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# The Politics of Austerity in Ireland

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Ireland has featured prominently in recent times as the most successful of the countries that have been required to implement tough austerity budgets since the onset of financial crisis in Europe in 2008. The EC-IMF-ECB (Troika) loan programme which Ireland entered in December 2010 has severely constrained domestic budgetary discretion: all budget decisions must be cleared with the Troika, fiscal performance is subject to quarterly reviews, and Troika personnel are embedded in the core government departments. But it has been noted that, since Ireland has a strong export-oriented sector, if recovery through austerity can take place anywhere, it will be here. The official Irish government position is that Ireland is indeed complying well, and the current Prime Minister Enda Kenny has been pleased with his accolades, including an appearance on the cover of *Time* magazine under the title 'The Celtic Comeback' in October 2012, followed by the award of the title of 'European of the Year' in Germany. As Ireland took over the presidency of the EU in January 2013, Kenny announced that Ireland hoped to exit the Troika bailout programme before the end of the year.

But it would not be unduly sceptical to suggest that much of this upbeat talk is built on wishful thinking. Or more accurately perhaps, to suggest that the real purpose is to prepare the way for Ireland to make a hard case for better terms on part of its debt liabilities, particularly those to do with recapitalizing the banks, since this is the component of Ireland's fiscal crisis that is the most crushing and about which there is strongest public discontent. The Irish financial *cum* sovereign debt crisis is directly related to a decision in September 2008 to guarantee all the private liabilities of its principal national banks, without full

information, but under severe pressure from domestic banking interests. To put the Irish case in a comparative perspective, Ireland accounts for 1.2 per cent of the Eurozone population and less than 2 per cent of GDP, yet it has paid 42 per cent of the total cost of the European banking crisis. In the aftermath of this government decision, the public debt-to-GDP ratio increased from less than 40 to almost 100 per cent; it is due to hit 120 per cent at the end of 2013, just as the EC-IMF-ECB funding is due to run out. Despite this, the Troika adjustment program remains firmly fixed on reducing the fiscal deficit to 3 percent of GDP by 2015, with major implications for economic performance and for the democratic welfare state.

For while it is true that Ireland has been achieving its fiscal retrenchment targets, and at a relatively low cost to date in terms of social and political conflict, it is also the case that the Irish experience confirms what most economic theory has always taught, which is that contractionary budgets produce economic and employment contraction. The Irish economy has experienced a severe downturn since 2008 and is currently flat-lining; living standards have fallen; both unemployment and emigration have risen. The political and social costs of managing austerity are rising rapidly. We outline here the scale of the fiscal effort that has been made to date in Ireland, and the implications for economic and employment growth. We analyse the manner in which fiscal adjustment has been undertaken, and the implications for the profile of spending cuts and tax increases, and we then consider the distributive consequences. Finally, we consider where the main lines of conflict lie between what Irish recovery prospects need and what the European policy framework permits.

## **The scale of adjustment**

Ireland experienced a very sudden worsening in its fiscal balance with the onset of the crisis. During the buoyant 2000s, government ran small deficits and sometimes a small surplus. But weaknesses had been built up in the public finances during these years of house-price inflation that worsened the effects of the crisis. A series of exemptions had narrowed the tax base; additional spending commitments had been incurred; and increasing reliance was placed on

revenues flowing from property-related transactions. The tax base was increasingly narrowed, and 50 per cent of employees were taken out of the income tax net altogether. When credit stalled and construction activity abruptly came to a halt in 2008, the gap between public expenditure and revenues diverged sharply, resulting in a deficit of -7.3 per cent of GDP in 2008 and -14 per cent in 2009 (1). During 2008/9, government revenues fell by almost €18bn or 20 per cent of GNP. Given the rapid rise in unemployment, and associated social protection payments, government expenditure increased from 37 to 47 per cent of GNP (2).

