

Chapter Seven

Repeating History: Fiscal Squeeze in Two Recessions in Ireland

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Introduction

Ireland has been taken as an exemplary case of fiscal adjustment, not once, but twice, in its recent history: firstly in the late 1980s, more recently in the implementation of a sharply contractionary policy mix after the crisis of 2008, underpinned by the terms of the international loan agreement negotiated in November 2010. History has in a sense repeated itself, first as tragedy, we might say, and then as tragedy again. In both cases, Ireland attracted international plaudits for the determined way in which it implemented fiscal consolidation measures. Indeed, since the experiences of the 1980s were followed by a return to growth within a few years, Ireland was one of the key cases on which the argument for 'expansionary fiscal contraction' was made.¹ The lessons from Ireland have therefore played an important role in shaping international conventional wisdom in the post-2008 period.

Critics of the 'expansionary fiscal contraction' hypothesis have shown that growth in the Irish economy in the late 1980s came about not as a result of fiscal consolidation – the biggest achievements in which followed, not preceded, the resumption of growth

¹ Additional references are included in an earlier draft of this paper, at Hardiman, 2013.

– but from factors such as the devaluation of 1986 which improved Ireland’s international competitiveness position, and the ‘Lawson boom’ in the United Kingdom, which induced a sharp upturn in the demand for Irish exports. These conditions could not be replicated within the Eurozone, since currency devaluation was not possible and deflationary policy kept international demand conditions sluggish.

But a focus on the politics of fiscal squeeze shifts our attention to a number of other considerations that are usually excluded from discussions about the determinants of fiscal consolidation and its likely implications for growth. As Chapter One of this volume notes, the focus must be on governments’ *ex ante* intentions. This may extend the time period to be studied backward, beyond that normally studied when the focus is on explaining successful outcomes. A second implication is that the policy mix involved in phases of fiscal squeeze might look different once we look at the political effort exerted over the whole period of interest. A third area that opens up for consideration is the political and electoral consequences of undertaking fiscal squeeze. Advocates of expansionary fiscal contraction argue that there is no electoral penalty for undertaking difficult fiscal squeezes (Alesina, Carloni, & Lecce, 2010). Under certain circumstances, governments may indeed be able to persuade their own members and the electorate at large that a fiscal squeeze is necessary (Mauro, 2011). But there is also evidence that governments that presided over tough fiscal decisions suffered electorally (Mulas-Granados, 2004). All of these considerations suggest that we need to attend more closely than has hitherto been the case to the politics underlying phases of fiscal squeeze.

How the Politics of Fiscal Squeeze Set the Agenda in the 1980s

Most analyses of the fiscal corrections undertaken in Ireland during the 1980s focus narrowly on the period 1987-1989, because this is the period during which an appreciable change occurred in the recorded deficit. But the size of the public debt was central to political debate for longer than that. Fiscal squeeze was a central issue in Irish public life from 1981 right through to 1989 and beyond.

Framing the Debate About Fiscal Squeeze

Understanding how this came about required us to take a somewhat longer view of the trajectory of budgetary policy. Irish fiscal policy adhered to conservative principles for several decades following independence in 1922, under the guidance of the then fiscally orthodox Department of Finance. Governments were reluctant to permit budget deficits in any circumstances. The total tax take was small in comparative OECD context, and social services were poorly developed until some modernisation began in the late 1960s.

The departure from an orthodox fiscal stance was driven in large part by party-political competition, and specifically by the terms on which the populist, centre-right Fianna Fáil party, then in opposition, contested the general election of 1977. Between 1973 and 1977, the government was formed by a coalition of the centre-right, fiscally orthodox Fine Gael party with the centre-left but much smaller Labour Party. This period saw the worst of the oil-price crisis, and the coalition had grown increasingly unpopular as it sought to manage stagflation without incurring large increases in debts or deficits. As in many other European countries at this time, the result was felt in rising unemployment. Fianna Fáil, the ‘natural’ party of government since the foundation of the state in 1922, was deeply anxious to return to power. The party committed itself to a series of expensive election pledges. It promised to restore

prosperity and to boost employment through a sustained expansion in public spending, in what was to be the first sustained attempt at Keynesian stimulus measures. Fianna Fáil, if elected, would 'spend its way to full employment'. The party simultaneously proposed to abolish revenue instruments such as local domestic rates and car tax. It was elected with a landslide victory, and set up a new Department of Economic Planning and Development to oversee the government programme.

However, the main plank of the spending plan involved creating new public sector jobs. Additional spending commitments resulted from the Fianna Fáil government's attempts to broker two pay deals with the trade union movement and the employers' associations (the 'National Understandings' of 1979 and 1980). But in a highly open economy, with a currency pegged to sterling, the stimulus package tended to increase the consumption of exports, thereby worsening the trade deficit. Moreover, these measures had a pro-cyclical effect, taking effect as they did during a period of economic recovery, thus adding to public spending obligations during an upturn.

Official advisers in the Department of Finance and economic commentators alike warned about the growth of budget deficits. But leadership struggles within Fianna Fáil meant that the expansionary policy stance persisted into the early 1980s. During 1981 and 1982, efforts to address the growing budget deficit, conceived of as the Public Sector Borrowing Requirement, fell foul of volatile electoral politics: three general elections were held in an 18-month period. This is the period during which the public finances became a central issue in public debate. On the one side stood Fine Gael, the party of fiscal orthodoxy, under the leadership of Garret FitzGerald, whose father had been a prominent member of the government of the Irish Free State that was established in 1922. Fine Gael voiced increasingly urgent concern about the

unsustainable debt dynamics. On the other side was Fianna Fáil, whose flamboyant and mysteriously wealthy leader Charles J. Haughey was still struggling to win a majority of seats in order to establish his own leadership over the party, and was therefore anxious to postpone having to take unpopular electoral decisions. The conflict between FitzGerald and Haughey was the stuff of many parliamentary set-pieces, dramatising in their style and personality as much as in their politics two contrasting strands in Irish public life.

It was not until late in 1982 that a stable new government was formed, and this held power until 1987. FitzGerald's Social Democratic-inflected preferences made it possible for Fine Gael to form a coalition with the much smaller Labour Party (Mair, 1987). But Labour had been taking a turn toward the left since 1969. The coalition was bound from the start to encounter difficulties in implementing the fiscal squeeze, the necessity of which Fine Gael was committed to, and to which the Labour Party had reluctantly assented.

The period after the return to government of Fianna Fáil in February 1987 is normally seen as the principal period of fiscal retrenchment. But in the framework of fiscal squeeze, this can be seen as just one moment of a much longer political effort. The politics of fiscal squeeze dominated every budget introduced by the Fine Gael-Labour coalition, starting with the tough budget that caused the short-lived government that had been elected in June 1981 to fall in January 1982. The most difficult years came in the first half of the 1980s, when it was not altogether clear that Ireland would be able to recover from the compounded problems of ever-rising debt and stalled growth, very high unemployment and mass emigration, along with ongoing uncertainty about the potential spillover of the Northern Ireland Troubles into the politics of the

Republic. Moreover, a great deal of Ireland's public borrowing was held in foreign currency, so Ireland was vulnerable to shifting international interest rates.

