Economic and Fiscal Policy

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Abstract and Keywords

This chapter argues that Ireland did not need to impose the level of fiscal austerity it did in order to recover after the global financial crisis of 2007/8. After reviewing Ireland’s fiscal history, this chapter argues that the structural features of the economy, its remarkable openness, and a range of international factors, explain Ireland’s success. It looks at the relationship between government spending into the economy and the extraction of taxes from sectors of the economy to fund those services and effect a redistribution of income and wealth. Structurally, Ireland differs significantly from the other peripheral economies that imposed austerity after 2008, such as Greece and Spain. Accordingly, Ireland is not a poster child for austerity but rather a beautiful freak.

Keywords: austerity, fiscal history, Ireland, openness, government spending
Introduction
The purpose of this chapter is to examine Irish economic and fiscal policy from 1996 to 2016, looking particularly at the experience of austerity from 2009 to 2013 using macroeconomic data. The success of the Irish experience relative to other countries within adjustment programmes is frequently used by policymakers across the world to justify the imposition of austerity on other countries. Ireland is very often touted as the poster child for such policies. For example, the International Monetary Fund’s (IMF) Christine Lagarde cites Ireland’s experience as setting ‘standards for the correct measures to follow towards a recovery’ (IMF 2015: 12).

This chapter will try to answer why, exactly, a small open economy like Ireland was able to marry growth and large-scale fiscal consolidation. The answer lies in the institutional structure of the economy, its openness and particularly the sectoral structure of the economy.

Following Blyth (2013a: 866–7), let us define austerity, at least for the rest of this chapter as:

[C]utting the state’s budget to stabilise public finances, restore competitiveness through wage cuts, and create better investment expectations by lowering future tax burdens.

Thus, austerity is not simply fiscal consolidation, nor is it a static concept. Austerity is rooted in a dynamic conception of the economy as an evolving object with its own inter-temporal budget constraint. The objective of austerity is to inspire confidence amongst international investors that their investment will yield positive returns. The signal provided by the large drop in government expenditure or increase in taxes is traded for increased investment as a result of this increased confidence, generating a so-called ‘expansionary fiscal contraction’. Using fiscal policy to influence investor expectations has been roundly criticized. Guajardo, Leigh, and Pescatori (2014) offer a good summary of these critical voices. Alesina and colleagues (2015) provides a rejoinder to these critics.

Ireland’s evolution from the catch-up era from 1996 to 2002, characterized as the ‘Celtic Tiger’ years, will not be discussed. Readers should consult Ó Riain (Chapter 2, this volume, and 2014) for an overview of these years. Honohan and Walsh
(2002) provide a compelling argument for the ‘catch-up’ thesis, essentially arguing that Ireland’s Tiger years represented a regression to the European average living standard after decades of underperformance.

Instead, more recent fiscal and economic policies will be discussed, especially in terms of the decisions taken with respect to the fiscal stance—the relationship between government spending into the economy and the extraction of taxes from sectors of the economy to fund those services and effect a redistribution of income and wealth.

The Irish experience of fiscal policy has been studied previously by Lane (2011), Bergin and colleagues (2011), and Fitzgerald (2009), who found that Ireland’s fiscal stance was worryingly pro-cyclical. Kinsella (2012) and Kinsella (2014) compare the Irish experience of fiscal retrenchment in the 1980s to the 2009–13 experience. Weymes and Bermingham (2012) examine the optimal structure of fiscal consolidations, finding a 50:50 mix of tax increases and spending cuts is broadly optimal, while Ball (2014) examines the long-run damage to Organisation for Economic Co-operation and Development (OECD) economies from the experience of austerity, finding austerity episodes may damage the long-run potential growth of the country. Considine and Duffy (2014) examine the role of expectations and the ‘confidence faeries’ in managing crises, using Ireland as a case study. Fiscal consolidations are supposed to inspire confidence in international investors. The argument is quite simple: cutting government spending calms markets, because it shows governments have a clear and credible strategy for reducing debt levels and thus avoiding default. With a rapid cut in government spending and deficit reduction, it should help bond yields remain low as the ‘faeries’ come on board. Considine and Duffy find, unsurprisingly, that the confidence faeries do not exist. Blyth (2013b) provides an overview of the intellectual architecture, and indeed the history of various austerity episodes, including Ireland. Perotti (2011) defends the theory of expansionary fiscal contraction critiqued in Kinsella (2012).