But what has proven particularly difficult to manage in Ireland is the consequences of bailing out the banks. The state guarantee for the liabilities of six main domestic financial institutions was intended as a short-term measure, on the assumption they were facing a liquidity crisis. In fact, risky lending had been undertaken on such a scale that the banks were insolvent. The total cost to the Irish taxpayer amounted to €64bn, or about 40% of GDP (3). In effect, Irish taxpayers have 'taken one for the team', preventing the Lehman-style collapse of a collapsed Irish bank, which could have had catastrophic consequences for the whole European banking system. But in the absence of any Europe-wide bank rescue mechanism, the ECB has resisted Irish proposals to restructure this debt. Therefore the terms on which the recapitalization of the Irish banks is funded continue to be a contested issue in relations between the Irish government and European officials.

Ireland has managed to meet its fiscal adjustment targets to date, and the deficit in 2013 is expected to be below the deficit ceiling of 7.5 per cent of GDP. But the growth projections on which depends the credibility of the loan programme have consistently had to be revised downward. Irish GDP is barely into positive terrain, with an out-turn of about 0.5 per cent in 2012, as export performance slowed in the context of weak demand in other markets. What is most worrying is that the domestic economy is in a much worse condition than GDP data suggests. This is because of a peculiarity of the Irish economy, whereby the exporting sector is largely powered by foreign-owned US investment, which is largely impervious to cyclical tendencies, but which repatriates most of its

profits. But the bulk of employment is in the domestic economy, in traded manufacturing and services and in the non-traded service sector. Between 2008 and 2011, real GDP declined by 11.8 per cent, while real GNP declined by 14.5 per cent, implying a more severe reduction in domestic living standards than is reflected in the GDP data.

The ex ante fiscal effort undertaken by government between 2008 and 2012 amounted to about €24bn, which represents 16% of GDP in 2011. The general government primary balance improved by some 7 percentage points between 2009 and 2012. Only Greece (14.5 points) and Iceland (9 points) experienced larger adjustment; the change in Spain and Portugal was almost as significant as in Ireland. The further adjustment measures to be introduced in Ireland between 2012 and 2015 are expected to come to about €8.6bn, or an additional 5% of GDP. In total therefore, between 2008 and 2015, the Irish economy will have experienced total cuts of about 20% of GDP. And this doesn't take into account any of the multiplier effects on unemployment, output, and prices, following from the withdrawal of demand from the economy (4, p.13).

### **The composition of fiscal adjustment**

Ireland's budget deficit management relies on expenditure cuts for about two-thirds of the adjustment, and tax increases for one-third. This is consistent with 'orthodox' liberal views about the appropriate policy mix of fiscal adjustment (5). In assessing the fiscal adjustment of both the centre-right Fianna Fáil-Green and the centre-right Fine Gael-Labour coalition, it is important to analyse what is 'off the agenda', to illustrate the domestic political (as opposed to Troika-induced) choices that have been pursued. The composition of the Irish policy package is shaped by a number of compromises reached with important actors in Irish public life. A key element is the priority accorded to maintaining Ireland's low tax regime, particularly in relation to the business sector.

The 12.5 per cent corporate tax rate, which is the lowest in the EU15, remains unchanged; it is the central element of Ireland's industrial policy to attract inward investment and promote export-led recovery. This reflects a consensus amongst all of the main political parties in parliament, employer groups and

some trade unions, that any attempt to adjust corporate tax rates would lead to capital flight and a collapse in foreign direct investment. It also underpins the Irish government's decision to oppose the introduction of a coordinated European Financial Transaction Tax (EFTT) in the Eurozone. There has been no increase in social insurance contributions for employers, which remain the lowest in the EU15, and there has been no change in marginal income tax rates, though there have been changes to exemptions and tax credits, and to the ceiling on social insurance liability. The average tax take for all households has increased, especially through indirect measures. But marginal rates remain below the European average, with only Spain, Portugal and Greece taxing high-income households less. This commitment to a low-tax regime is part of an overall policy preference to maintain Ireland's business-friendly labour market. According to Eurostat and the OECD, Ireland has the second most flexible labour market in the EU, and this is defended as a comparative advantage by government officials (6).

