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The politics of fiscal effort in Spain and Ireland:

Market credibility versus political legitimacy

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Abstract

Austerity measures in response to Eurozone crisis have tended to be conceived, debated, and implemented as if only the technical parameters of budget management mattered. But policies that impose budgetary hardships on citizens, whether in the form of increased taxes or cuts to public spending go right to the heart of voter expectations about what it is both appropriate and acceptable for governments to do. Pro-cyclical measures that worsen an already difficult situation in a recession run counter to deep-seated norms and expectations in European countries, built up over decades of democratic governance, whereby governments are expected to provide offsetting protection for their citizens against the vicissitudes of the market. If austerity measures are held to be unavoidable in response to market turbulence, and especially if this view is underwritten by international authorities, new challenges of political legitimation are likely to arise. These issues are explored through the experiences of Spain and Ireland.

Variations in extreme austerity

The crisis that engulfed the Eurozone from 2008 onward may be classed as extreme by any standards, in duration and severity. The interactions between financial and fiscal politics at national level proved difficult to manage effectively at national level, yet the mechanisms for policy coordination at European level were few and strengthening them proved to be fraught with political obstacles. The approach taken to crisis resolution, whereby each country's problems were to be addressed one at a time, proved particularly burdensome for the worst-affected countries of the periphery, in the absence of any early prospect of debt mutualization, bank resolution mechanisms, or sizeable fiscal transfers.

The Greek experience has undoubtedly been more severe than that of the other periphery countries experiencing crisis, that is, Ireland, Spain, and Portugal. This paper focuses on the tension that national governments within the Eurozone face in making tough choices in hard times, between the need to devise policy responses that will stabilize market expectations about economic performance on the one hand, and the pressures to maintain responsiveness and accountability to their own voters. The dynamics of political competition between the main political parties are central to accounting for what governments choose to do. We wish to show that crisis conditions heighten the difficulties governments experience in bridging the twin demands of economic stabilization and political legitimacy, and that this plays out rather differently depending on the nature of the political cleavages and the degree of policy convergence across the main political parties.

We explore these issues through the divergent experiences of Spain and Ireland. Countries' responses to crisis between 2008 and 2010 initially displayed a range of variation. In response to a G8 initiative, many countries put stimulus measures in place to counteract the severe contraction in the wake of the financial crisis. These involved different combinations of tax cuts and spending programmes, and have been credited with preventing the headlong tumble of the developed economies into 1930s-style depression (Eichengreen & O'Rourke, 2010). But Ireland and Spain responded very differently (Armingeon, 2012; Dellepiane &

Hardiman, 2012b). Both countries had comparably low levels of aggregate debt and no fiscal deficit, so on the face of it, they had comparable levels of fiscal 'headroom' to engage in stimulus measures. But while Spain was among the most fiscally active in supporting economic performance through fiscal intervention, any small stimulus at work in Ireland was an overspill from the pro-cyclical measures the government had been running in the years before the crisis hit. Between 2008 and 2010, Ireland undertook a fiscal contraction that was larger in scale even than Iceland's (OECD, 2010, p.290).

During this time, however, the growing severity of the crisis in Greece had made European policy leaders ever more anxious about the fiscal balances across the Eurozone – a key policy indicator of Eurozone stability, in accordance with the terms of the Stability and Growth Pact (SGP). Greece's slide into an emergency loan agreement in May 2010 was a moment of acute nervousness among market actors, when fear of a contagion effect reached a new peak. At this moment, we find the Spanish government under extreme pressure to do something to provide reassurance to the highly volatile international markets – and experiencing pressure from European and other international policy makers too. The only apparent resources with which to regain market confidence were those of fiscal austerity. From May 2010 therefore, we see a sea-change in official policy in Spain with a sharp turn toward austerity measures.

From this point, Ireland and Spain were on convergent policy paths, locked into the politics of austerity in order to regain market credibility. In Ireland, orthodox measures were already in place, but the intense economic pressure to bring down the deficit and control the debt, in the face of escalating interest rates, forced the government into entering an EC-ECB-IMF loan programme in November 2010. In the process, where Irish taxpayers were required to take on the total losses of the banking sector while private bondholders were fully reimbursed, which raised the total volume of debt by about one-third by 2013, and the total cost of which is estimated ultimately to reach some 40% of GDP.

The scale of fiscal effort in the Eurozone periphery has been considerable. Figure 1 shows that Greece made the most dramatic improvements among OECD

countries in its primary fiscal balance between 2009 and 2012, and after Iceland, Ireland and Spain were the next most successful in these terms.

Figure 1. The scale of fiscal effort, 2009-2012

However, the political capital expended on making these considerable efforts has not necessarily paid of in terms of improving the recorded fiscal deficit. For the deficit is a function not only of governments' efforts to cut spending and raise taxes, but also of the performance of the economy itself, since recessionary conditions dampen the revenue base while pushing up claims on automatic entitlements. Table 1 shows that governments have experienced different levels of success in meeting their mandated targets. Greece, mired in the deepest levels of recession, has found it most difficult to reach the required goals; Spain has suffered repeated slippage; Ireland has mostly managed to perform to target, but even at that, there was often slippage on particular items such as healthcare spending, and the postponement of targets between reporting periods, which darken the story somewhat (European Commission, 2013a, p.214).

Table 1. Expected and actual deficit out-turns in Greece, Spain, and Ireland

The competing imperatives of market credibility and political legitimacy

The global economic crisis exposed sharply divergent views about the political economy of democratic societies, and these had far-reaching implications for managing conflicts between committing to economic stabilization measures and ensuring the democratic sustainability of these measures. One the one hand were the voices of those adopting a Keynesian perspective on macroeconomic performance, who argued that no fiscal corrections should be undertaken in the depths of recession, when output was falling and unemployment rising. Stimulus measures, in this view, should be sustained until growth was re-established, and only then should excessive deficits and cumulative debts be addressed. On the other hand, the orthodox economic perspective that had taken hold since the 1980s, round which neo-classical and New Keynesian views converged, was strongly averse to the emergence of large deficits and rising debts.

The Eurozone had no institutional capacity to treat the members of European Monetary Union as a macroeconomic entity within which stimulus now could be balanced against fiscal stabilization during a subsequent recovery (Dellepiane & Hardiman, 2010). Official policy insisted that fiscal contraction must be undertaken to conform to the deficit rules of the SGP. From 2009, therefore, we may discern a growing official preoccupation with securing market credibility as a measure of the success of a government's policy stance.

The orthodox perspective, committed to the view that reducing deficits was a precondition for the resumption of growth, drew upon an older and contested literature on fiscal consolidations of the 1990s which held that fiscal contractions could be expansionary, and that spending cuts were a more reliable route to sustained budget stabilization than tax increases. The logic was that by displaying a commitment to tackle budget deficits by reducing demands on the public purse, governments would gain credibility among investors as the guarantors of a business-friendly environment, and that new investment would follow that would generate a new phase of sustained growth. Thus building the confidence of the markets became the keystone of European responses to crisis.

At this time though, market confidence in the capacity of sovereign governments to manage the crisis was very volatile. Between 2002 and 2008, interest rates across the Eurozone had converged upon German rates. But from 2008, when investors realized that there was in fact no prospect of debt mutualization, no burden-sharing of the cost of rescuing failed banks, and no fiscal transfers to alleviated the costs of adjustment, what had been a financial and a fiscal crisis suddenly became a sovereign debt crisis as well, as the peripheral governments encountered sharply rising costs of rolling over their own debts. As De Grauwe and Yi have argued, market panic in the face of European policy disarray caused interest rates to diverge dramatically. The orthodox response to this from the European policy-makers, was to require countries to address this within their own national policy resources. Regaining market confidence was interpreted in the orthodox view as a matter of displaying commitment to closing budget deficits and bringing down debt. The official response to market panic was a panicked imposition of austerity (De Grauwe & Ji, 2013).

The economic feasibility of doing this in the depths of recessionary conditions was challenged from the outset. But the political sustainability of such a strategy had been accorded very little if any weight by its framers (Blyth, 2013; Dellepiane, 2012). Adjusting to market requirements was treated primarily as a technical matter. When this proved deeply politically unpopular, the European policy makers were at a loss. In the countries that proved least politically capable of driving these measures through in Greece and in Italy, temporary technocratic governments were appointed. European leaders proved willing to dispense with democratic processes altogether to ensure that orthodox policies were sustained.

