | 117.1 | 113.8 | 114.0 | 114.4 | 109.1 | 106.6 | 110.8 |
| 1996 | 117.3 | 127.6 | 124.5 | 114.9 | 116.3 | 117.1 | 117.9 | 108.4 | 111.2 |
| 1997 | 123.1 | 150.4 | 127.3 | 118.2 | 119.1 | 122.1 | 122.2 | 109.8 | 115.7 |
| 1998 | 128.9 | 162.2 | 127.7 | 118.6 | 124.2 | 126.4 | 124.7 | 111.3 | 118.7 |

Note: CSO data. Earnings deflated by CPI inflation. Finance is average of banks, insurance and building societies. Public sector excludes health.

In thinking about public sector pay, the impact on the level of provision of public services is important. Along the affordability dimension, there is a trade-off between improving the breadth of public sector provision (by hiring more public sector workers) and the level of public sector pay. However, this can be offset by requiring productivity improvements in exchange for pay increases and through the impact of pay levels on the quality of job applicants. A good example is the education sector: highly-skilled, highly-motivated and well-paid (by international standards) teachers do much to reduce the impact of relatively high pupil-teacher ratios.

Finally, it is by now appropriate and fair to introduce regional variation in public sector pay scales to reflect the sharp differences in the cost of living between the Dublin metropolitan area and other locations. A pay premium would also help address the problem of unfilled vacancies in the capital city.

## An Opportunity for Tax Reform

The Irish tax system is characterised by an extremely narrow base, resulting in a disproportionately high tax burden on labour. Despite significant reductions in income tax rates in recent years, reform of the tax system remains seriously incomplete. In terms of design, there is widespread agreement that a priority is to reduce, or eliminate, the income tax burden on the lowest-paid, both for reasons of equity and to improve the relative attractiveness of paid employment. Another priority is to widen tax bands, reducing the share of income that is taxed at the highest marginal rate. The impact of fiscal drag in recent years has been that tax bands have declined relative to income levels, partially offsetting the positive impact of the fall in tax rates on living standards.

Unfortunately, a truly radical decline in income taxes is infeasible in the absence of a widening of the tax base. Callan et al (1999) raise the option of eliminating the preferential tax treatment of married couples as one such move that would allow a decline in the average tax burden. Moving beyond income taxes, it is difficult to envisage a system that promises low labour taxes in the absence of a broadly-based property tax. A well-designed property tax would also provide the additional benefits of cooling down the housing market and improving labour market flexibility, by reducing the differential between owner-occupancy and renting. Similarly, imposing user fees for infrastructure (including roads) would both raise revenue and help to relieve congestion. A carbon/environmental tax would again serve the twin goals of raising revenue and improving efficiency.

With respect to capital gains tax, the recent rate reduction has predictably generated a once-off revenue gain, with the liquidation of long-held investment positions. It is indisputable that a low capital gains tax rate confers efficiency gains, by raising asset turnover and increasing incentives for entrepreneurs. However, these efficiency gains must be set against the inefficiencies imposed by higher distortionary taxes elsewhere, particularly on labour. Moreover, the discrepancy between capital gains and income tax rates distorts the design of compensation schemes in sectors in which it is possible to shift remuneration between the two categories.

Unfortunately, political economy factors make it unlikely that such a redesign of the tax system will be implemented. Although the average citizen would benefit from a widening of the tax base, small numbers of individuals and corporations with a high exposure in specific sectors will vigorously lobby against the introduction of new taxes. The relative lack of transparency in the formulation of tax policy (plus the dependence of political parties on private donations) are not helpful in improving the resistance of the political system to such lobbying activities.

## Designing a State Investment/Pension Fund

Demographic projections make clear that expenditures on social welfare and public sector pensions are set to rise in the coming decades. Rather than inefficiently raise the future tax burden, a far-sighted approach is to prefund anticipated future spending increases by accumulating assets that can deliver an extra investment income stream to meet the increase in public spending obligations.

Although there is wide agreement on the principle underlying the establishment of such a fund, much remains to be clarified concerning its design and operation (see also Lane 1999b). However, there is little doubt that the fund should overwhelmingly invest in overseas assets. This strategy would minimize the politicisation problem that can bedevil state investment vehicles, improve portfolio liquidity and flexibility and is a sensible risk-diversification mechanism. Moreover, it is sensible to allow some competition in the management of state investment assets by involving a number of (domestic and international) fund managers. Unlike in the management of the public debt, there is no strong reason to give the NTMA a monopoly in running a state investment/pension fund.

The debate on the financing of state pensions should also encompass: raising the retirement age; the dynamic sustainability of subsidised early retirement schemes; and the potential merits of defined-contribution schemes for public sector workers.

## Conclusions

Thanks to its new prosperity and bulging state coffers, Ireland faces important choices about the future direction of its economic and social policies. The political and budgetary systems are under heavy strain in successfully reconciling myriad spending and tax proposals with a prudent and dynamically sustainable overall fiscal position. A reform of fiscal procedures in the direction of greater transparency and accountability would help improve efficiency and equity in this key decisonmaking process.

A structured approach to public sector pay determination must be re-established. Unfortunately, individual public sector pay claims cannot be evaluated in isolation, since the spillover impact on other public sector groups and the private sector is too large. Moreover, *sustainable* changes in relative pay parities can only be achieved in the context of a comprehensive, encompassing public sector pay package and cannot be effectively achieved through bilateral negotiation with the government. Introducing regional pay differentials may be important in filling public sector job vacancies in the Dublin metropolitan area.

The current strength in the public finances also provides an extraordinary opportunity for comprehensive tax reform. Fiscal drag means that there is room to widen tax bands without reducing the overall tax-output ratio. However, a substantial and permanent deeper reduction in the income tax burden requires a greater contribution from other tax sources. In particular, it is hard to envisage a truly labour-friendly tax system without the introduction of a comprehensive property tax.

Finally, it is clear that the proposed state investment/pension fund should predominantly invest in overseas assets. Moreover, there is no reason for a monopoly in the management of this fund, with competition among a set of fund managers providing a useful performance benchmark.

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