The preferential consideration given to corporation tax, and the priority accorded to keeping income tax rates constant, has important implications for the distributive impact of fiscal consolidation. It means that tax increases must be found in other areas. It also transfers the burden of fiscal adjustment onto the public sector, through cuts in pay and services, including downward pressure on social welfare payments where demand is increasing due to rising unemployment.

Ireland's welfare regime relies heavily upon tax expenditures (or tax breaks) as a mechanism to encourage the private purchase of social services, including health, education and pensions. In 2005, it was estimated that tax expenditures in Ireland were equivalent to some 18 per cent of all tax revenue, compared with an average of 5.6 per cent in 22 other EU countries. Some of these have been closed off, but those related to private pensions and finance are still generous compared with provisions in other countries, including Britain. In 2011, the Fine Gael-Labour government introduced additional tax breaks for the financial sector, to incentivize corporate executives to relocate from London to Dublin.

The commitment not to increase income tax rates or introduce a third, higher rate of income tax was central to the electoral platform of the main political party in government, Fine Gael. Most of the tax increases have been implemented through indirect measures such as an increase in VAT. A universal social charge has been put in place. So too has a flat rate of tax for all households, originally set at a low level, and subsequently changed into a higher-yielding property tax based on the value of the house. This tax has been the focus of a widespread discontent in response to austerity measures in Ireland. It reflects an implicit constraint facing policymakers and government. In the good times, the Irish economy could commit to higher public spending while sustaining a low tax regime. The electorate now experiences higher and more visible taxes, just at the moment when the quality of public services becomes significantly worse.

### **Distributive implications of fiscal adjustment**

In 2009 and again in 2010, the government cut public sector pay by a total of 15 per cent on average. This was designed to send a signal to the rest of the economy that internal devaluation requires downward wage flexibility to improve national competitiveness. In 2009 the Fianna Fáil-Green party coalition cut the minimum wage by 15 per cent, but this was restored by the Fine Gael-Labour coalition in 2011. But there is minimal evidence that wage reduction strategies have been pursued in the private sector. Both pay and employment in the export-oriented FDI sector remained relatively buoyant, in the context of high reported productivity. Most of the adjustment in the domestic business, retail and construction sectors has occurred through employment losses. Unemployment surged from 6.4 per cent in 2008 to 14 per cent in 2010, and almost 15 per cent in 2012. These figures, however, mask the extent of the employment crisis. Long-term unemployment (over one year) is rising, from half of those unemployed in 2010, to 60 per cent in 2012. Since 2008, net emigration has increased rapidly (82,000 in 2012), and is currently acting as a safety valve in the Irish labour market. The job vacancy ratio is 54:1. Only one-quarter of those aged 15 to 24 are working, down from half before the crash, and this cohort is shrinking significantly through emigration. In the absence of mass

emigration, youth unemployment figures would be closer to those in Southern Europe.

Social welfare payments were reduced at a rate comparable to public sector pay in 2009 and 2010. The Fine Gael-Labour coalition committed itself not to cut headline social welfare rates further. But not cutting headline rates masks significant cuts in the payment of child benefit, carers' allowances, single parent supplements, and other transfers and services targeted at vulnerable groups. Eligibility and means-tested criteria for benefit payments have become more stringent, reinforcing the liberal nature of Irish social assistance. Indeed, Ireland has the highest proportion of social protection payments that are means-tested in the EU15. Presently, those who are over 21 and unemployed receive a flat-rate monthly payment of €188 for 12 months. Under pressure from the Troika's structural adjustment priorities, it is anticipated that this payment will be reduced to 9 months. Labour market policy is now firmly focused on supply-side reforms aimed at workplace activation, even though the employment crisis is principally due to the collapse in domestic economic demand.

In addition to cuts in public sector pay and social security payments, the government adjustment strategy has relied heavily upon downsizing the public sector (health, education, security and civil service) through voluntary redundancies. The political process through which this has taken place has been a centralized public sector agreement between the state (represented by the Department of Finance, Expenditure and Reform) and the public executive committee of the Irish Congress of Trade Unions (ICTU). This deal, known as the 'Croke Park' agreement after the conference centre in which it was negotiated, was agreed in mid-2010. This is not a tripartite social pact involving private sector employers, but a sectoral agreement between government as employer and public sector trade unions (and professional associations). It breaks significantly with the Irish industrial relations tradition developed in the 1990s and 2000s of encompassing and competitive oriented social partnership agreements aimed at employment growth.