We examine three interrelated themes of fiscal policy. First, we discuss the components of both taxation revenue and expenditure, both current and capital, in some detail. Second,
we examine the change in what we call ‘the fiscal stance’ over the period from 2002 to 2014. Third, we comment on the Irish experience of austerity relative to other European nations.

We make three, interlocking arguments related to these themes in this chapter.

First, Ireland’s highly pro-cyclical fiscal policy has historically challenged its ability to weather sustained economic crises (Lee 1989). The majority of the decisions taken from 2002 to 2007 substantially decreased the ability of the economy to cope when the downturn of 2007 and 2008 took hold, particularly as a large amount of government revenue from standard income taxes was replaced with capital gains and capital acquisitions-type taxes over this five-year period.

Second, Ireland’s experience of austerity from 2008 to 2013 was a unique one, given the level of openness of the economy and the lack of large-scale social unrest, neither of which are features of other countries who experienced austerity during the same period. The negative changes in current (non-pay), capital, and public sector wages were buttressed, to a certain extent, by robust demand for Irish exports, especially after 2009, while a large-scale emigration, particularly of the young, kept unemployment rates, with corresponding social protection spending, lower than otherwise.

Third, looking forward five or ten years, it is clear the Irish economy has a new ‘target-driven’ approach to fiscal policy based on regulating the Eurozone’s macroeconomic imbalances, which will generate tensions of its own over time, especially when these targets are not met.

The rest of this chapter is laid out as follows. The section ‘The Fiscal Evolution of the Irish Economy, 1996–2016’ examines the fiscal evolution of the Irish economy. Then comes the section ‘Austerity and the Arrival of the Troika’, which discusses the issues surrounding austerity and looks at the crucial issue of Ireland’s openness. This is followed by the ‘Conclusion’.

Irish fiscal policy was, and to a certain extent, still is, highly pro-cyclical (Fitzgerald 2009; Weymes and Bermingham 2012). The composition of national revenue and expenditures have changed remarkably over the time period we study, which begins, roughly, when the ‘Celtic Tiger’ period of catch-up growth ended and a new phase of economic growth based largely on an asset price bubble took over.

Let us look in turn at the scale of the Irish government’s revenues, its sources, and then at the uses of those revenues, and their changing compositions over time.

Pre-crisis taxation sources were largely made up of four groups: income taxes, taxes on consumption (valued added taxes (VAT) and customs/excise), corporation taxes, and taxes on capital transactions, particularly on property (stamp duties, capital gains, and acquisitions).

In 2002, roughly 31 per cent of all taxation revenue came from income taxes. In 2006 that had fallen to 26 per cent. By 2015, that proportion rose to 40 per cent. In comparison, revenues from VAT remained largely static, and averaged 29 per cent over the entire period, as did customs and excise taxes, averaging 15 per cent of all taxes. Capital gains and acquisitions taxes comprised only 7 per cent of all tax revenue in 2002. In 2006, this was 16 per cent, and by 2015 it had returned again to 15 per cent of all income, but this time included a local property tax (LPT). Corporation taxes fell from 16 per cent in 2002 to 12 per cent in 2008, reaching only 11 per cent by 2014 and jumping suddenly in 2015 to 15 per cent. Figure 3.1 shows the breakdown in percentage terms. It shows the composition and source of government revenue from 2002 to 2015, expressed as a percentage of the total tax take in each year. The large increase in the use of income taxes from 2009 onwards, and the large drop in stamp duties and corporation taxes, are apparent in the figure.