Public spending net of debt service was rising, firstly as a consequence of the pro-cyclical spending boost of the late 1970s, and then because the demands on welfare spending grew as unemployment began to mount – it rose from 8% in 1980 to almost 17% in 1985. Meanwhile, revenues had fallen in the late 1970s as a result of the budgetary give-aways promised in the 1977 election.

Tough Choices Between Tax Increases and Spending Cuts

This leads us to our second consideration, that is, the timing and composition of budgetary adjustment. The politics of fiscal effort that underlay the sustained budgetary squeeze of the 1980s throw the 'orthodox' story about Ireland's fiscal adjustment into question. The total public debt continued to accumulate until 1987, when it was about 112% of GDP, after which it started to come down. However, even though the debt-to-GDP ratio was not stabilised in the first half of the 1980s, significant fiscal retrenchment had been undertaken during the lifetime of the Fine Gael-Labour coalition government. Between 1982 and 1986, on the key indicators of the time, the Exchequer Borrowing Requirement actually did fall by three points and the Public Sector Borrowing Requirement by more than five points (Honohan, 1992, p.290). Contrary to the standard account of Ireland's fiscal squeeze of the 1980s, 'most of the improvement in the fiscal balance was achieved through increases in tax revenues rather than expenditure cuts' (Honohan, 1992, p.312). In fact, the years in which the central government deficit showed its worst performance were 1982 and 1983. In those years, the total deficit stood at about 12.5% of GDP. Revenues had been around 33% of GDP during the 1970s, and accounted for 37% of GDP in 1981,

and that this percentage rose rapidly to 41% in 1983, where it stabilised until 1988. These changes meant that the public finances almost reached a primary balance in 1985, and actually did so in 1988, as Figure 7.1 shows.

]FIGURE 7.1 HERE[

The reason why the coalition government relied more heavily on increased taxation than on spending cuts arises from the divergence in political priorities at the heart of the coalition government. Although both parties recognised that something had to be done, agreement over how precisely to address the deficit proved difficult to obtain. Emigration also picked up pace in the mid-1980s, disguising the true effects of job losses and underemployment. Even after the resumption of GDP growth in the late 1980s, a period of ‘jobless growth’ followed, with no appreciable change in employment rates until after 1994. This put sustained pressure on welfare expenditure, and on other categories of entitlement such as housing benefits. But while welfare payments – still set at low levels at this time – were not cut, other categories of public spending were indeed targeted. For example, an embargo on public sector recruitment was introduced, a controversial measure at a time when private sector employment was falling.

Cabinet debates were famously prolonged and indecisive, not least because of the irreconcilability of party political preferences over how to address the ongoing fiscal crisis. But if forthright public spending cuts were contentious, so too were overt tax increases. Indeed, the short-lived coalition government of 1981-2 fell in February 1982 when an independent socialist ally vetoed the compromise budget package, an occasion memorialised as a vote against introducing a new indirect tax on children’s shoes. So the question arises as to how much of the increase in total revenues was

attributable to uncorrected fiscal drag at a time of high inflation – requiring little ex ante agreement on fiscal squeeze – and how much of it followed from more difficult budgetary innovation.

The question is perhaps not so easily resolvable in these terms though. By the 1980s, over-reliance on fiscal drag as a revenue raiser had itself become highly politicised. Some of the largest street demonstrations ever seen in Ireland were held across the country in 1979 and 1980, organised by the trade union movement, to protest against what had come to be seen as an already very unfair income tax system. The Irish revenue system had evolved in a rather ad hoc manner over time, so the distributive consequences of tax increases were not well planned. Many categories of income and expenditure used in other countries were exempt in Ireland, particularly property and wealth. Corporation tax had been held at a low rate since the 1950s, as part of an economic development strategy based on attracting foreign direct investment. Groups such as farmers and the self-employed were able to avail of advantages such as self-reported income and lagged tax payment. Tax administration was patchy and inefficient. The result was that ever-heavier tax burdens were imposed on employees on ever-lower levels of income, since these were the easiest sources of revenue to target effectively. Pay-As-You-Earn (PAYE) and consolidated income and social insurance contributions had only been introduced in the early 1970s, and high inflation had pushed ever-larger numbers into the tax net. In 1965, the marginal tax rate on a single person on average industrial earnings was 31.5%, and that of a single person on twice the average level of earnings was the same. In 1985, these rates were 56.3% and 62% respectively.

The coalition government was highly constrained in its policy options, but much of the agonising over budget policy was about how best to extract yet more revenue from a system that was already creaking, without damaging the labour market even further. In 1983/4, the number of tax bands was increased to six and the top marginal rate was raised to 65%; and the following year the lowest rate of 25% was abolished, leaving employees with a tax rate on 35% on the lowest income tier. The distortions in the overall tax system only worsened as the fiscal crisis deepened. However, although Fine Gael was by tradition a fiscally orthodox party, under the leadership of Garret FitzGerald it supported tilting the balance of the income tax increases in a somewhat progressive direction, and this made agreement with the Labour Party a little easier to achieve.

Paying the Political Price

This brings us to our third consideration, the political costs of engaging in tough fiscal squeeze, and the electoral penalties this may entail. The Fine Gael-Labour government performed poorly in the opinion polls as the date for the next general election drew nearer, and the centre-right, populist Fianna Fáil stepped up its attack. It made increasing political capital out of the high income tax rates and the under-funding of what were still quite low-level social and health services. Fianna Fáil stood on a platform of reversing the cuts that had already taken place. It also initiated talks with the trade union movement and employers' associations, with a view to trying to revive a negotiated stance on economic management.

The election results were disastrous for Fine Gael and for Labour, and the principal beneficiaries were Fianna Fáil. Also benefiting was a new party, the fiscally conservative, socially liberal, and anti-nationalist Progressive Democratic Party,

which was a breakaway from Fianna Fáil but which also appealed to some disillusioned Fine Gael voters. But though Fianna Fáil was now the largest party, it did not command a majority in parliament. Labour was deeply unwilling at this time to consider a possible new coalition alliance with Fianna Fáil.

What was especially striking about the results of the 1987 election was that in a country with no strong left-right political cleavage, the class basis of support for parties was more strongly marked than previously. Fianna Fáil still won a large vote share across all social groups, but its support among working-class voters rose disproportionately, while its middle-class support base shrank. Meanwhile, Fine Gael's support among middle-class voters stayed fairly secure, while its ability to reach across class divisions, never very strong, became weaker. There was a strong core of support, mostly middle-class, for 'responsible' fiscal policies. But there was also a rising wave of social discontent, especially among the working class, for an end to spending constraints and redress of the high tax burden (Penniman & Farrell; Sinnott, 1995).