Under standard assumptions about democratic governance, governments must consider whether or not they can win enough popular support to implement policy. Opposition can come about immediately through popular protest, or at election time, when the incumbent government may risk losing power. We know relatively little about the conditions under which governments can undertake austerity measures on a sustained basis. Earlier phases of fiscal retrenchment seemed to suggest that it might be possible if the government could persuade enough of the electorate that the measures were unavoidable; if there is cross-party agreement on the objectives such that they cannot be derailed through adversarial party competition; and – crucially – that the austerity measures would be no more than a temporary correction (Mauro, 2011). But in a democracy, there are likely to be limits to how long voters will endure ongoing hardships without looking for protection from their consequences, and ultimately for an end to these policies (Polanyi, 1944/2002).

Efforts to secure political legitimation for the new politics of austerity became increasingly problematic. Democratic politics implies that government will act in the interests of its national constituency. Political contestation may divide opinion, often sharply, but the institutional framework requires that those who exercise power both represent and are accountable to those who vote for them. But increasingly, the key decisions affecting the citizens of a state are made at a level beyond that of national political debate. National politicians find that they are required to be 'responsive' to their own voters; but the matters on which

they have to make decisions are not within the control of national politics, and they are required to be 'responsible' to stakeholders beyond the state's borders (Mair, 2009, 2011). Indeed, the transnational mobility of capital, and the globalization of economic activity more generally, means that many aspects of international market activity are not accountable to any democratic forum. International coordination on matters such as the codification and enforcement of regulatory standards are a limited substitute for the equivalent of national democratic governance systems at a transnational level (Crouch, 2011; Koppell, 2010; Rodrik, 2011).

The link between voters and their representatives is further attenuated by other developments in party political organization: the mass parties of old, which were deeply rooted in their membership and closely tied to the advancement of common concerns and issues of collective interest, have given way to a professionalized cadre of professional politicians. Public opinion has become more fragmented, and more likely to be expressed through other kinds of civil society organizations including single-issue pressure groups and loosely structured new social movements (Crouch, 2004). The implication of this is that political parties are not well positioned to take up and advance the grievances of their own voters. Yet they are required to be ever more attentive not only to the policy-makers at the level of trans-national governance, such as the European Commission, the European Council, and the European Central Bank, but also to the preferences of transnational economic actors such as international lenders, corporate investors, and big businesses.

In the Eurozone, when 'fiscal effort' did not translate into sustained improvements in fiscal deficit outcomes, countries found that the political credibility they had expended on making the fiscal adjustments did not necessarily translate into gains in market credibility. As Figure 2 shows, as late as autumn 2009, the Eurozone states were able to secure long-term loans on the bond markets at rates that were very similar to those of Germany. Over the following years, the dearth of credit caused an economic contraction that worsened fiscal balances, which in turn contributed to making fresh loans more difficult to secure. And yet interest rates appeared to vary not only in relation to

economic fundamentals and the realities of governments' fiscal effort, but were also shaped by market expectations of European actions to alleviate issues of debt sustainability and financial sector recapitalization (De Grauwe, 2013).

Figure 2. Ten-year interest rates on government bonds

Long-term structural shifts in the reach of political power, combined with the problems of the governability of the Eurozone economy in the wake of crisis, raised two new questions about the interplay between economics and politics. Firstly, the politics of austerity, so far from creating the conditions for renewed growth, has pushed the countries of the Eurozone periphery into new self-perpetuating cycles of low growth and high unemployment. Secondly, it became clearer that the sustained implementation of austerity exerted a high political cost on the legitimacy of the mainstream parties, with implications for democratic politics itself that are as yet unclear.

And yet there are also important variations not only in the way governments have responded to crisis, but also in the extent to which they have managed to bridge the conflicting imperatives of gaining market credibility and sustaining political legitimacy. The contrasting dynamics of party politics in Spain and Ireland help us to understand these differences.

Credibility and legitimacy issues in Spain

The Spanish government's first response to the emergence of international economic crisis was to claim that its relevance to Spain was minimal. The Socialist Party (PSOE) had been re-elected in March 2008 at a time when concern was already mounting, as in Ireland, over the sustainability of the housing boom that had gathered pace under the low interest rate regime of European Monetary Union. Prime Minister Zapatero initially preferred to characterize the situation as an economic slowdown, through which the hoped-for 'soft landing' would resolve the asset price bubble painlessly. Moreover, spending commitments in the run-up to the election (including an annual income tax rebate and a grant for new-born children), following on a series of expansionary budgets, were predicated on continued economic buoyancy. As in Ireland, fiscal populism based

on lower taxes and higher spending under conditions of growth had yielded electoral benefits, even though this weakened the bases of government's fiscal capacity. Nevertheless the PSOE government implemented an early fiscal stimulus, mostly in the form of tax cuts and extra welfare entitlements, as a counter-measure to what was depicted as a temporary weakening in domestic demand. This was viewed as entirely consistent with the European Economic Recovery Plan. Discretionary fiscal stimulus in Spain accounted for 2.4% of GDP in 2009, as opposed to only 0.3% in Ireland (European Commission, 2009, 2010).

The budget for 2009 gave effect to a number of the spending commitments promised in the election campaign, based on projections of GDP growth of 1% and a deficit of 2%. These quickly proved to be unrealistic. It became clear that Spain had indeed entered a crisis when the actual outturn was a fall in GDP of 3.7% and a fiscal deficit of 11.7%.

Once the severity of the economic crisis became clear, Zapatero adopted what he termed a 'Social Democratic approach to the crisis'. The budget for 2010 was intended to phase out the extraordinary stimulus that had been in effect during 2009, not by cutting spending, but through a revenue-based consolidation strategy. The Budget for 2010 was primarily based on revenue-increasing measures such as withdrawing the earlier tax rebate and increasing VAT, which raised taxes by about 1.5% of GDP. The overt objective was to protect core social spending and to shield welfare beneficiaries from the effects of the downturn. For example, in one of his speeches Zapatero said 'I am going to ask for a share of people's income out of solidarity and to meet the demands of the most needy'. The conservative opposition Partido Popular (PP), in contrast, argued for spending cuts to be introduced.

The pivotal moment in Spain's fiscal response to crisis came in May 2010, and it was triggered by the crisis in Greece. Paradoxically, Spain's fiscal fundamentals were not in bad shape at this time. Its projected debt for 2010 stood at some 65% of GDP. It was a combination of market panic, and panicked international political response to the Greek crisis, that put enormous pressure on Zapatero to change political course. According to insiders, the pressure was simply

'unbearable'. Over the 8/9 May weekend, Merkel and Sarkozy "demanded" an immediate €30bn cut in the Spanish budget (Merkel especially stressed that the sacrifice must engage pensions). International pressure also involved telephone calls by many leaders, including President Obama.

Ironically, only weeks ago, Strauss-Kahn, the then IMF General Director had allegedly warned Zapatero about the sizeable risks associated with an early withdrawal of fiscal stimulus (taking into account Spain's available fiscal space and notably high unemployment). This suggests that the big policy reversal of May 2010 might have been surrounded not only by high levels of uncertainty, but also by a good deal of improvisation. As Ortega and Pascual-Ramsay (2012) argue, the Spanish government was compelled to implement the adjustment quickly (in a matter of days!), without much reflection, and of course without enough time to deliberate and build consensus, let alone develop a convincing political narrative. In the event, the austerity package, widely constructed by the media as "the major social adjustment under democracy", was approved in parliament by only one vote.

In what was depicted as a 'Copernican shift' in the government's stance, a new emergency budget intensified the pace and impact of the deficit reduction programme announced in the 2010 Budget, and switched from a revenue-based to a spending-based strategy. The dramatic shift in fiscal strategy aimed to secure €15bn in spending cuts for the second half of 2010 and into 2011, or 1.5% GDP. The plan was to achieve a debt to GDP ratio of 60.1% for 2010, instead of the previously forecast 65.9% - relatively low debt levels by European standards. The measures included direct cuts to civil service salaries of an average of 5% in 2010 and an ongoing freeze in 2011, cuts of 15% to politicians' pay, changes to pension entitlements, elimination of the headline-grabbing grants to infants, elimination of dependency benefits, and cuts to the public capital programme (Mulas-Granados, 2010).

These measures represented a radical break from the government's prior fiscal stance, and it was a very difficult moment for the 'social Zapatero' who had insisted upon the primacy of Social Democratic priorities over market pressures.