The crucial role income taxes have played in making up the difference between the government’s expenditure and revenues allows us to infer that the largest burden of the adjustment fell on those with middle to high incomes, as this is the largest tax-paying segment of Irish society. Income tax was 28 per cent of the total tax take in 2003, and 40 per cent in 2015. In contrast, capital gains and stamp duties
combined represented 10 per cent of the tax take in 2002, 15 per cent of the tax take in 2006, and 6 per cent of the tax take in 2015.

The distribution of tax and spend does matter in computing the overall welfare changes to the different cohorts represented in Ireland over this period. From 2002 to 2007, almost every sector of society benefited from lower tax rates, and higher levels of spending, particularly on social welfare elements like Jobseeker’s Benefits (JB), pensions, and Child Benefit payments. Callan et al. (2014) looked carefully at the impact budgetary policies have had from 2009 to 2014, both on the top and bottom of the income deciles. They found budgetary policies reduced top incomes by 16 per cent, while incomes of those at the bottom fell by 12 per cent. The marginal effective tax rates on different household types also changed in the 2002 to 2007 period, as welfare rates increased, only to change again post-2007 as fiscal retrenchment, combined with a rapid deterioration in labour market conditions, forced income taxes on those remaining in work to balloon while payments on those without incomes either fell significantly, or stagnated.

The changing composition of the tax take was a policy judgement born out of sheer necessity. Faced with a 15 per cent drop in employment, a 22 per cent drop in domestic demand, an almost €40 billion euro bill required to bail out Ireland’s banks, and a policy commitment to maintain corporation tax rates at 12.5 per cent, the state’s options for revenue generation were relatively circumscribed. Income

**Figure 3.1. Components of government revenues, per cent**

*Source:* ‘LPT’ is the local property tax, introduced in 2013. <databank.finance.gov.ie>
taxes have plugged the gap left by property and consumption taxes. The newer taxes on property, carbon, and water have yet to make any substantial changes to the composition of taxation revenue, and, though the profile of Ireland’s tax base is moving in an anti-cyclical direction, the pro-cyclical nature of the state’s revenue cannot be avoided.

Turning from revenue now to the expenditure side of the equation, if we look at the changes in the components of how the government spends those funds on an annual basis, the following picture emerges.

Three broad components of spending need to be analysed: current (non-pay), pay, and capital spending. Figure 3.2 shows these spending levels from 1994 to 2016, indexed to 2007 to compare their changes directly. The overall picture is one of relentless expansion in line or slightly above nominal gross domestic product (GDP) growth from 1994 to 2007, followed by a particularly deep retrenchment in capital expenditure from 2007 to 2013, and relatively modest increases thereafter.

Current (non-pay) expenditure was 60 per cent of its 2007 level in 2002, and only 26 per cent of its 2007 value in 1994. As mentioned, successive governments used large tax receipts to simultaneously increase the scale and scope of the welfare state, while decreasing the rate of tax many individuals and entities (p.45) paid. These large nominal increases resulted in a 40 per cent increase relative to the government’s 2007 level in current spending, which was cut back in certain areas
after 2009, such as spending on Jobseeker’s Allowance (JA) for younger workers, spending on expenses for public sector workers, decreases in funding to higher education, and many more cuts. However, large increases in payments for those not in work counterbalanced many of these decreases and so the relative size of the non-pay spend increased as automatic stabilization policies were employed.

By 2016, despite large cutbacks, current expenditure had increased to 116 per cent of its 2007 level. Capital spending was 72 per cent of its 2007 level in 2002, and only 47 per cent of its 2007 level in 2016. Public sector pay was 64 per cent of its 2007 level in 2002, only 34 per cent of its 2007 level in 1994, growing to 88 per cent of its 2007 level in 2016.

Current (non-)pay expenditure has many components, voted on by the Irish Parliament in annual finance bills. Figure 3.3 shows large elements of these ‘votes’, including a breakdown of the large social protection expenditure line in 2014.

It shows, in billions of euros, the three largest components of voted current voted expenditure, on health, education, and social protection (p.46) from 1994 to 2016. Together they represent almost 67 per cent of the total spend in 2016, and this proportion has increased from 52 per cent in 2002.