At first, it appeared that Ireland was about to enter another phase of electoral instability in which no party would be able to form a stable government. But two developments in the aftermath of the election changed the situation. Firstly, with the prospect of forming a government in view, Fianna Fáil shifted its pre-election stance dramatically. It now accepted the case made by the outgoing government that the public finances had to be stabilised, since the total debt was still on an upward trajectory. Secondly, Fine Gael's new leader, Alan Dukes, committed the party not to oppose Fianna Fáil budgetary measures for electoral advantage (as Fianna Fáil in opposition had consistently sought to do), provided Fianna Fáil adhered to a deficit-

reducing strategy that Fine Gael could assent to. Fine Gael's so-called 'Tallaght Strategy' (named after the Dublin suburb where Dukes secured his reluctant party's acquiescence) gave Fianna Fáil considerable freedom of manoeuvre. But it proved electorally very costly to Fine Gael. The new minority Fianna Fáil government then went on to undertake a programme of fiscal consolidation more dramatic than anything of which the preceding government had been capable.

Fianna Fáil's policy mix between 1987 and 1992 differed from that of the preceding government in its willingness to undertake severe spending cuts. At the same time, it committed to a modest programme of reform in both tax composition and tax administration. A tax amnesty in 1988 signalled the start of a new era of tax enforcement. Employee tax rates were reduced, the base was broadened and the net widened, and new compliance measures were introduced. All this was made possible by a tripartite agreement negotiated in 1987, the Programme for National Recovery (PNR). This involved pay increases lower than the anticipated inflation rate, which would be offset by improvements in disposable income as a result of changes in the incidence and level of taxation.

The 1987 and subsequent pay-tax deals were later held to be pivotal to achieving fiscal consolidation (MacSharry & White, 2000). But as Figure 7.1 shows, without the increase in revenues that had been achieved in the preceding years, the corresponding cuts in expenditure would have had to be very much more severe, or the new tax concessions much smaller, to achieve the fiscal consolidation the government was aiming for.

A corollary of the social partnership agreement was that the trade unions acquiesced to deep cuts in public spending, including not only an embargo on further public

sector recruitment, but sharp cuts in spending on social services. Fianna Fáil also squeezed welfare spending in real terms, which the coalition government had not done – real welfare rates had remained constant between 1982 and 1987. Large cuts were also made in the capital budget. In retrospect, many economic commentators noted that this was a mistake, and that squeezing investment in infrastructure had long-lasting damaging effects on growth as well as on the quality of services. But since the main target at the time was to reduce total borrowing, it was counted a successful strategy.

Fianna Fáil's public successes in bringing about improvements in the budgetary situation in the years after 1987 were only in part attributable to their new determination to stabilise the public finances. As noted earlier, international factors played a key role in facilitating deficit stabilisation during the 1980s. The parity between the Irish Pound and sterling had been severed in 1979, and Ireland participated in the European Exchange Rate Mechanism (ERM) during the 1980s and 1990s, before entering European Monetary Union in 1999. In October 1986, the government managed a smooth devaluation of 8% of the Irish Pound against sterling. This meant that during the period of fiscal consolidation of the 1980s, the Irish government was able to avail of changes in exchange rates to adjust the distributive costs of fiscal management. During the ERM currency crisis of 1992, the Irish Pound was further devalued by 9% against the Deutschmark (Honohan & Conroy, 1994).

Ireland's attempts to reduce its public deficit and regain control over its debt dynamics were also greatly assisted by an upturn in the international economy in the late 1980s. Devaluation, supported by domestic attempts to restrain costs, was making Irish goods and services more competitive. But the so-called Lawson boom in the

United Kingdom made a significant difference to the capacity of Irish producers to benefit from domestic policy efforts. The importance of these international contextual factors has all too often been overlooked. Once the international framework is fully brought into focus, Ireland's model status as a case of 'expansionary fiscal contraction' becomes much less convincing.

The distributive effects of fiscal squeeze during the 1980s were mixed. Fine Gael and Labour, despite their urgent rhetoric about fiscal crisis, maintained real welfare rates, even at the height of the crisis and during the worst of the unemployment. Fianna Fáil, despite having campaigned on issues of social justice, imposed spending cuts that had more severe effects on the most economically and socially vulnerable. By 1989 though, it was already presiding over an economic upturn, and its inability to secure an overall majority again is attributable to voters' concerns over accountability and corruption scandals.

The electoral consequences of fiscal squeeze in Ireland provide scant endorsement for the expectation that governments will suffer no adverse effects. Both governments suffered large losses after their period in office. Fine Gael suffered all the more as it was credited with responsibility for endorsing Fianna Fáil-initiated hardship, because it provided external support for the minority Fianna Fáil government of 1987-89 without extracting visible concessions. The experience of fiscal crisis can be credited with giving rise to a new era in Irish electoral politics. The long Fianna Fáil hegemony had ended, and coalition governments appeared to have come to stay.

A Return to the Politics of Fiscal Squeeze Since 2008

The circumstances in which Irish governments found themselves required to engage in very tough fiscal squeeze once again, in the wake of the 2008 global economic crash, were very different from those of the 1980s. Ireland had been a member of the European Monetary Union since its inception in 1999. It could not secure competitiveness gains by devaluing its currency, and it was bound by the terms of the EU's Excessive Deficit Procedure. There was no external demand boost to stimulate domestic growth, and the fragility of the European banking sector as a whole constrained the availability of credit. Ireland was additionally encumbered by the terms of its own bank rescue decisions. The Fianna Fáil-led government had provided a blanket guarantee to six major domestic financial institutions in September 2008 in order to stabilise a worsening run on the banks, but the liabilities turned out to be considerably worse than anticipated (Clarke & Hardiman, 2012). Thus in November 2010, Ireland was obliged to enter a loan programme provided by the European Commission, the European Central Bank, and the International Monetary Fund (which became known as the 'Troika'). The bailout of the Irish banking sector was amongst the largest in comparative terms (Laeven & Valencia, 2012, pp.20-21); but the home-grown fiscal mistakes made during the boom made their own large contribution to the severity of the debt and deficit problem.

From late 2010 onward, although there was some domestic discretion over the details of how spending cuts and tax increases were to be implemented, the terms of fiscal consolidation programme were set by the external lenders. Against this very different backdrop compared with the 1980s, it is striking that, this time round, there was extensive cross-party agreement on the principles and priorities of the extreme fiscal squeeze that were to be undertaken. The return to government of a Fine Gael-Labour coalition in February 2011 involved minimal changes in overall policy priorities.

Once again, we might consider how the terms of debate about fiscal squeeze came to be shaped, and how the composition of adjustment between tax increases and spending cuts was arrived at, before we turn to the political costs of undertaking fiscal squeeze, and the electoral consequences for the parties involved.