But market pressures were probably part of the story. It seems that Zapatero having notoriously failed to accept and confront the crisis on time, felt compelled to go overboard to restore its highly damaged reputation. Indeed, avoiding the national humiliation of an European bailout "at all costs" became his overarching mission (Sanchez-Cuenca 2012; Estefania 2013). The social approach to the crisis was practically abandoned in favour of an "epic" rhetoric based on the ideas of necessity, responsibility and collective effort (Ortega and Pascual-Ramsay 2012). This over-commitment to the austerity cause, reflected in the reluctance to enforce compensatory measures, but also in PSOE's counter-intuitive parliamentary support to the constitutionalization of budget limits in August 2011, further alienated Zapatero's constituents.

In any case, it is far from clear that the change of fiscal direction and political strategy actually succeeded in securing market confidence. Successive moves to tighten fiscal policy were intended to signal to the markets that the government was serious about deficit reduction. But we can see from the ratings' agencies assessments of Spain's prospects, in Figure 3 below, that each moment of tightening was followed by a downgrading of its loan status – because of expectations that growth would be further dampened.

Figure 3. Ratings agencies' ratings for Spain

The about-turn in fiscal strategy during 2010 was driven by the perceived need to restore market credibility. But from this moment, we can see that a considerable political cost was exerted on the Socialist government. From May 2010 onward, Zapatero was obliged to prioritize market credibility over the party's programmatic priorities, and this made it difficult to sustain the party's core support in the teeth of painful fiscal retrenchment. The May 2010 Emergency Plan was a turning point in the PSOE's popularity, illustrating the difficulties in both accommodating market pressures and building democratic legitimacy. The minority PSOE government lost the strategic support of all the small left-leaning groups (including BNG, ERC and IU) on which it had relied to secure voting majorities in parliament. These were alienated not only by the shift

in focus toward spending cuts, but also by the lack of balancing measures such as the apparently favourable treatment of wealth and of high-income earners.

From May 2010, as Figure 4 shows, we can see a steep decline in confidence in the government. A socialist deputy said in May 2010 that 'today we have lost the next general election'. Indeed, the first of what was to be a series of general strikes was held in September 2010.

Figure 4. Opinion poll ratings of political parties in Spain

Zapatero's government continued to pursue measures oriented toward bringing down Spain's fiscal deficit, in an orthodox contractionary manner. The Budget for 2011, introduced at the end of 2010, came at a time of ongoing instability on the bond markets. Ireland entered an EU-IMF loan programme at this time, and speculation was running high as to whether Portugal or Spain would be next in line. The prospect of Spain needing a rescue programme was the great worry for European decision-makers: it was thought 'too big to fail', yet too big to rescue too (Jones, 2010).

The objectives of this Budget were twofold. On the one hand, government stated its intention to embark on a steady path of fiscal consolidation; on the other, it stated its intention to undertake a programme of structural reforms aimed at ensuring long-term fiscal sustainability and accelerating 'the change of the productive model' ('el cambio en el modelo productivo'). The key objective was to meet the deficit target of 6% of GDP. The deficit had been 11.1% in 2009 and 9.3% in 2010. But in the context of a slow recovery, in which growth was expected to be 1.3%, this could prove challenging. Budget 2011 consolidated the emergency measures taken in May 2010 mostly through spending cuts. Non-financial spending was set to decrease by 7.9%. Austerity measures also entailed a drastic cut in public investment in infrastructure, which was reduced by 30%, and a moderate reduction in personnel.

And yet, throughout all these spending cuts, the PSOE government continued to protect the core components of the welfare state and social policy. According to the government, social cohesion was still a central objective, even in the context

of austerity. In the words of the Socialist Minister for Economy and Finance Elena Salgado, 'Son unos Presupuestos austeros, que generan cohesión social e impulsan la actividad económica' ('This is an austere budget that generates social cohesion and fosters economic activity'). The government had some discretion over how to manage the deficit-reduction strategy whose targets it had accepted, under the aegis of the European Excessive Deficit Procedures.

In the election of November 2011, PSOE suffered the expected electoral defeat. It was not a business-as-usual incumbent defeat; the socialists suffered the worst electoral defeat since 1977. A change of government did not mean a change in the policy objectives the government pursued, but it did mean a change in the priorities and methods adopted. The new PP government, headed by Mariano Rajoy, accepted the framework of deficit reduction. Cristobal Montoro, the Ministry for Finance, made clear the objectives of the incoming government: 'The first objective is the deficit; the second, the deficit; and the third, the deficit' (El Pais, 4/4/12). If anything, the budgets for 2012 and 2013 deepened the commitment towards spending-based consolidation and structural reforms. In the interests of boosting business confidence, and consistent with the market-liberalizing advice coming from the EU policy leaders, the emphasis shifted more decisively toward cutting expenditure rather than broadening the tax base and increasing revenues.

The results were highly disappointing, though. The promised "expansionary fiscal contraction" never materialised. The economic slump continued and unemployment kept raising to historical thresholds. In the context of increasing uncertainty (lower credibility), the Spanish financial system was finally bailed out. In the legitimacy front, the conservatives struggled as much as the socialists, not least because they were forced to break, one by one, practically all their electoral pledges, on taxes, on pensions, on the bailout, on the bank rescue. In November 2011, PP had a voting intention of 44.6%; in May 2013, this figure was down to 22.5% (the ratings of the government and its key figures, including Rajoy, were at record-low levels). Strikingly, the opposition PSOE was performing even worse: the socialists had a voting intention of around 20%, some nine points below the already low levels of November 2011. Crisis

management has clearly compromised, and indeed heavily undermined, the political bases of the PP-PSOE duopoly.

Credibility and legitimacy issues in Ireland

In marked contrast with the Spanish experience, the Irish government composed of the centre-right Fianna Fáil party and the small Green Party, in power between 2007 and February 2011, took the view from mid-2008 that closing the deficit was an urgent priority. It also held the 'orthodox' position that an emphasis on spending cuts over tax increases was the most appropriate way of doing this, and this view was consistently maintained throughout the very tough times to follow. Furthermore, although the opposition parties that formed the subsequent coalition government, comprising the centre-right Fine Gael party and the Labour Party, differed on matters of emphasis, they accepted the constraints imposed by the loan agreement of November 2010. There was no fundamental disagreement over the policy objectives Ireland was required to adopt or over the means of achieving them.

The consistency of approach after 2008 was frequently lauded by EU and IMF policy leaders: by 2012 and 2013, Ireland was widely seen as a so-called poster-child for austerity, meeting its targets for deficit reduction, and giving rise to some signs that investor confidence was improving. The worst moment (as Figure 2 illustrates) was in mid-2011, when market confidence in Irish capacity to return to borrowing on the international markets was at its shakiest, as the scale of banking-related losses was subject to further upward estimation. Matters improved subsequently, such that Ireland was expected to be able to exit the loan programme on schedule at end-2013.

However, mismanagement of the economy during the boom years, especially between 2000 and 2008, had contributed to making the crisis much more sever than it needed to be. A persistent bias toward pro-cyclical fiscal policy during the boom meant that public spending had increased rapidly year on year. Meanwhile, the income tax base had been narrowed through cuts in headline rates and exemptions for the lowest-paid, resulting in a situation where the average incidence of income tax and social insurance liabilities on most

households was among the lowest in the OECD, and about 40% of employees paid no income tax at all (Dellepiane & Hardiman, 2012a; OECD, 2009). Reckless bank lending, combined with inappropriate fiscal incentives, resulted in a housing boom on an even larger scale than that of Spain's. Government had come to rely ever more heavily on buoyant revenues from construction-related activities, and the implosion of the building industry had a disproportionate impact on the public finances.

The collapse of Lehman Brothers in the US brought underlying worries about the stability of the Irish economy to a head. In particular, the banks now revealed that, despite assurances under the 'light-touch' financial regulatory regime that all was well, they were in fact in deep trouble (Clarke & Hardiman, 2012). On the assumption that this was a liquidity and not an insolvency problem, Minister for Finance Brian Lenihan took the single most far-reaching decision in the Irish crisis on 30 September 2008, which was to guarantee not only all bank deposits, but the liabilities of most categories of bondholders. At the time, due to the wholly inadequate information available to government about the devastation the banks had brought upon themselves, Lenihan announced that the Irish bank bailout would be 'the cheapest in the world', compared with bank rescues in other countries, including the UK and the US, where 'billions and billions of taxpayers' money are being poured into financial institutions' (Carswell, 2008). When the scale of the implications became clearer, it would appear that the European Central Bank exerted pressure to insist that no measures should be introduced to require burden-sharing by the private sector (or at least not until the permanent European debt resolution facility came into effect, which was expected to happen in 2013). The consequence was that the total liabilities of the domestic banks were to be borne by the taxpayers (Donovan & Murphy, 2013; O'Brien, 2011).

