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Irish approach vs. Grecian Formula

By: Alan Reynolds
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Some may say that Greece has too much of a good thing.

But if the Obama economic team really believes budget deficits provide “fiscal stimulus” to an economy, why aren’t they advising Greece to run bigger budget deficits?

Though Greek deficits and debts have dominated the news lately, Ireland’s fiscal crisis was widely considered at least as dangerous to the euro late last year. Ireland is in the worst trouble of all the eurozone countries, the International Monetary Fund then reported. Ireland’s budget deficit was as large as that of Greece in 2008, and the Irish economy had shrunk 9 percent in 2009.

But we don’t hear much about Ireland today. Why not? Because that country successfully repeated what it had done so boldly in the late 1980s — slash spending on payrolls and benefits, subsidies and transfer payments.

Ireland’s public service salaries, for example, were reduced last year by 5 percent to 15 percent. Unlike Portugal, Ireland did not adopt damaging tax increases. Unlike Greece, which is getting ever deeper in debt to its neighbors by begging for a bailout, Ireland is now lending 1.3 billion euros to Greece.

In short, Ireland offers an admirable lesson in fiscal responsibility for Greece, Portugal and Spain — and, possibly, the United States.

White House Budget Director Peter Orszag recently said the U.S. is in “no imminent danger” of a crisis of Greek proportions. But, he added, “I would prefer to be addressing this sooner rather than later.”

The Greek national debt amounts to 125 percent of the economy’s annual gross domestic product, compared with 60 percent for U.S. debt.

Were spending to keep rising as it has during the Bush-Obama years, however, the U.S. debt could easily exceed 90 percent of GDP by 2020. At that level, the idea of the U.S. facing a crisis of Greek proportions is no joke.

“High debt/GDP levels (90 percent and above) are associated with notably lower growth,” economists Carmen Reinhardt of the University of Maryland and Kenneth Rogoff of Harvard write in the May issue of American Economic Review. They studied the effect of government debt on economic growth in 44 countries since 1900. When debt exceeds 90 percent of GDP among advanced countries, they found, annual economic growth slows from more than 3 percent to only 1.7 percent.

“We want to make sure we never wind up facing the sorts of choices that Greece now faces,” Orszag has warned.

That requires making the correct choices sooner rather than later. From the experience of other countries — including Ireland — we know that means getting spending under control, not raising tax rates.

In a study for the National Bureau of Economic Research, Harvard economists Alberto Alesina and Silvia Ardagna examined how 21 leading economies addressed government spending and taxes from 1970 to 2007. When it came to cutting budget deficits, they found that “fiscal adjustments, those based upon spending cuts and no tax increases, are more likely to reduce deficits and debt over GDP ratios than those based upon tax increases. In addition, adjustments on the spending side rather than on the tax side are less likely to create recessions.”

Successful deficit reduction plans — ones that cut the deficit without hurting economic growth — are “completely based on spending cuts accompanied by modest tax cuts,” the authors found. Spending was cut by about 2 percent of GDP, with entitlement reductions accounting for half that.

Ireland, for example, first became a “Celtic tiger” by slashing government spending 6.9 percent from 1987 to 1989. Those spending cuts facilitated the celebrated 12.5 percent tax on corporate profits, plus substantial cuts in rates for personal income taxes, payroll taxes and consumption taxes.

The Irish economy suddenly switched from a 0.2 percent rate of economic growth in the early 1980s to annual real GDP growth of 7.2 percent from 1989 to 2001. It slowed only slightly, to 5.3 percent, from 2002 to 2007. With GDP nearly doubling each decade, the ratio of Ireland’s government debt to GDP dropped from 125 percent of to 25 percent by 2007.

In 2008-09, however, Ireland suffered one of the world’s worst housing and banking crises. But the government nonetheless avoided “fiscal stimulus” schemes. Instead, it cut spending by more than 6 percent.

One important result was to preserve the government’s credit rating. The European Central Bank reports that the yield on 10-year Irish government bonds was 4.76 percent in April, compared with yields for Greece of 7.83 percent — and close to 15 percent at times.

Unlike Greece, the Irish economy is showing encouraging signs of recovery. Manufacturing increased strongly in March and April, and consumer confidence and retail sales are also up.

“The Irish approach to tackling the recent recession,” investment adviser Michael Johnston said, “was vastly different than the strategies implemented by the U.S. and much of the rest of the developed world. Most governments cranked the printing presses into high gear and began injecting round after round of capital into the global economy. Ireland went the opposite direction, imposing draconian budget cuts and reeling in government spending.”

The Irish approach worked in 1987-89 — and it’s working now.

This is a lesson that Washington should learn sooner rather than later.

Alan Reynolds, a senior fellow at the Cato Institute, is the author of “Income and Wealth.”

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