Fiscal Squeeze as the Only Option

Ireland found itself in serious fiscal trouble early on in the course of the international crisis. Having been lauded for its super-normal growth experiences in the 1990s and 2000s, its crash proved to be one of the most severe among the developed economies. The immediate causes of Ireland's fiscal crisis, and the protracted experience of fiscal consolidation that began during 2008, were not due to excesses in the public finances prior to the crisis. Ireland's general public debt at the start of 2008 was 27.5% of GDP. By the end of 2011 it stood at 108.2%. Having run little or no deficit during the 2000s, the general government deficit rose to 7.3% in 2008 and 14% in 2009. The cost of bank recapitalisation resulted in a deficit of 31.2% being recorded in 2010 (as Figure 7.1 shows), which drove up the public debt in subsequent years. But the government's own deficit was still considerable, at over 12% in 2010, well outside the 3% EMU rules.

How did Ireland end up in such dire straits, from such apparently virtuous fiscal performance in the preceding years? Three features of the Irish public finances combined to produce hidden vulnerabilities. Firstly, the low interest rates available under EMU after 2000 resulted in a surge in borrowing, producing a large property bubble (Dellepiane, Hardiman, & Las Heras, 2013). Government failed to control these unintended perverse consequences of monetary union, and indeed intensified them through incentivising construction and property speculation. Lax and even non-

existent financial regulation permitted banks to become severely over-exposed, especially in the years between 2003 and 2007 (Clarke & Hardiman, 2012). Secondly, the tax reforms that had started in the late 1980s, involving lower rates and broader bases, were not systematically pursued. Rather, tax cuts came to be valued for their own sake. Tax measures that were intended to be job-friendly relieved large numbers of lower-paid employees of any tax liabilities, so that by 2008, some 50% of employees were outside the tax net altogether. This resulted in a continuous weakening of the state's revenue capacity, a vulnerability that only became fully apparent when the crisis hit. Thirdly, the surge of economic growth from 1994 to 2008 had given governments a new freedom to engage in public spending. They could do this without impairing EMU fiscal targets because the revenue stream was so buoyant. But after 2000, permanent public spending commitments, especially current spending on public sector pay and welfare transfers, were increasingly reliant on transient revenues from the property bubble. Thus when the international crisis erupted in Ireland, the public finances were unusually vulnerable.

Ireland's fiscal squeeze from 2008 onward was harsh indeed. Between July 2008 and spring 2013, Ireland had nine episodes of fiscal adjustment. By 2014, the total adjustment has been estimated to total almost €30bn, through a combination of spending cuts and increased taxation. The overall government deficit, which was 7.3% GDP in 2008 and 14% in 2009, was reduced somewhat to 13.1% in 2011 and 7.6% in 2012. Ireland was originally committed to getting the deficit to under 3% by 2015, a timetable relaxed somewhat in spring 2013. GDP was estimated to have fallen some 18% between 2007 and 2010 alone.

The context of the early adoption of fiscal retrenchment, and the unwavering commitment to this on the part of two successive governments, needs some explanation. After all, most developed economies adopted expansionary measures during 2008/9 in response to the global downturn; Ireland was an outlier (Dellepiane & Hardiman, 2012). The explanation lies partly in the new information that was then coming to light about the true fragility of the public finances. Part of the explanation can also be found in economic analysts' retrospective understanding of the fiscal squeeze of the 1980s. The persistent weaknesses in Irish macroeconomic policy-making and implementation were coming under more intense scrutiny. Academic economists were increasingly vocal in their criticism of governments' tendency to engage in pro-cyclical fiscal policy (Bénétrix & Lane, 2012; Lane, 2010). The stimulus of the late 1970s had been followed by an unfortunately timed correction that worsened an already pronounced downturn. Again during the 'Celtic Tiger' period in the 1990s and 2000s, fiscal policy had been too expansionary, and many held that a fiscal squeeze could no longer be postponed in spite of the severe downturn. Prominent professional economists in Ireland argued that the difficulties experienced by the coalition government in pursuing fiscal squeeze between 1982 and 1987 had led to an excessive delay in stabilising the public finances; that this had had adverse consequences for lost output and had unnecessarily prolonged unemployment; and that these mistakes should not be repeated. And while Irish policy experts held no brief for 'expansionary fiscal contraction', there were few voices to counter the prevailing view that regaining 'national economic sovereignty' was a top priority, that the scope for fiscal stimulus was vanishingly small, and that closing the deficit quickly was the most defensible way to restore the conditions that would facilitate recovery (Kinsella & Leddin, 2010).

Total government expenditure escalated rapidly from 42.8% GDP in 2008 to 48.8% in 2009. This was brought down to 44.1% in 2012. But percentages can be misleading when both numerator and denominator are fluctuating. Total government expenditure continue to rise, from €77.1bn in 2008 to €78.4bn in 2009. By 2011 it had been brought down to €76.4bn, and to about €70bn in 2012. But meanwhile, revenues had plummeted from €63.9bn in 2008 to €55.9bn in 2009. New tax increases pushed this figure up somewhat to €57bn in 2012, and projections would have it at €63.1bn by 2015. The overall fiscal adjustment, in an economy with a GDP of €161,034bn in 2012, was estimated at almost €21bn between 2008 and 2011, a considerable fiscal effort².

The Composition of Fiscal Adjustment

The composition of Irish fiscal adjustment after 2008 followed the ‘orthodox’ approach whereby priority is given to cutting expenditure over increasing revenues (Dellepiane & Hardiman, 2012). The profile of fiscal adjustment is summarised in Figure 7.2, which shows that the Irish strategy was based on securing about two-thirds of the fiscal effort through cutting spending, and one-third through raising taxes.

]FIGURE 7.2 HERE[

The first aim of fiscal squeeze was to prevent public spending from continuing the upward trajectory on which it was headed during the 2000s. It has been estimated that if no action had been undertaken, the deficit in 2011 would have grown to 20% of

² GNP was €129,232bn in 2012. The gap between GNP and GDP in Ireland rose steadily from the 1980s on, due to the significance of the foreign-owned sector in the Irish economy; see (Department of Finance, 2012a, p.12; Economic and Social Research Institute, 2013). These companies pay low rates of corporation tax on profits, sizeable proportions of which are repatriated. Consideration of the resources available for deployment in the Irish economy must take account of the implications of an FDI-led industrial policy for the politics of revenue and redistribution.

GDP, and Ireland would have been heading for a debt to GDP ratio of 180% GDP by 2014 or 2015 (Coffey, 2011). Coffey estimated that between 2008 and 2011, ‘almost €9bn of current expenditure cuts have been announced, but gross voted current expenditure is only €0.5bn lower than it was four years ago’. On the other hand, government was running to stand still on the revenue side, in the context of declining and depressed economic activity. Coffey noted that almost €8bn of revenue-raising measures were introduced over the period, but that revenue was actually €7.4bn less than it had been four years previously. Large spending cuts were announced, and significant tax increases were announced and implemented, but total revenues still fell far short of spending commitments.