As with the revenue data reported in Figure 3.2 from 1994 to 2007 each heading increased in line with nominal GDP. Post-2007, however, education spending flatlined, while social...
protection spending continued to increase as unemployment increased, as a series of automatic stabilizers took effect. The sharp decrease in 2014 from €14 billion to €11 billion in 2016 came about as unemployment levels began to fall, reflecting the ‘automatic’ element of this element of voted expenditure. Despite decreases across the rest of the system, health spending has maintained its very high level of spending each year after 2007, requiring supplementary budgets each year since then, with spending almost returning to trend by 2016. In education, no increases have been seen after 2013, with 2016’s voted expenditure roughly equivalent to its 2007 level. (p.47) In education especially, post-crisis, large infrastructural deficits and human capital shortages may well emerge as a result of the decreases in the growth rates of funding, especially as demographic pressures mount.

The breakdown of these services is significant, as reductions or increases to expenditure generally are not applied equally throughout a large ‘vote’. Taking social protection—vote 37—as an example, we see the 12 billion euros spent in 2014 was spent in the following way. Housing took up 8 per cent of funds, survivors’ benefits took up 7 per cent, payments to children and families another 12 per cent, state pensions took up 29 per cent, disability and sickness 21 per cent, and unemployment benefits in total absorbed 20 per cent of all payments. The complexity of the architecture of the state needs to be understood when discussing austerity, and the ‘target-driven’ approach to fiscal policy now employed.

Figure 3.4. Evolution of expenditure and revenue as per cent of GDP, excluding interest payments

Source: CSO.
Finally, putting both revenue and expenditure together and scaling by GDP gives us the basic funding position of the Irish state from 1996 to 2016, summarized in Figure 3.4. Without including spending on interest payments or other spending items, we can see the large difference between revenue and (p.48) spending which took place after 2007. This gap was filled with state monies and borrowing from the private market until 2011, after which a loan package comprised of bilateral loans from countries like the UK and Denmark and the ‘Troika’ of the European Commission (EC), the IMF, and the European Central Bank (ECB), was used. Ireland regained access to the sovereign bond markets in 2013.

We can see the changing fiscal stance of the Irish state over this period. The ratio of tax to GDP changed slightly over this period. In 2002, the ratio was 28.3 per cent. In 2011, it was 28.7 per cent, and in 2016 it was 26.5 per cent. The real change, however, is in the division of the tax burden from labour, capital, and land. Labour’s share has risen substantially over the crisis period in order to fund necessary services.

Using the institutional sectoral accounts, and breaking down

\[ \text{Figure 3.5. New debt and interest payments as per cent of GDP from 2007 to 2016} \]

\[ \text{Source: CSO.ie.} \]
the 2015 figure of 31.3 per cent, again as a percentage of GDP we find 11 per cent comes from taxes on production and imports, 13.6 per cent comes from current taxes on income and wealth, 0.2 per cent comes from capital taxes, and 5.3 per cent comes from net social contributions. It is unlikely this fiscal stance will change in the short term, unless larger taxes on capital are introduced.

The fiscal position of the country deteriorated, requiring a large increase in debt. Figures 3.5 and 3.6 show the changes in debt per annum from 2007 to 2016, and break these changes down into new debt issued to maintain a funding balance, and interest payments incurred. The clear increase in net debt, which takes account of all cash equivalents on the state’s balance sheet, from 14 per cent of GDP in 2007 to 90 per cent by 2013, is obvious. What is not obvious is the path of debt reduction post-2016, and this path is highly dependent on external factors.

Moving from the government’s finances to the interplay between financial corporations, non-financial corporations, and households, it is appropriate to focus on the role the expansion of credit played, given the financialized nature of the crisis. Credit was typically extended for asset purchases of residential and commercial properties. In 2002, the net amount of new personal loans produced by the Irish economy was roughly €370 million, and grew by about 25 per cent per annum from 2002 to 2007.