A series of deficit-tightening measures during 2008 and 2009 failed to improve Ireland's market credibility, and they also stoked up some one-day episodes of strike action and street protest by public sector union employees (Dellepiane & Hardiman, 2012b). The sharpest budget cuts came in December 2009, and involving overall cuts to public sector salaries of between 7% and 15%, and cuts

to all categories of welfare recipients. The aim, as ever, was to put some distance between Ireland and Greece. This preemptive approach to fiscal consolidation was widely lauded as exemplary and a model to other countries under pressure: 'In a week when Greece and Spain both saw their credit ratings under attack, the budget at least gave the government an opportunity to reassure international investors that Ireland, unlike some other EU countries, is serious about controlling its budget deficit and public-debt burden' (The Economist, 2009).

Greece's need to avail of a new EU loan facility in May 2010 was a key moment in Ireland as in Spain, but for different reasons. As the scale of losses in the Irish banks – particularly Anglo Irish Bank – became clearer, and as fear of the contagion effects of Greek vulnerability spread, Irish bond spreads reach a new high, and the rate continued to go up throughout May and June (Carswell, 2011a). In the course of 2010, GDP fell more than anticipated, and the scale of the fiscal consolidation that would be required to meet the 2010 3% deficit target continued to escalate. The effort required to rescue the distressed banking sector also increased, and the new 'worst case scenario' estimate for bank bailout in the autumn of 2010 was €51bn (a figure that would go up again in spring 2011).

In September 2010, the government projected that the fiscal consolidation required in 2011 would now be €3bn. The estimated total effort required between 2011 and 2014 had stood at €7.5bn. Now a revised estimate indicated that €15bn of fiscal consolidation would be needed to meet the Stability Programme deficit targets.

At this time, government spending needs were fully funded into mid-2011 and there was no immediate need to return to the bond markets. There was no immediate prospect of any sovereign debt default. Right up to a very short time before the loan agreement actually happened, the government continued to deny publicly that it was in negotiations with the EU and the IMF.

The Irish banks, along with the Irish government, were now locked out of international lending markets, and something needed to be done about their drastically impaired balance sheets. Ireland's 2008 bank guarantee was due to

expire at this time. Investors were slowly haemorrhaging abroad. The banks were becoming ever more heavily reliant on short-term liquidity from the ECB. It would appear that extreme pressure came from the ECB to require the Irish government to seek a loan agreement until 2013 in November 2010 (Economist, 2010). Not only this, but the government came under intense pressure to extend its earlier blanket guarantee to the banks. This meant that instead of imposing some of the burden of adjustment on private sector bondholders, and getting assistance for the public rescue of the banking system from the Eurozone at large, all the liabilities of the ruined banks now had to be met by Irish taxpayers.

In a wide-ranging interview he gave in April 2011, after he had left office and shortly before he died, Brian Lenihan gave a wide-ranging interview about what had happened. He confirmed that the ECB had played a central role in insisting that the full cost of the ruined banks had to be borne by the Irish state. He recounts that neither the European Commission officials nor the IMF had been concerned about the Irish situation, and that it was the ECB that forced the issue. Their top echelon pressed their view 'with great vigour' that 'putting the fiscal house in order' more rapidly would resolve the banking problem, a view that Lenihan did not agree with. But the ECB insisted that 'the future of the currency union was at stake' (O'Brien, 2011).

The terms of the €85bn EU-IMF loan package were controversial. They included an obligation to deploy the National Pension Reserve Fund in the front-line of bank recapitalization plans. The interest rate on the tranche of the loan extended by the ECB was subject to a higher interest rate than expected, also a subject of contention. By 2011, the Irish banks were being kept afloat on about €100bn in ECB loans at very low interest rates of 1%, plus a further €70bn in liquidity provided by the Irish central bank and ultimately underwritten by the ECB (Brown & Atkins, 2011; O'Brien, 2011).

In November 2010, the Government announced in its National Recovery Plan 2011-2014 that was in fact entirely consistent with the terms of the Memorandum of Understanding with the ECB and IMF announced at the same time. This was intended to front-load the fiscal adjustment process. On the

framing of the 2011 budget that implemented the Plan, Lenihan later said: 'I was concerned that once we went beyond the figure of €4.5 billion adjustment, about the economic damage it would do to the country, and I was unhappy at having to put the figure much higher than that' (O'Brien, 2011). In the event, a total of €6bn was to be taken out of the economy in 2011 (Department of Finance, 2010).

The National Recovery Plan projected adjustments of €15bn between 2011 and 2014, €10bn in spending cuts and €5bn in taxation. It anticipated that the deficit would be reduced to 9.1% GDP in 2011, with steady reductions thereafter to below 3% by 2014. The debt to GDP ratio was expected to peak at 102% GDP in 2013, and to fall to 100% by 2014.These projections set the framework for the specific measures set out in Budget 2011 in December 2010. At this point, national per capita income was already 20% lower in 2010 than it was in 2007. But as Table 1 shows, these estimates had to be revised over time, because fiscal contraction in a stagnant economy caused further worsening of the outcomes, meaning that government was chasing a moving target.

In addition to large spending cuts, there were big increases in most forms of taxation in the December 2010 Budget. Rates of income tax remained constant, but the tax net widened to cover an extra 300,000 people, broadening the tax base from 45% to 60% of the workforce. The other key measure was the introduction of a Universal Social Charge, which replaced both the existing income levy and the health levy (also known as the health contribution) on 1 January 2011. The national hourly minimum wage was cut by €1 to €7.65, with a view to increasing low-end labour market flexibility.

However, already in December, the underlying budget deficit was estimated at 11.6% GDP, and the Budget statement claimed that the measures adopted would stabilize it at that level. The Budget also stated that GDP was expected to grow at an annual rate of 2.7% until 2014. Commentators considered these commitments to be optimistic, and indeed ECOFIN extended Ireland's excessive deficit target deadline from 2014 to 2015 at this point. Meanwhile, government was also committed to undertaking a range of structural reforms including

stronger fiscal oversight arrangements, review of labour market flexibility, and rigidities in some of the professions.

As in the Spanish case, Ireland's long-drawn-out efforts to improve its market credibility proved self-defeating. As Figure 5 shows, the ratings agencies slashed their ratings at this time, and they continued to fall as Irish governments made ongoing efforts to deal with the very large deficit it had incurred. The Irish government made massive fiscal efforts that resulted in relatively little visible fiscal retrenchment. By end-2010, the size of the public deficit had risen to 12% or about €18bn (with a GDP of €153.9bn), the debt-to-GDP ratio was about 100%, and the IMF projected that it would peak at 120% in 2013 before stabilizing (IMF, 2011). Eurostat reports Ireland's deficit at -32% GDP for 2010, since the bank rescue costs are all charged against that year; thereafter they accrue to the total public debt. Minister for Finance Brian Lenihan noted in Budget 2011 that Ireland had undertaken an implicit consolidation effort of about 10% of GDP in two years. The total fiscal adjustment between 2008 and 2014 (according to the National Recovery Plan 2011-2014) amounts to €30bn, equivalent to about 20% of 2010-level GDP.

Figure 5. Ratings agencies' ratings for Ireland

By the time of the loan programme in November 2010, the incumbent government was extremely unpopular. The fact that Irish taxpayers had been required to renew the bank guarantee and to assume total liability for their private-sector debts was the focus of intense anger and frustration in the run-up to the election of February 2011.

The fiscal burden of rescuing the banks proved to be extremely onerous. There were three moments of attempted final bail-out of the banks, following stress tests in March 2010, September 2010, and then again in March 2011. The running cost of rescuing the banks rose from an estimate of €5.5 billion in late 2008, to €11 billion in the first half of 2009, to €35 billion in March 2010, to €46 billion in September 2010, by which time the total bank recapitalization requirements totalled about €70bn, in what was announced as the last and final upward revision of the cost of bailing out the Irish banks (Irish Times, 31 March

2011). Fine Gael Finance Minister noted that 'The state will be committing approximately 45 per cent of gross domestic product in the banks in a two-year period' (Noonan, 2011). Losses at the Irish banks and the foreign lenders in Ireland topped €100 billion. In an ironic though unintended reversal of Lenihan's early claim about how lightly Ireland would get out of its bank bailout, the Governor of the Central Bank Professor Patrick Honohan called this 'one of the costliest banking crises in history' (Carswell, 2011b).