That is not to say that the effects of spending cuts were not felt in a very real way. The first round of fiscal squeeze, in a small supplementary budget in July 2008, involved attempts at efficiency-gaining cuts. But it was not enough, and a series of scheduled and emergency budgets followed in 2008, 2009, and 2010, to try to arrest the slide toward a potential sovereign debt crisis. Rates of social welfare were cut for most categories of recipients. Public sector pay, which had risen rapidly for many employees during the 2000s was cut on a tapered basis on two occasions, in 2009 and again in 2013. In 2011, almost one-third of current expenditure in the public service was accounted for by pay alone. Allowing for difficulties in comparing education levels and skill deployment across sectors, it was estimated that between 2003 and 2006 alone, the relative overall gap (or pay premium) between public and private sector workers had risen from 14 to 26 per cent (Kelly, McGuinness, & O’Connell, 2009). The EU-IMF progress report of March 2012 reported that as a result of the spending cuts, gross rates of public service pay were reduced by about 14% cumulatively in 2009 and 2010.

In 2009, the Fianna Fáil-led government commissioned a report from economist Colm McCarthy on cutting public spending. This recommended reductions in the order of 17,300 personnel or approximately 5% of the public service. An overall reduction of some 25,000 personnel (albeit on pre-crisis 2008 figures) by 2014 was agreed with the EU-ECB-IMF in November 2010 as part of Ireland's bailout deal; these targets were met in 2013 through a combination of a hiring embargo and incentivised retirement. The profile of changes in the composition of spending can be seen in Figure 7.3.

]FIGURE 7.3 HERE[

The scale of the fiscal squeeze implemented in Ireland resulted in a fiscal consolidation that ranked third only after Iceland and Greece (OECD, 2012, Annex Table 30). Bootstrapping out of a fiscal crisis in recessionary conditions is particularly painful. Despite the many tax increases imposed since the onset of the crisis, Ireland's total tax take relative to GDP was 28.9% in 2011, down from 32.1% in 2006, which made it 'the sixth lowest in the Union and the second lowest in the euro area' (Eurostat, 2013). The profile of tax revenues is summarised in Figure 7.4.

]FIGURE 7.4 HERE[

The fiscal squeeze this time was undertaken in conditions that differed from the 1980s in important ways. The country was now richer, living standards had risen rapidly during the 2000s, and large cutbacks might now be expected to be more easily absorbed without causing major hardships. However, the constraints of EMU meant that any competitiveness gains could only be achieved through painful and unevenly experienced 'internal deflation', that is, by reducing real living standards. EMU member countries were all undergoing simultaneous deleveraging in the public sector,

thereby intensifying the cumulative impact of parallel internal deflation.

Notwithstanding their extensive public recapitalisation, banks sought to consolidate their balance sheets and still faced large unresolved issues of non-performing private sector loans and mortgages. This meant a dearth of lending activity, further squeezing the activities of firms in the private sector. Fiscal squeeze in these conditions has contractionary and not expansionary effects (De Grauwe, 2013; De Grauwe & Ji, 2013).

The effects of fiscal squeeze within a monetary union might therefore be expected to be experienced unevenly across different sectors of the population. Heavier tax burdens on income and on transactions may raise more revenue, but new revenue streams on items such as residential property, waste disposal and water were more visible. Public spending cuts were felt in shrinking pay packets and welfare payments, and in worsening health, education and other social services. But the cost in the private sector were most clearly felt in the form of unemployment, first in the devastation of the construction sector, then across a whole range of mostly domestically-owned enterprises that shed employees or simply went out of business.

The impact of fiscal squeeze on the disposable income available to households can be difficult to estimate accurately, in light of the multiple effects of changes in income tax and indirect taxes, public sector pay and welfare entitlements. Some research findings suggest that while the impact of income tax, pay and welfare changes on household disposable income was more severe in Ireland than elsewhere, both the overall policy stance and the distributive outcomes between 2008 and 2012 had a progressive profile (Callan, Keane, Savage, & Walsh, 2012, p. 53; European Commission, 2012, p.17). That said, the increasing reliance on indirect taxation is

regressive in effect, and different kinds of households were disproportionately affected. People dependent on welfare suffered most, and cuts to Child Benefit were particularly marked, whereas older people fared less badly overall. The proportion of the population deemed to be suffering ‘deprivation’ almost doubled from 11.8% in 2007 to 22.5% in 2010, and was 24.5% in 2011 (Nolan et al., 2014).

Resistance, Protest, and Fragmentation of the Party System

What, then, of the political costs of imposing fiscal squeeze this time round? Street protests against ‘austerity’ in Ireland were much less in evidence compared to the mass mobilisation that occurred in Spain, Portugal, Greece, and Italy. Some public sector unions organised small-scale industrial action, and in one early and quite successful rally, older people protested over medical entitlements. But negotiated agreements about the scale of pay cuts, concluded between both governments and the public sector unions, kept mass organised protest off the streets. Regular small-scale protests organised by various left parties made relatively little public impact.

The political effect of fiscal squeeze is seen most clearly in the electoral arena. Irish political life was transformed by the ‘earthquake election’ held in February 2011.

Fianna Fáil, Ireland’s historically dominant party, suffered devastating losses at the polls. It secured only 17% of the popular vote, falling from 71 to 20 Dáil seats. Figure 7.5 illustrates a trend that had been apparent for quite some time, that is, that Fianna Fáil was deeply unpopular.

[FIGURE 7.5 HERE]

Fianna Fáil was being punished not only for its implementation of fiscal squeeze after 2008, but also for its longer-term mismanagement of the economy. It was now also paying the price for its panicked bank guarantee of September 2008, and for the years

of inadequate financial regulation that had led the domestic banks to the brink of melt-down, and the Irish economy to catastrophic collapse.

The Fine Gael-Labour coalitions government that was formed in February 2011 recognised that it was bound by the conditions of the EC-ECB-IMF loan agreement. While voter dissatisfaction with Fianna Fáil ran deep, these two parties similarly held that the only feasible or realistic course of action was to continue with fiscal squeeze, modified a little where possible, at least until the terms of the loan programme was finished and the fiscal deficit was sufficiently reduced. It is therefore striking that these two parties gained an additional 42 seats in the election.

But the extent and durability of electoral acquiescence should not be taken for granted. New institutions that had been set up to monitor the public finances resulted in some shifts in priorities, for example in capital spending and in labour market policy. But in Ireland as elsewhere in the Eurozone, it was unclear how long fiscal squeeze could be sustained without a clear expectation that better economic performance would eventually come about. Much of Europe suffered from a ‘mutually reinforcing interaction between limited productivity gains, protracted deleveraging, weak banking sectors and distorted relative prices’ (Darvas, Pisani-Ferry, & Wolff, 2013, p.7). The commingling of financial crisis with sovereign debt crisis in Ireland, in the context of an all but stagnant European economy, appeared to point toward real problems of debt sustainability. It is surely a matter of some concern that Irish citizens’ trust in their own government, always more contingent than the EU average, fell precipitously after the crisis began. It recovered in the context of anticipation of fresh elections and a change of government, but fell sharply again thereafter, as Figure 7.6 shows.