By 2006, almost €1.2 billion in new credit was being produced by a euphoric banking system to meet the ever-growing demands of the household sector. Household credit simply could not stay at these boom levels, absent a large and liquid international wholesale market for interbank lending, which was disrupted following the collapse of Lehman Brothers (p. 50) on 15 September 2008. Net new lending fell precipitously from 2007 onwards, reaching an historic low of less than €100 million in 2012, before rising again to around €300 million in 2014.

The expansion of credit, the societal euphoria this
produced, and the subsequent collapse in both asset prices and credit flows have followed the classical Minsky cycle rather closely.

Minsky (1986: 42) wrote that:

Whenever profits decreased hedge units [when anticipated cash flows from operations exceeds anticipated commitments at all future times] become speculative and speculative units [situation when anticipated cash commitments will exceed anticipated cash flows at some points in the future] become Ponzi firms [situation when anticipated cash inflows falling short of anticipated commitments at most or all future times]. Such induced transformation of the financial structure lead to falls in the price of capital assets and therefore to decline in investment. A recursive process is readily triggered in which a financial market failure leads to a fall in investment in which leads to a fall in profits which leads to financial failures, further declines in investment, profits, additional failure, etc.

This is precisely what happened in Ireland. In 2008, the private debt generated by transactions between the household and financial sectors of the economy was transferred in large part to the government sector via a state guarantee of the assets and liabilities of the banking sector worth roughly €440 billion in 2008.
Table 3.1. The balance sheet of the Irish sovereign

<table>
<thead>
<tr>
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<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
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</thead>
<tbody>
<tr>
<td>1. Non-Financial Assets</td>
<td>61</td>
<td>58</td>
<td>57</td>
<td>57</td>
</tr>
<tr>
<td>2. Financial Assets</td>
<td>72</td>
<td>65</td>
<td>62</td>
<td>73</td>
</tr>
<tr>
<td>3. Liabilities</td>
<td>114</td>
<td>138</td>
<td>167</td>
<td>208</td>
</tr>
<tr>
<td>4. Net Financial Assets (=2+3)</td>
<td>−41</td>
<td>−73</td>
<td>−105</td>
<td>−135</td>
</tr>
<tr>
<td>5. Net Worth (=1+4)</td>
<td></td>
<td>20</td>
<td>−15</td>
<td>−48</td>
</tr>
<tr>
<td>Net Worth, Per Cent of GDP</td>
<td>12</td>
<td></td>
<td>−9</td>
<td>−29</td>
</tr>
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This guarantee, enacted in September 2008 by then Finance Minister Brian Lenihan to calm market fears about illiquid banks quickly became a fiscal straitjacket as questions about the illiquidity, and then the solvency, of the banking system were replaced with questions about the solvency of the Irish state. The Eligible Liabilities Guarantee (ELG) scheme made sure that deposits in Irish banks were kept safe, and kept the taxpayer on the hook for some losses in the banks if they occurred. (Because the state summed a contingent exposure for the banks, there was a fee charged to each covered bank. The state in fact earned €4.4 billion from 2008 to 2015 when the ELG scheme was discontinued.)

It is worth viewing the change in the fortunes of the Irish economy from the lens of the balance sheet, where assets and liabilities are valued at a particular moment in time and their difference, or net worth, can be seen. Table 3.1, from Barnes and Smyth (2013: 20), shows the deterioration of the balance sheet of the Irish state from 2009 to 2012 in both nominal terms and relative to GDP. In terms of the health of its balance sheet, from 2008 onwards, the Irish sovereign moved from one of the stars of the Eurozone to experiencing a balance sheet crisis, as described by Koo (2009). The marked increase in liabilities, from 114 billion euros in 2009 to 208 billion euros in 2012, (p.51) illustrates this deterioration. The negative net position more than triples from 2009 to 2012. The remarkable change in net worth as a percentage of GDP is testament to this, with Ireland’s net worth valued at around 12 per cent of GDP in 2009, and a striking −47 per cent of GDP in 2012.
The individual sectors of the economy also experienced large changes in their fortunes. A very useful way to see these changes is by computing the sectoral balances of the private sector (savings minus investment), the public sector (government spending minus taxes), and the rest of the world (exports minus imports plus net factor income from the rest of the world). The sum of the private and public balances must equal the rest of the world’s financial balance by simple arithmetic. Because these are identities, and not equations, these relationships hold true regardless. The sectoral balances represent an ex post accounting identity resulting from rearranging the components of aggregate demand, showing how the flow of funds affects the financial balances of the private sector, government sector, and foreign sector. Figure 3.7 shows these changes over time for Ireland.