The Fianna Fáil-Green coalition's support in the polls had been sliding steadily over time. Fianna Fáil was historically the dominant party in the Irish party system, and typically secured up to 40% of the total vote, drawn from across all social classes. Figure 6 shows that the first marked drop in support for the governing parties came after the bank guarantee in September 2008, and that it plummeted after the EC-ECB-IMF loan programme in November 2010.

Figure 6. Opinion poll ratings of political parties in Ireland

The general election of February 2011 brought the expected change of government – a coalition of Fine Gael and Labour – but the scale of the losses suffered by Fianna Fáil was very striking (Gallagher & Marsh, 2011). Its vote-share sank to some 17%. Its historically strong cross-class support base fragmented. Fianna Fáil was held responsible for causing the crisis, but it gained no credit for tackling the crisis consistently: this was one of the most dramatic experiences of the political toll taken by austerity on any European political party.

But the political gains made by Fine Gael and Labour were not guaranteed to be durable. The government's standing in the opinion polls fell sharply in the wake of the further tough measures they took in subsequent budgets. And notwithstanding some success in renegotiating some of the terms of the refinancing of Anglo Irish Bank, now a zombie bank with massive liabilities but no future as a functioning financial institution (Whelan, 2012), the government did not manage to gain any traction with the main issue on which it had campaigned originally, that is, retrospective European support for direct refinancing of the Irish banking sector.

Dynamics of party competition and the challenges of political legitimation

In Spain and in Ireland, governments experienced less difficulty than in Greece in adopting and implementing tough budgets. But the Spanish and Irish terms of debate about what to do and when to do it proved to be very different from each other. This can best be understood by considering what the partisan profile of the party system looks like in each case, and how this translated into party competition in the context of crisis.

The choice of economic strategy and the composition of budget adjustment was subject to regular and vigorous partisan debate in Spain, where strong left-right partisanship was well-established. Zapatero's rhetoric was consistently Keynesian and Social Democratic. The shift in strategy in May 2010, he insisted, arose not from conviction but from necessity, under pressure from the international markets. And public opinion in Spain consistently showed much stronger support for tax increases over spending cuts. Ever since the stabilization of democracy had been assured through the belated expansion of the welfare state, a constituency of support had been built up that had a strong vested interest in welfare transfers and services (Molina & Rhodes, 2007).

Partisan strategies of fiscal adjustment have been observed in Spain in the past (Mulas-Granados, 2006; von Hagen & Strauch, 2001). In the early 1990s, the PSOE undertook revenue-based adjustments that protected social policy, public wages and investment. Between 1996 and 2000, the conservative PP preferred expenditure-based strategies of adjustment that focused on spending cuts and structural reforms. Zapatero continually stressed the Social Democratic motivation of his initial strategy in 2008 and 2009. This is grounded in the broader Spanish Socialist conception of how structural adjustment may be undertaken without conceding the ground to conservative opinion, by enhancing competitiveness through building up the skill base, and improving productivity through public investment (Boix, 2003).

In contrast, in Ireland, the political left was historically very weak, and most political contestation was tilted toward the centre-right, with little basis

therefore for clearly differentiated ideologically grounded debate over either policy objectives or the mix of policy methods. The 'orthodox' perspective that prioritized the need to restore fiscal business in order to boost business confidence was much more widely established than in Spain. Prevailing opinion among professional economists at the outset of the crisis was that the most appropriate course of action was 'shock therapy'. Citing the experience of a 'lost decade' of delayed deficit reduction in the 1980s, they now recommended a quickly undertaken, massive fiscal consolidation, primarily based on spending cuts, and front-loading the pain (Kinsella & Leddin, 2010; McCarthy, 2010).

Critical voices came from the trade union movement, which pointed to the changed circumstances of this crisis and the risks of choking off growth prospects (Begg, 2009; Irish Congress of Trade Unions, 2009a, 2009b). But this view gained little political traction. And public opinion in Ireland showed a consistent preference for spending cuts over tax increases, even after two decades of tax cuts had made Ireland one of the most lightly taxed of all the OECD countries (Regan, 2012).

Both Ireland and Spain may be contrasted with Greece in the nature and scale of popular protest against the politics of austerity. Even in the face of very high unemployment, trade union leaders led largely peaceful short-term general strikes and occasional street protests without the violent confrontations that were a recurrent feature of Greek politics.

Wage-setting institutions came under intolerable pressure in both countries as the crisis deepened. In Ireland, government chose not to follow the social partnership route of gradual efficiency-based cost recovery in December 2009, but imposed direct spending-based adjustment. In Spain, the government lost the support of the unions and left-wing political sectors after the May 2010 emergency programme. Yet in both countries, some form of social dialogue was re-established. In Ireland, the public sector unions engaged in a new form of concession bargaining in June 2010, securing efficiency gains in exchange for a suspension of direct pay cuts. In Spain, a new social pact, deemed the most important since the celebrated Moncloa Pacts of 1978, was agreed in January

2011. This enabled the government to secure support for a critical pension reform (from 65 to 67; the Irish government had similarly changed public sector pension entitlements from 65 to 66 for new entrants as a matter of budget decision) (Rhodes, 2011).

In the short term, the capacity to engage in even limited social dialogue and to negotiate social pacts is likely to result in a more coherent economic adjustment path, and by making it more legitimate, ensures its viability (Baccaro & Simoni, 2008; Culpepper, 2008; Molina & Rhodes, 2007; Pérez, 2000; Pérez-Díaz, 1993; Roche, 2009). Social pacts were negotiated in both Spain and Ireland by governments of varying partisan composition. But social partnership may also have serious unintended consequences. For example, Spain, older 'pactista' traditions contributed to delaying reform of labour market rigidities that confer employment security to 'insiders' at the expense of other categories of workers (Cuñat, 2012). New forms of mass mobilization and street protests by labour market outsiders, especially young politically disaffected people, presented a new kind of challenge to the political insiders from both major parties during 2011 and 2013.

In Ireland, the insider power of the public sector and the low levels of unionization of the private sector, especially in the exporting sector, may have distorted wage structures (McGuinness, Kelly, & O'Connell, 2010). Public sector deals on pay cuts in 2010 and again in 2013 were undertaken under the clear threat of unilateral government action. But at the same time, the terms of the deals excluded those with the weakest power in the labour market in both public and private sectors, especially the growing numbers of temporary and part-time workers, the rising numbers of unemployed, and those who had voted with their feet in growing numbers and who had simply emigrated.

And yet, in both Spain and Ireland, despite the extreme problems in securing market credibility and the profound challenges posed to the major political parties, in neither country has there been, to date, any fundamental challenge to the political system itself. Unlike in Greece, both countries managed to sustain some broad level of agreement across political parties about what the principal

objectives needed to be. Spanish parties were more adversary-inclined about policy objectives, at least until May 2010, and Irish parties more consensus-inclined in their party positioning. Spanish political narratives also featured more adversarial narratives about the composition of policy adjustment. In neither country do we see the emergence of the strongly polarizing contestation that has characterized Greek politics, or the prevalence of street protests, nor has either country experienced the sustained rise of an anti-system protest party of the extreme right. Despite the stresses on social services, especially in Spain, neither country experienced the effective collapse of the social contract that, as Polanyi warned, could presage a fundamental threat to the sustainability of democracy itself.

But neither should this be taken as grounds for complacency. Eurobarometer data on trust in national governments, shown in Figure 7, indicates a growing trend in popular dissatisfaction with their own national political systems among citizens in the Eurozone periphery countries. In mid-2012, no government had experienced net positive ratings since before the crisis. The average for the 17 countries of the Eurozone as a whole was about -25%, and in Germany the figure was better again, at under -20%. But dissatisfaction was most marked in Greece, where the difference between those who trust and those who do not trust their own government was recorded at a massive -80%. The other periphery countries were not far behind, with Spain, Portugal and Ireland recording rates of between -50% and -70%. Notwithstanding brief rallies with changes of government, the downward trend is very marked in all these countries; and it started as the first symptoms of impending crisis began to appear, with the stalling of the housing boom, the tightening of the availability of credit, and the worsening market performance of bank shares. It is far from clear what it would take for national governments to recover their political credibility and legitimacy in the eyes of their own citizens.