The core features of the 'Croke Park' agreement include a government commitment not to impose further pay cuts until 2014, in return for industrial peace and productivity increases; reform of the bonus payment system; a recruitment embargo in the health and education sectors; and significantly reduced pay and conditions for new entrants to the public sector. The bulk of cost savings are taking place through voluntary redundancies and early retirement, in an attempt to reduce the pay bill by a further €3bn by 2014. Since 2008, public sector employment has been reduced from 320,000 to 291,000, a drop of over 30,000 employees, mostly lost from health and education. This is despite the fact that the public sector in Ireland remains relatively small compared to international standards. In 2011, Ireland recorded one of the lowest levels of industrial action: there were only eight strikes (or 4,000 days lost), despite the employment crisis and unprecedented austerity budgets. The Croke Park agreement has delivered on its core objective, which is to deliver political stability for government whilst they implemented the EC-IMF-ECB adjustment program (6).

In 2013, the government will have a choice whether they want to renew the Croke Park agreement with the public sector unions, or proceed with further unilateral pay cuts. It appears likely that an agreement will be renegotiated, based on another policy package of reducing costs through employment numbers rather than wages. The impact of this strategy of fiscal adjustment is twofold. First, it reinforces a trend toward labour market dualization: new entrants will be entering into the public sector on significantly reduced pay and conditions, compared to their older unionized colleagues. In turn, this is feeding into a public backlash against what is perceived to be an insider deal obtained by the higher echelons of the public sector (with a high wage premium and secure employment), in the context of an increasingly precarious private sector labour market. Secondly, if the government is committed not to cut social welfare and public sector pay, then it is inevitable that social services will be hardest hit in the additional austerity measures to be introduced between 2013 and 2015.

The net distributive consequences of budget measures can be hard to assess, and there all sectors have grounds to feel aggrieved (7). But the Irish Central

Statistics Office (CSO) suggests that the cumulative outcomes of Irish fiscal adjustment, particularly the 2012 budget, have been regressive. According to the Survey on Income and Living Conditions (SILC), the bottom decile has seen net disposable income reduced by 25 per cent, whilst the income of the top decile increased by 5 per cent. Consistent deprivation levels have increased. So too has the percentage of those at risk of poverty, which has risen to 15.8 per cent or 700,000 people, of whom 220,000 are children. The modest gains that were achieved throughout the Celtic Tiger period in reducing household poverty have effectively been reversed.

### **The unresolved issues**

Official EMU policy requires the countries of the EU periphery that are currently in crisis to undertake sharp fiscal correction in a tight time-frame, and this imperative is all the more pressing for the countries that are currently in loan programmes (Ireland, Portugal, and Greece). The assumption is that by persisting with efforts to reduce their fiscal deficit, these governments will increase market confidence in their performance, which will benefit their capacity to borrow on the open markets. Furthermore, by engaging in internal deflation, they are expected to become more competitive relative to other countries, which is meant to boost exports and to encourage private sector investment.

But all these assumptions are seriously problematic. Ireland has undertaken a particularly severe internal deflation, as Figure 1 here shows.

Figure 1. Internal devaluation in the European periphery

But none of the pain that has been endured by the populations of the countries of the European periphery is translating into growth. Besides, while they gain in competitiveness relative to their earlier experiences during the period of excessively cheap credit, Germany is doing the same. This is a beggar-my-neighbour cycle, and the knock-on deflationary effect between countries further intensifies domestic contraction. Investment is stagnant because demand is

lacking. Eurostat expects Ireland to have the lowest level of public and private fixed capital formation in the EU in 2013.