]FIGURE 7.6 HERE[

Weakening support for all the established political parties is also reflected in Figure 7.5. This shows that, while support for Fine Gael and Labour had been strong for over two years prior to the election, it peaked shortly thereafter. For as long as this government was implementing the more systematic fiscal squeeze required by the Troika, its popularity was shrinking. The biggest beneficiaries of this were a wide variety of small leftist parties and independent politicians. In September 2013, Fianna Fáil was reported to be making some comeback in the polls. But Sinn Féin was reported to be the third most popular party, with 21% support, while the diverse array of ‘others’ (independents and small socialist parties) came in next with an aggregated support level of 18%. Fine Gael dropped to 27% of voters’ support, while Labour fell back from the 19% they had won in the election to about 10% (Elections Ireland, 2013). Meanwhile, new protest groups, organizing around local issues to do with increased levies and service charges, prepared to contest local elections in 2014. Electoral volatility seemed to be considerable. Exit from the loan programme in December 2013 entailed little real change in tough budgets or in economic performance. It remained unclear whether or not Ireland was entering into a new phase of electoral realignment, or facing a sustained phase of potentially destabilizing electoral dealignment.

Conclusion

While Ireland has been taken to be an exemplary case of successful growth-promoting fiscal retrenchment, many of the apparent lessons drawn from its experience turn out to be more complex upon closer inspection. The politics of fiscal squeeze is

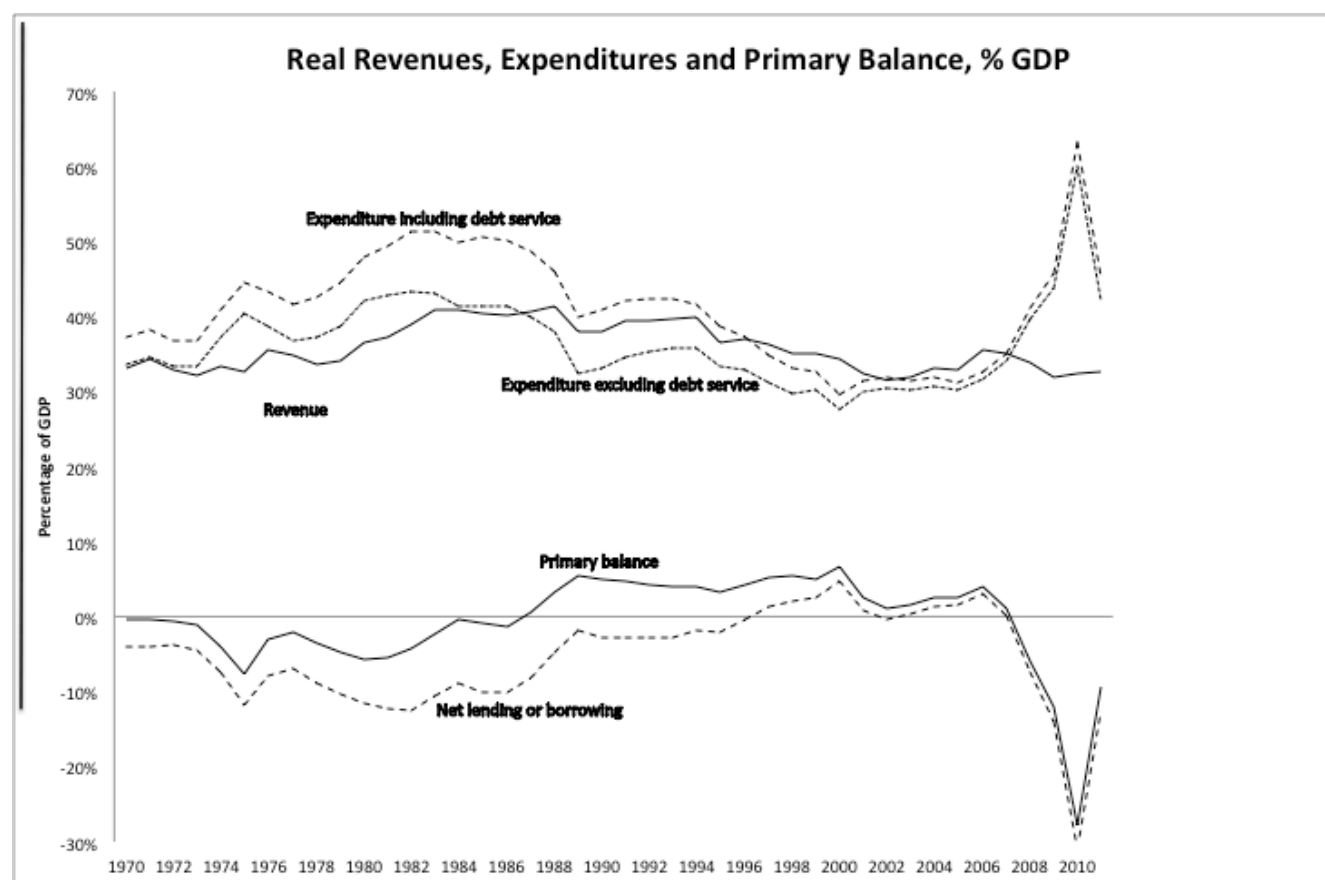
problematic on three counts: the framing of the decision to undertake fiscal consolidation, the composition of adjustment, and the electoral costs suffered by the parties who implement such measures.

During the 1980s, the decision to commit to fiscal squeeze was difficult for all parties, and that this affected the consistency of political effort. These memories shaped governments' response to the economic crisis from 2008 on, when there was more ideological convergence over the inevitability of fiscal squeeze.

The policy mix during the 1980s relied on increasing taxes at first, followed by a bias toward spending cuts after 1987. But neither the politics of fiscal planning, nor the design of the revenue system itself, was subject to systematic institutional reform. The fiscal squeeze after 2008 entailed yet another episode of pro-cyclical fiscal correction. And without the option of devaluing, or of availing of an international growth surge, the effects were harsh indeed.

The political costs of fiscal squeeze in the 1980s were somewhat ambiguous. Both Fine Gael and Labour lost seats, but Fine Gael suffered doubly because of its 'responsible' stance, supporting the new minority Fianna Fáil government externally. Fianna Fáil was unpopular for its spending cuts, but still benefited from the rebound by 1992. The political costs incurred by political parties after 2008 may be more far-reaching. Fianna Fáil suffered unprecedented collapse. The 2011 general election signalled a new phase in Irish electoral politics, with all the mainstream parties subject to challenge from less-organised contenders. What the significance might be for the profile of the Irish political system remained an open question.