The balance for the private sector shows investment falling rapidly after 2008, with precautionary saving and retrenchment taking place after this period, combined with a rapid movement away from highly indebted positions, which economists call deleveraging. The trade balance shows a marked upswing after 2008, with exports returning rapidly to their pre-crisis levels while imports do not. This strange effect is explained by the extremely open nature of the Irish economy, and the dominance of the export sector by multinationals. Faced with a world economy which partially had recovered by 2009, exports returned to trend. The domestic economy, meanwhile, had to cope with a large negative change in unemployment, a collapse in construction—
related activities, and a fiscal crisis by the sovereign. Import demand, therefore, did not recover, pulling the ‘rest of the world’ sector upwards after 2009. The public sector, as we have discussed extensively, moved from a condition of rough balance from 2002 to 2007, to an excess (p.52) of government spending over taxes, which necessitated, first, large-scale borrowing, and then reduction via austerity.

Overall, using the sectoral balance approach, we can see a sharp movement from foreign surplus composed of deposits and equity from 2002 to 2007, to foreign surplus composed of loans and equity from 2007 to 2016. The turnaround is remarkable, both in its speed and its scale. Because we have these balances as accounting identities and not causal relationships, it cannot be said where these balances will tend in the future with any certainty.

However, we can say that austerity policies have achieved the rather dubious objective of making the difference between government expenditure and taxation as small as possible. In this movement towards fiscal balance, the domestic authorities imposing austerity were accommodated, first, by a private-sector balance adjustment and, more crucially, by the rest of the world via the ‘rest of the world’ balance. This meant that Irish austerity, rather than being a domestic success, was in fact facilitated by Ireland’s openness to the rest of the world. (p.53)

Austerity and the Arrival of the Troika
Once private capital markets became closed to the government in 2010, creating an effective ceiling on any expansionary fiscal policy, a loan facility was arranged with official funders (the IMF, EC, and the ECB) in exchange for the adoption of austerity policies, many of which were already underway by mid-2009, when a mid-year budget began the process of increasing income taxes, reducing planned expenditure, and effectively cancelling capital developments.

Three separate reports and a parliamentary banking enquiry into the Irish crisis have established that macro-prudential regulation of banking was lax, that fiscal policy, and in particular Ireland’s fiscal stance, was inappropriate given its membership of the Eurozone during a period of low real interest rates, and, finally, that Ireland’s political elite was inappropriately enmeshed with property developers, whose
interests were served before those of the national interest. Each report has noted with dismay the failure of macroeconomic models used by Ireland’s Department of Finance and the ECB to accurately predict the crisis (Honohan 2010; Regling and Watson 2010; Nyberg 2011).

The Troika rescue plan, negotiated in 2010 after Ireland had lost its access to private bond markets, had a specific strategy. The IMF’s Memorandum of Understanding (IMF 2010) set out, in detail, the austerity measures the Irish undertook until 2014. Briefly, they fell under the following categories and subcategories.

1. Fiscal consolidation
   a. Taxes were to be raised. Carbon, property, and water taxes were to be introduced, personal income tax bands lowered, and credits to be pursued.
   b. Government expenditure, including social protection expenditure and numbers of public sector workers, was to be reduced.

2. Financial sector reforms
   a. A deleveraging of Irish banks by €72 billion over three years.
   b. A reorganization of the banking sector.
      Smaller banks merged with larger ‘pillar’ banks.
   c. Increases in Tier 1 capital ratios of ‘pillar’ banks.
   d. Burden-sharing by holders of subordinated (not senior) bond debt.