But even if there was an appetite for new private investment, funding it would prove very difficult. There are still major unresolved problems in the Irish banking sector, and until these are resolved it will be difficult to see how any recovery is possible. The two main functioning Irish banks are second only to those in Greece in their low rates of lending activity. They have received massive amounts in bail-out funds, and their ravaged deposit base has largely been replaced by ECB-provided liquidity. But they are now exposed to a growing volume of non-performing household debt, especially mortgages. Furthermore, the terms of the bail-out itself create disincentives for the banks to function as normal lenders. The Irish government is on the hook for the repayment schedules. The close link between banks and sovereign debt, in Ireland as elsewhere, has not been broken but is in many ways closer than ever.

This is why there was great interest in Ireland over the statement from the Euro Area Summit on 29 June 2012, which seemed to indicate a willingness to move quickly to permit the European Stability Mechanism (ESM) to take over bank recapitalization. This statement also seemed to recognize that the commitment already undertaken by the Irish state to shoulder the whole burden of bank rescue should be replaced by ESM. Equity funding would function as a form of 'patient capital' stake in Irish banks, as the IMF proposed in December 2012. This would improve the prospects of the Irish banks returning to profitability. It would support a fall in the debt-to-GDP ratio, which in turn would increase the chances of Ireland being able to exit its loan agreement on schedule.

However, as so often happens with EU summitry, the waning of the sense of crisis meant that putting new ESM measures into place soon seemed less urgent. The ESM timetable has now been put back until after the creation of a new bank supervisory mechanism, and indeed until after German elections in autumn 2013, and the appetite for negotiating a suitable deal with Ireland has noticeably waned.

Ireland has another urgent problem relating to its bank bail-out though, and this is now at the centre of Irish lobbying activity both with the European Commission and within the ECB. This concerns the 'promissory notes' to fund the €28.5bn bail-out of Anglo Irish bank, which the rescue vehicle known as IBRC must repay. The terms of the deal currently in place are 'equivalent to the state borrowing money at expensive terms to repay a low-cost interest-only perpetual loan' (8, p.662), with massive implications for the sustainability of the public debt. The government was able to raise some fresh loans on the sovereign debt on the open market at acceptable interest rates toward the end of 2012, suggesting that exit from the loan programme may be feasible. But many aspects of expected performance, and indeed of debt manageability, depend on growth projections that have, time after time, been downgraded, making current debt-GDP ratios even more burdensome. ECB permission for some form of restructuring of this debt is therefore considered to be a very high priority for the Irish state. Irish governments have not openly challenged or opposed the current European policy framework, but have implemented all the terms of the onerous fiscal adjustment, including the full weight of the bank bail-out, and on schedule. The clear expectation from the Irish government side is that some form of pay-back is now due.