Figure 7.1. Revenues, expenditure, and primary balance as % GDP



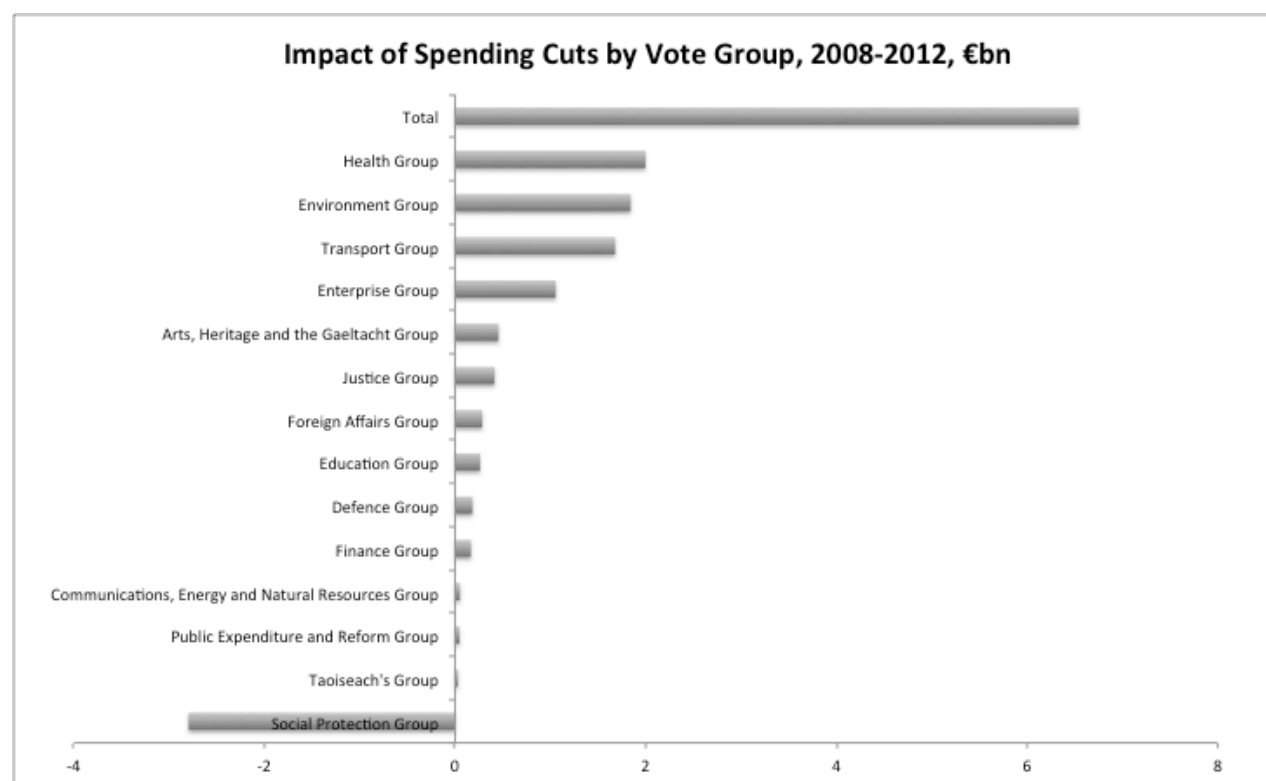
Source: Central Statistics Office, 2012; European Commission, 2013.

Figure 7.2. Composition of Irish Fiscal Adjustment Strategy, 2008-2012

Intervention	Key budgetary measures	Size of fiscal effort
July 2008: Expenditure adjustments	Efficiency cuts	€1bn
October 2008: Budget 2009	Income levy; spending cuts, including welfare	€2bn
February 2009: Expenditure Adjustments	Cuts to public sector pay as 'pension levy'; public sector pay increase stopped	€2.1bn (€1bn in 2010)
April 2009: Supplementary Budget	Tax increases esp. levy; €1.2bn current , €600m capital	€3.6bn Total €5.4bn €1.8bn
December 2009: Budget 2010	Spending cuts on all welfare, public sector pay and numbers; capital cuts; tax increases	€4.4bn
December 2010: Budget 2011	Current cuts €2.1bn, capital cuts €1.9bn, other €0.7bn; tax increases €1.4bn	National Recovery Plan 2011-2014 projects €10bn cuts, €5bn tax
December 2011: Budget 2012	Current cuts €1.4bn, capital cuts €0.8bn, Tax increases €1bn	€3.2bn
Adjustment 2008-2011		€20.8bn
Projected overall adjustment 2008-2014	65% Expenditure 35% Revenue	€29.6bn

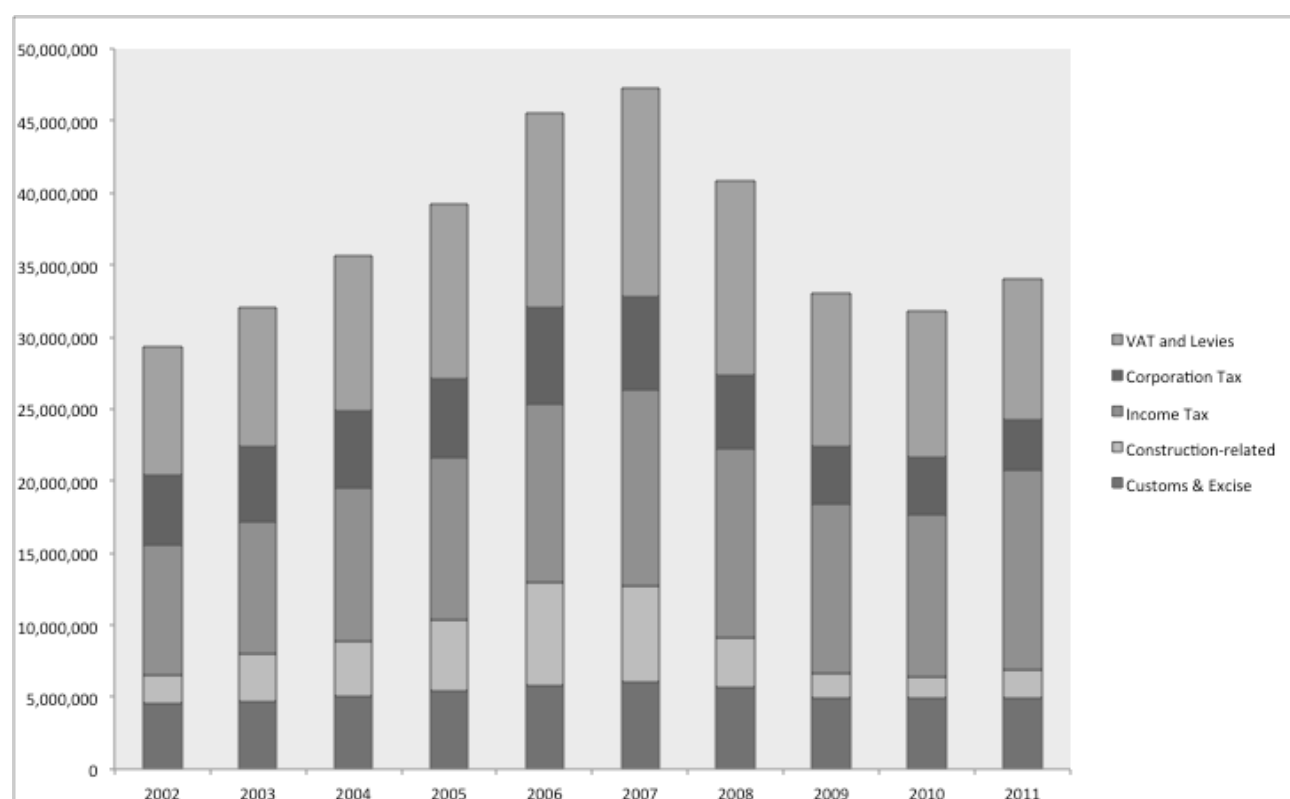
Source: Department of Finance, 2011; European Commission, 2010; Budget documents 2009, 2010, 2010, 2011.