3. Structural reforms to the labour market and protected sectors
   a. The IMF proposed a reduction of the minimum wage.
   b. Increased workplace training and internship positions.
   c. Government was to introduce legislative changes to remove restrictions to trade and competition in sheltered sectors including the legal and medical professions.
It is clear from this list that the proposed and implemented solution to the problem of fiscal imbalances in particular was a range of austerity measures across the real and financial sectors of the economy. Of the three major elements of the Troika programme, only elements 1 and 2 were carried out effectively. No serious reforms of any professions were carried out, and the minimum wage reduction was cancelled. Reforms were introduced to increase the activation elements of labour market policies for the unemployed, although as O’Connell argues in Chapter 13, these reforms were implemented slowly, despite the scale of the unemployment crisis, and questions remain about the effectiveness of many training and employment schemes.

The key issues of restoring fiscal balance and recapitalizing and reorganizing the banking system stand as the key achievements of the Troika’s time in Ireland. Much of the broad strokes of a fiscal consolidation were underway from mid-2009, and so it is unclear to what extent the Troika can be blamed, or take credit for, this return to fiscal balance. Certainly, their presence provided a convenient scapegoat for highly unpopular policies.

These policies had a specific mix: one-third of the measures to reduce the budget deficit would be increases in taxation, while two-thirds would be decreases in government expenditure. The result was, of course, a fall in domestic demand and an increase in unemployment. A minimum 18.3 per cent of GDP was extracted by government since 2008 in a near-zero inflation environment.

The collapse in domestic demand and in investment in gross fixed capital formation meant that unemployment peaked at 15.1 per cent in 2011. Unemployment has been falling, partly due to emigration, since 2012. The net result, however, has been the attainment
of the objective of a narrowing of the gap between spending and revenue. Austerity policies have achieved the rather dubious objective of minimizing the difference between government expenditure and taxation as they were accommodated by private-sector balance adjustment and, crucially, by the rest of the world via the current account balance. As mentioned, the key to understanding the seeming contradiction between austerity and growth in the Irish case lies within the structure of the Irish economy.

One important feature of the Irish economy is its relatively high levels of redistribution of income taxes, with relatively generous social welfare schemes and a large social protection programme. The scale and extent of this has already been discussed. The redistributive arm of Ireland’s fiscal policy affected income inequality and helped to reduce the impact of austerity. Figure 3.8 shows the percentage change in the Gini coefficient from 2009 to 2013 against social expenditure in 2009 (including social protection payments and health and education expenditures) for a range of OECD countries. Irish social expenditure is on a par with Denmark, Finland, and the Netherlands. Despite changes in inequality, social expenditure has helped to buttress the effects of the downturn.

(p.55) Note the key differences between Portugal and Greece and Ireland. Both of the former spend far lower proportions on social expenditure, and both have experienced large changes in inequality. This may be one reason why incidences of social unrest have been much higher in programme countries other than Ireland. Simply put, Ireland’s social welfare system was not allowed to deteriorate to the extent other countries’ systems were, and the redistributive systems of the state, broadly speaking, did their jobs.
The definition of austerity given by Blyth (2013a) includes a reference to regaining competitiveness. When a devaluation is not possible through the exchange rate, only a devaluation through the wage channel will suffice. So, did Ireland perform a large, across-the-board change in wages in response to its economic crisis? Several sectors, most notably the public sector, with around 330,000 workers, experienced a drop in real wages, but broadly across the economy wages did not adjust downward by more than 4 per cent. Wage bills were controlled through unemployment, for the most part. Computing changes in the Labour Cost Index over time for Germany, Ireland, Greece, Spain, Cyprus, and Portugal, we can see the year-on-year change from 2010 to 2014. It is clear that Ireland’s change was barely above zero, relative to European Union (EU)/IMF programme countries like Greece, Portugal, Spain, and Cyprus, which all experienced negative wage changes over this period as measured by the Labour Cost Index. The Irish experience of austerity is therefore not well described by a neoclassical theory where wages adjust downward to clear markets, but by an adjustment in the quantity of labour employed, which is precisely what is predicted by simple Keynesian economics, and which can only be restored by increasing effective demand, precisely what is being stripped from the economy during periods of austerity.