Figure 7. Net trust in national government

Conclusion

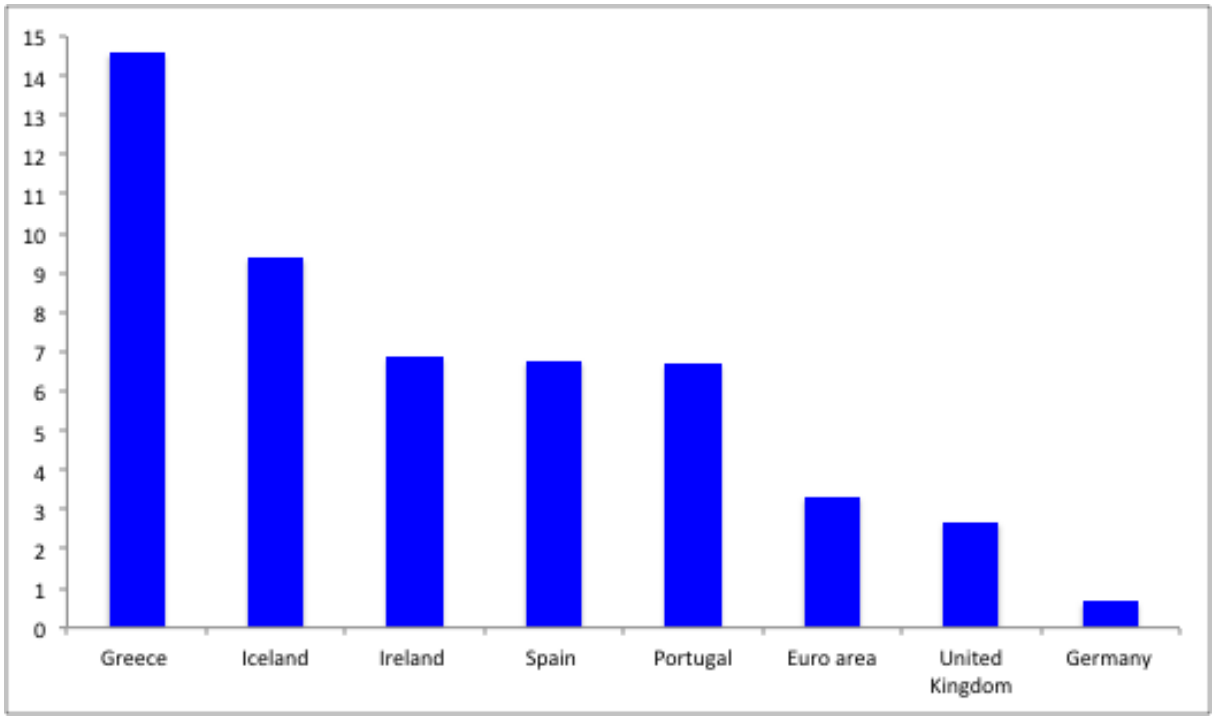
In neither Spain nor in Ireland was there a fundamental problem of adopting and implementing harsh policies once they were deemed to be necessary. In both countries, external pressures coming from European policy-makers caused important policy shifts on the part of national governments. But there are marked differences in the way these decisions were arrived at, which can only be understood in the context of the partisan dynamics of party competition and the underlying political cleavages in the two societies. Partisan differentiation of policy preferences was more deeply rooted in Spain than in Ireland, which meant that the breach in the preferred government policy stance in May 2010 was particularly damaging for the incumbent PSOE. In Ireland, weak ideological differentiation and a more market-oriented political discourse made an orthodox policy response more acceptable to two successive governments.

In both countries, though, we find that there are deeper consequences for the political legitimacy of the parties imposing austerity. The experience of duress, that is, the recognition that external pressures limited national options, generated additional citizen resentment in both Spain and Ireland. In Spain, the tipping point came in May 2010, when the PSOE was obliged to reverse its preferred policy response to crisis. In Ireland, the realization in September 2008 that the banking system was out of control was the moment at which trust in government started to fall, but it was the terms of the loan programme in November 2010, which put the entire burden of the bank bail-out onto the Irish taxpayers, that was particularly resented. However, in both countries, voters found that they could change their government, but they could not change the policies. This resulted in growing dissatisfaction with and alienation from the political system.

In both countries, the consequences of austerity include a worsening of social services and of the conditions underpinning social cohesion. In both countries, too, the crisis hit younger people harder than older people (in terms of job losses and exclusion from the labour market, household debt, and the burden of negative equity). In Spain, the distributive impact of adjustment measures tilted

over time, and since 2011, they have been broadly regressive in their effects. In Ireland, although the most salient forms of new tax – the Universal Social Charge, a tax on residential property, and moves to introduce water charges – were those that had a regressive impact, it has been estimated that the cumulative impact of all the tax and spending measures has been broadly progressive (Callan, Keane, Savage, & Walsh, 2012). But the reduction in access to public services, and especially the worsening of deep-seated inequalities in access to health services, increased dissatisfaction with government (Nolan et al., 2013, forthcoming).

Figure 1. The scale of fiscal effort, 2009-2012



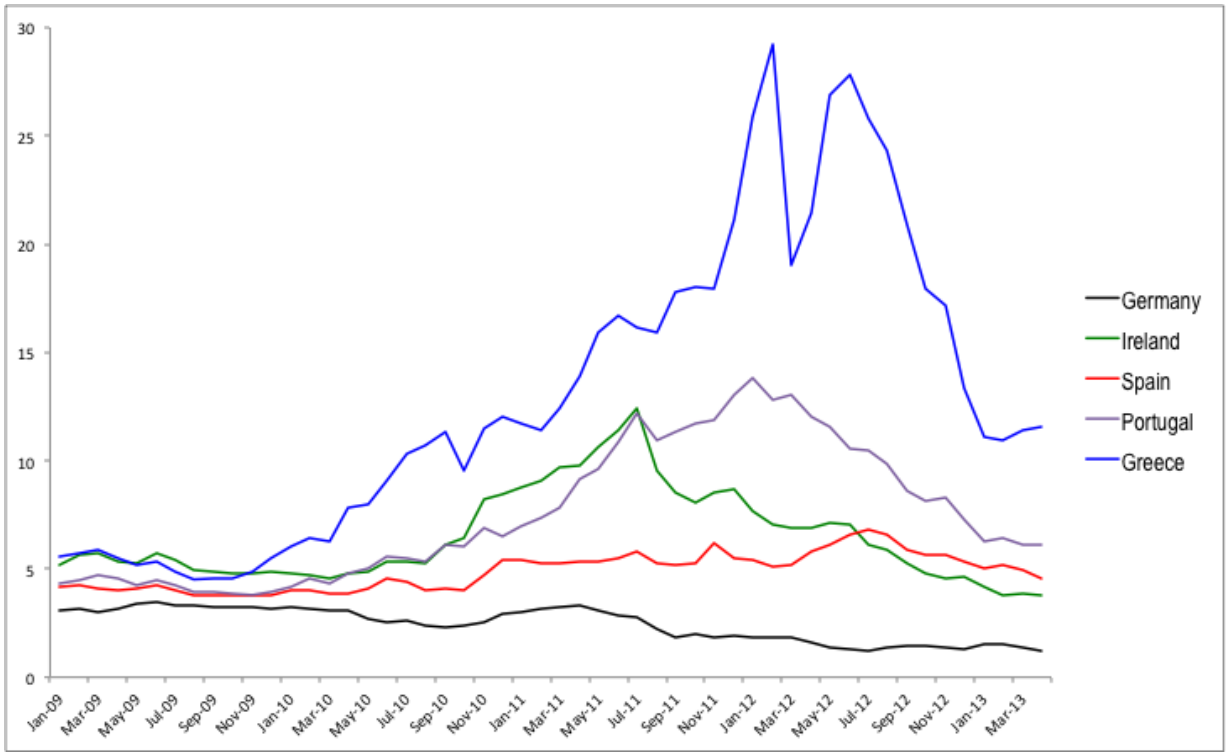
Source: General government underlying primary balances. OECD *Economic Outlook,* Vol. 2012, Issue 2, 17 December 2012. Accessed 16 January 2013.