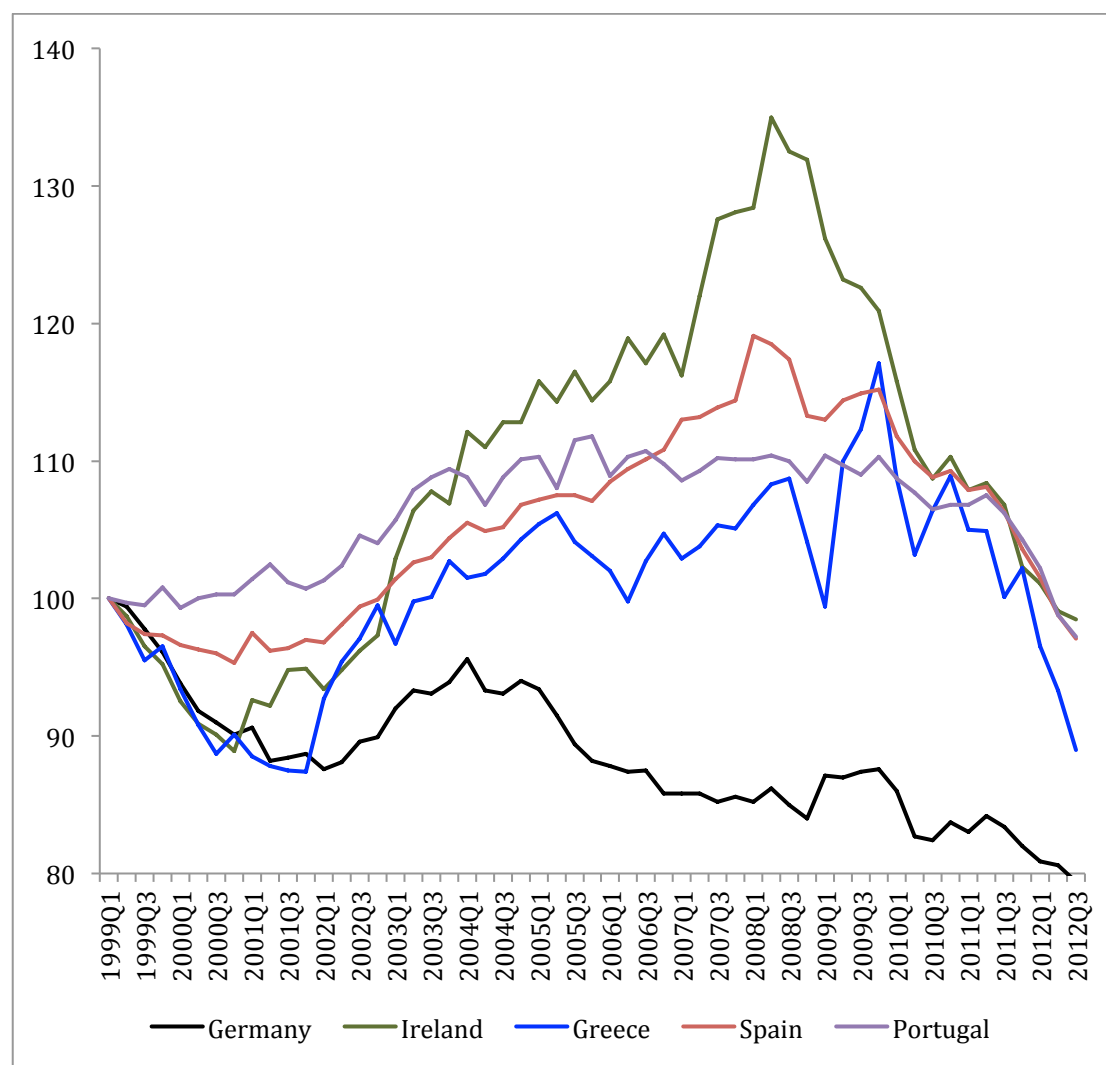
## **Conclusion**

Ireland has endured significant hardship in implementing austerity budgets since 2008, in response to the international financial crisis. As in other Eurozone periphery countries, this has further slowed economic activity, which in turn has further depressing revenues and intensified the effort required to reduce budget deficits. The scale of the Irish deficit, and of the accumulated debt, is very much worsened by the terms of the bank bail-out. Large numbers of people now feel the effects of increases in direct and indirect taxes, and of the visible worsening of public services, especially in health and education. Many sectors of employment have suffered badly, and many businesses are on the brink. Persistently high unemployment, unserviceable mortgages, and houses in

negative equity, have a demoralizing effect over time. The skills and talents of a whole generation of young people are put to waste.

So far, Irish governments have managed to implement the terms of the EC-IMF-ECB loan programme on schedule and without major social conflict. But there are indications that this situation may not persist indefinitely. Unlike other countries, no systematic reckoning has been undertaken of what exactly happened and why, and who was really responsible and for what, in the run-up to the crisis and in the early stages of its management, when some of the most catastrophic decisions were taken. While renewed emigration siphons off a good deal of youth discontent, there is still real anger over what has happened. An active if still fairly low-level tax resistance movement is welling up. The electorate took its revenge on the one-time establishment party, Fianna Fáil, which was devastated in the election of February 2011; the incoming coalition of Fine Gael and the Labour Party gained a historic majority. But the implosion of one pole of political competition leaves a whole new range of potentially unaligned political opinion. Confidence in political institutions is at an all-time low. Ireland awaits a European game-changer. It is all we can hope for.

Figure 1. Internal devaluation in the European periphery



Source: Harmonized competitiveness indicators based on unit labour costs indices for the total economy, 1999Q1=100. ECB Statistics Website. Accessed 16 January 2013.

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