Figure 7.3. Impact of spending cuts by category of public spending 2008-2012, €bn



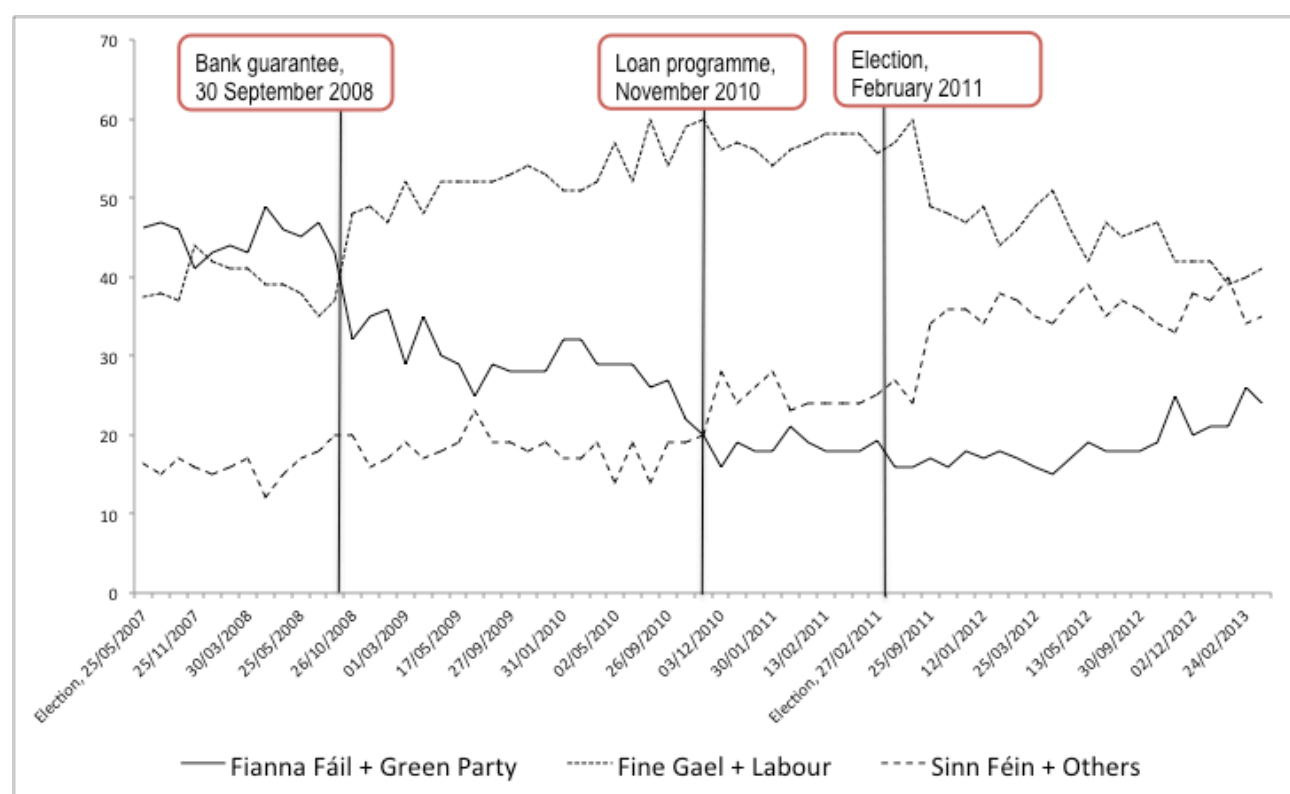
Source: Department of Public Expenditure and Reform, 2013

Figure 7.4. Actual Outturn in Revenue, 2002-2011, €bn



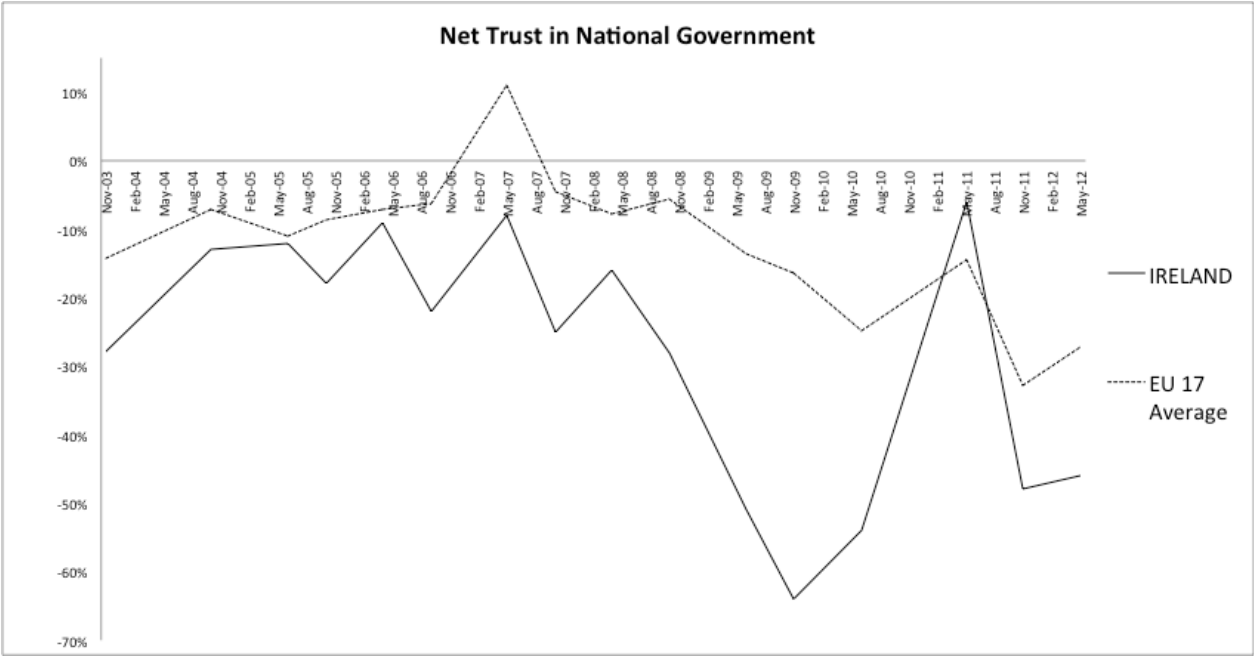
Source: Department of Finance, 2012b

Figure 7.5. Opinion Polls on Support for Parties, 2007-2013



Source: Elections Ireland, 2013

Figure 7.6. Net Trust in National Government



Source: Eurobarometer

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