Table 1. Expected and actual deficit out-turns in Greece, Spain, Ireland, Portugal

EU projections	2010	2011	2012	2013	2014	2015
SPAIN						
Spring 2010	9.8	7.5	5.3	3.0		
Spring 2011	9.2	6.0	4.4	3.0	2.1	
Spring 2012	9.2	8.5	5.3	3.0	2.2	1.1
Spring 2013			10.6	6.3	5.5	4.1
IRELAND						
Winter 2009	11.6	10	7.2	4.9		
Spring 2011	32.4	10.0	8.6	7.2	4.7	2.8
Spring 2012	31.3	9.9	8.6	7.6	4.8	3.0
Spring 2013			7.6	7.4	4.3	2.2
GREECE						
Autumn 2010	9.4	7.4	6.5	4.8	2.6	
Spring 2011	10.5	7.6	6.5	4.8	2.6	
Autumn 2011	10.6	8.7	7.0	5.3	2.9	
Spring 2012	10.6	9.3	7.3	4.6	2.1	
Summer 2013		9.4	6.3	4.1	3.3	2.1
PORTUGAL						
Spring 2010	8.3	6.6	4.6	2.8		
Spring 2011	9.1	5.9	4.5	3.0	2.3	1.9
Spring 2012	9.8	4.2	4.5	3.0	2.3	1.9
Spring 2013		4.4	6.4	5.5	4.0	2.5
Autumn 2013			6.4	5.9	4.0	2.5

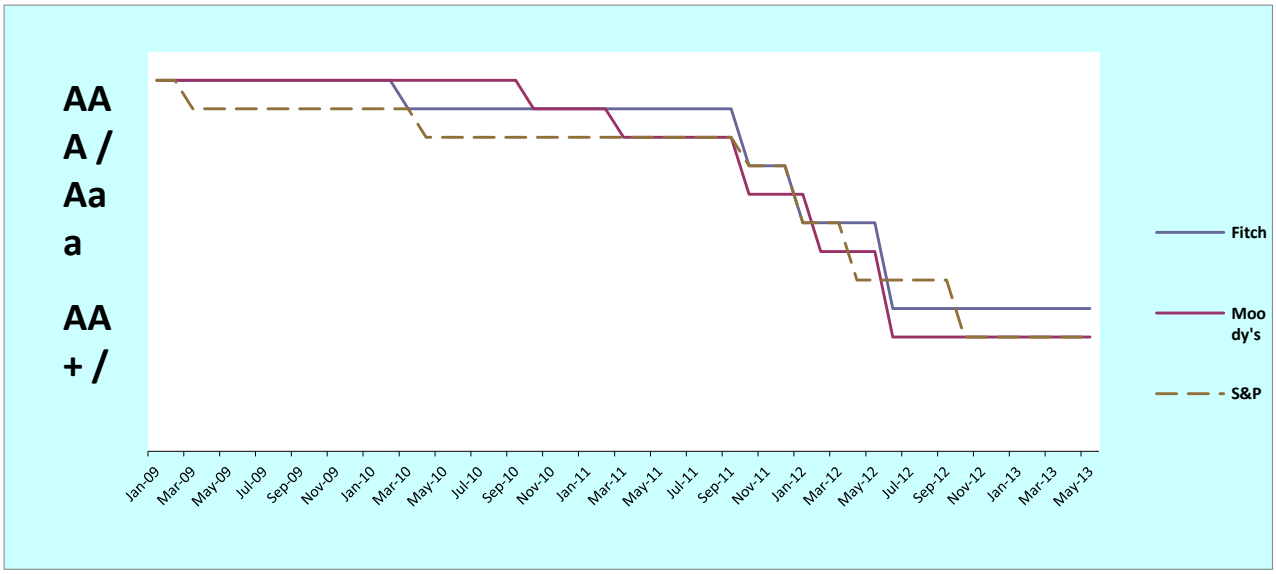
Source: Governments' Stability Programmes, and EC Adjustment Programmes

Figure 2. Ten-year interest rates on government bonds



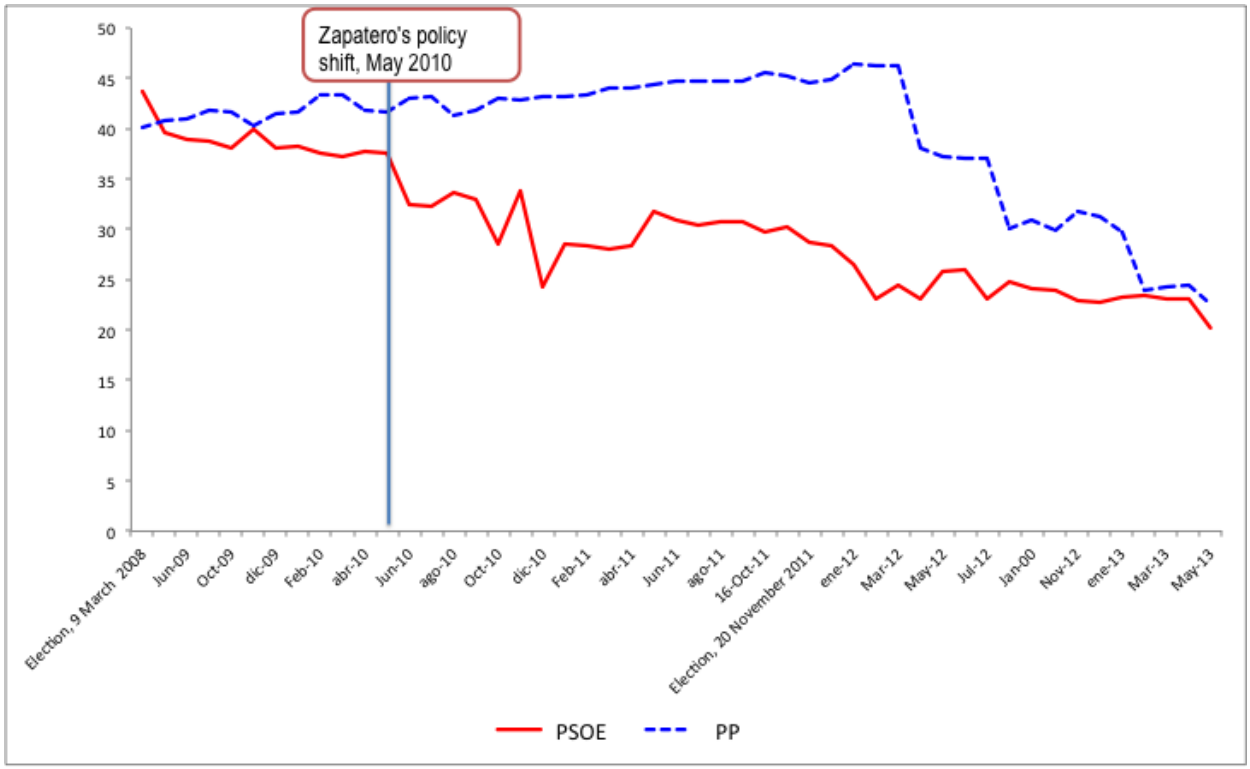
Source: ECB Harmonised long-term interest rates for convergence assessment purposes. Accessed 1 June 2013.
http://www.ecb.int/stats/money/long/html/index.en.html

Figure 3. Ratings agencies' ratings for Spain



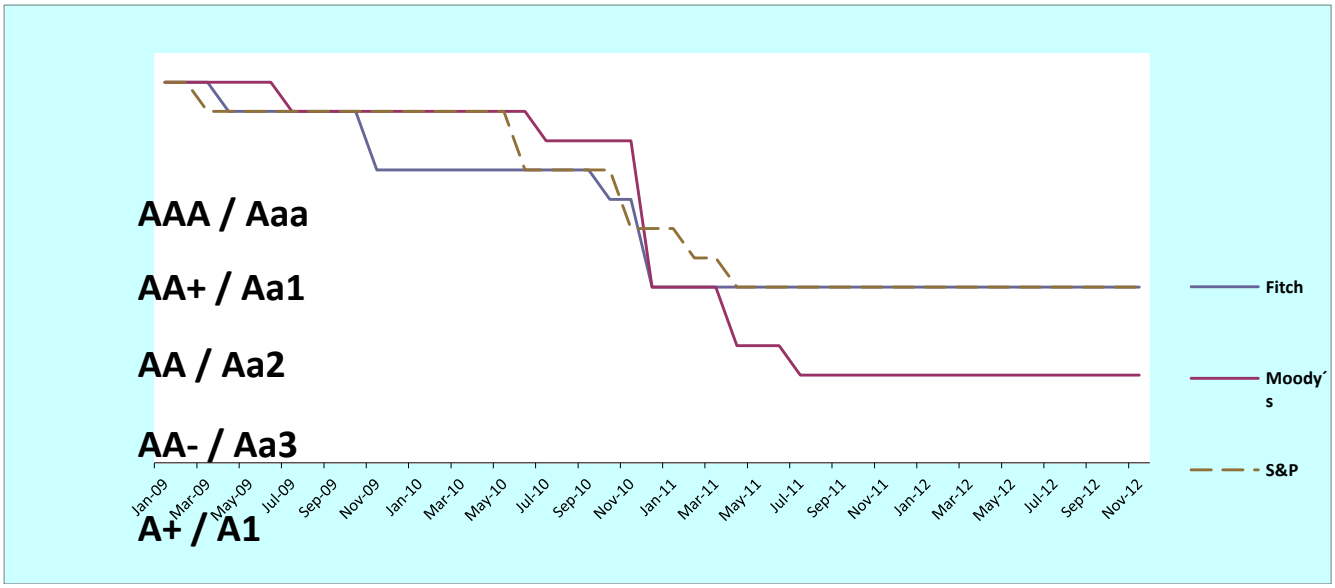
Source: Ratings agencies' websites

Figure 4. Opinion poll ratings of political parties in Spain



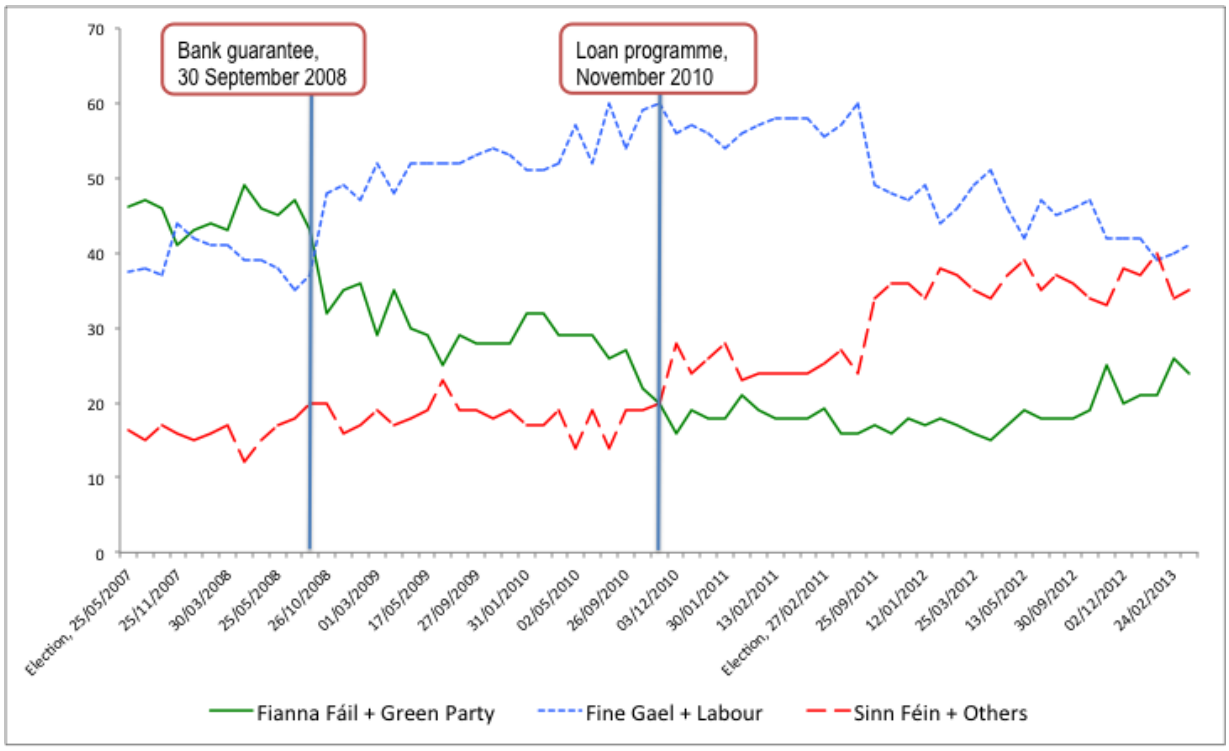
Source: Metroscopia opinion polls, http://www.metroscopia.org/seriestemporales/item/estimacion-resultado-electoral. Accessed 1 June 2013

Figure 5. Ratings agencies' ratings for Ireland



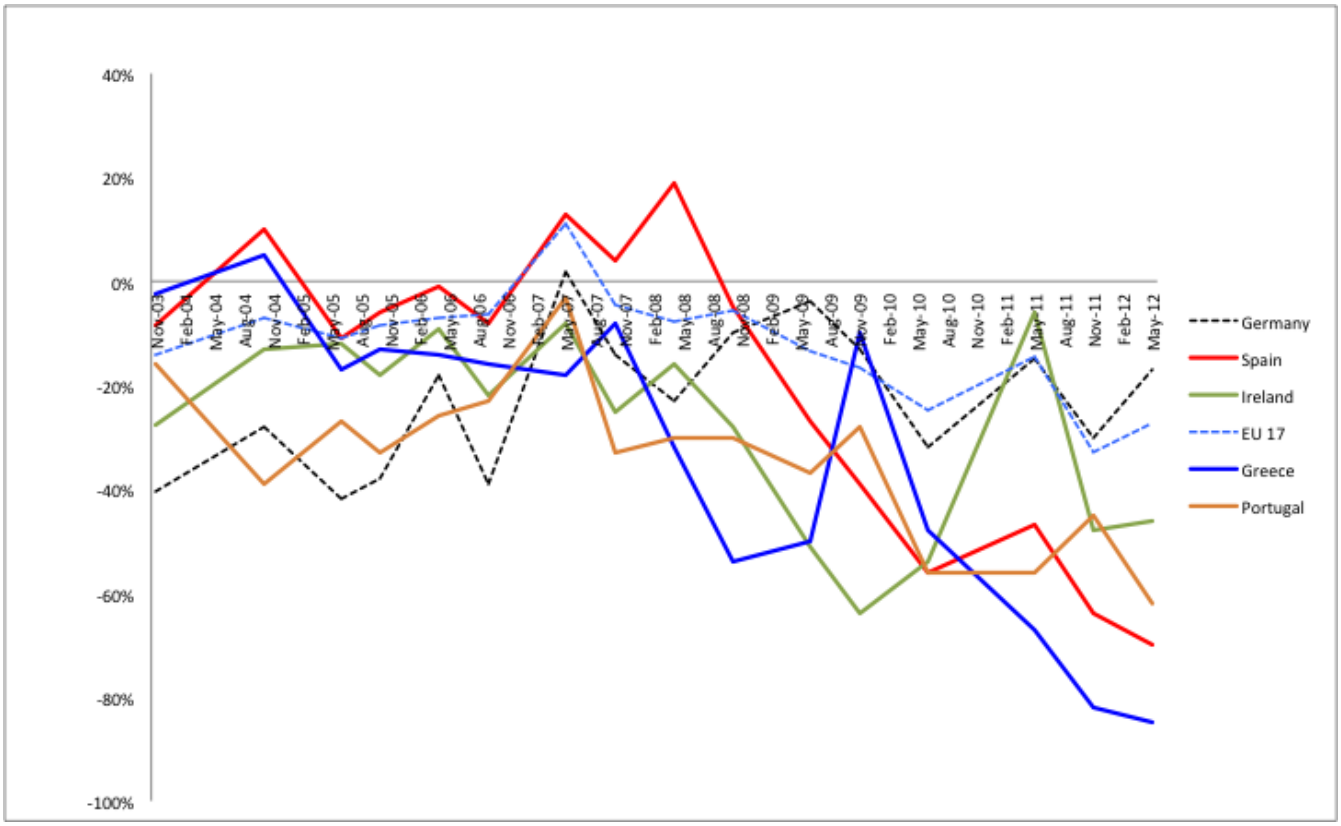
Source: Ratings agencies' websites

Figure 6. Opinion poll ratings of political parties in Ireland



Source: RedC poll data, from http://electionsireland.org/polls.cfm, accessed 15 May 2013.

Figure 7. Net trust in national government



Source: Eurobarometer

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