To see how the contribution of demand altered over the crisis, Figure 3.9 computes the contributions to real GDP growth from domestic demand, which is the sum of government expenditure, private consumption and investment, and net exports. In 2008 and 2009, domestic demand fell by 2.2 per
cent and 8.8 per cent of GDP respectively. Thus austerity, at the very moment demand is required to buttress the change in private-sector spending, removes that demand.

Finally, we must understand how Ireland managed to grow through its austerity experience. In this it is an outlier. To see this, compare the average percentage change in the primary balance, which is the difference between government expenditure and taxes before interest payments, adjusting for the cycle, where a positive value indicates a large decrease in expenditure or increase in taxes, or both, to the average percentage change in real GDP over the 2009 to 2013 period for selected countries.

Figure 3.10 shows us Ireland has managed to grow, along with the USA and the UK, while countries like Italy, Spain, Portugal, and Greece have experienced large changes with no corresponding growth. In the case of Greece, as we know, lack of growth and a failing welfare state have caused widespread societal problems. Indeed, these countries bear out the tautology that fiscal contractions are contractionary. Not so with Ireland, it seems. Ireland is also remarkable because it is clustered with two economies with their own monetary policies, both of whom enacted large-scale quantitative easing programmes as well as Keynesian-style fiscal expansions over this period. Comparing Ireland to Portugal, which experienced a drop in its real GDP of around 4 per cent combined with a large change in its primary balance of around 8 per cent,
seems to suggest the Irish did something differently to the Portuguese.

In practice, the Portuguese bailout was very similar in scope, scale, and intent to the Irish bailout. Like Ireland, in 2010 the Portuguese bailout plan targeted an improvement in the structural primary budget balance of 10 percentage points of GDP. The improvement between 2010 and 2013 has been about three-quarters of that. Public debt is forecast to peak at almost 130 per cent of GDP rather than the 115 per cent previously expected. The Portuguese current account has moved from a deficit of over 10 per cent of GDP in 2010 to a surplus of 0.5 per cent in 2013, but their banks are still heavily reliant on ECB funds, are still unprofitable, and still have high loan-to-deposit ratios, averaging around 115 per cent, albeit falling from a high of 167 per cent.

So what is different? How did Ireland manage to grow when Portugal, Spain, and Greece, did not? The answer is the degree of openness of the Irish economy. Ireland scores highly in any measure of openness. In one simple measure, the sum of exports and imports as a proportion of GDP, Irish openness (4.2) is 1.5 times Portugal’s (2.5) and double Greece’s (2.1). In another measure of openness, using foreign direct investment (FDI), Ireland scores 3.5 while Greece scores 2.6 and Portugal scores 3.4. Over the time period studied in this chapter, the degree of openness of the Irish economy has grown by eight times more than either Greece or Portugal. The macroeconomic significance of this is clear: because of its extremely large ‘tradable’ sectoral composition, Ireland was able to absorb the impacts of austerity in ways that Greece, Portugal, and Spain could not. Rather than being touted as a poster child for austerity, Ireland is instead a beautiful freak, whose institutional make-up, and relatively high levels of expenditure on social programmes, cushioned the impact of austerity on large sections of the population, while its exporting sectors managed to rebound earlier, and keep growth much higher, than in other countries facing the same fiscal problems.
Conclusion
This chapter set out to explain the evolution of Ireland’s fiscal and economic policies from 2002 to 2016. We found three striking features of Irish fiscal policy. First, it was highly procyclical in the 2002 to 2007 period, becoming less so after 2009, with the introduction of carbon, water, and property taxes. Second, the large increase in the proportion of taxes coming from income over the 2009 to 2014 period was, by necessity, harmful to the middle classes, but was important to keep the redistributive apparatus of the state working while reducing spending on capital, public sector pay, and non-essential spending. Third, the complexity of the state’s finances needs to be understood when computing both the distributional impacts of austerity and its long-run consequences. We gave the example of social protection expenditure in the section ‘The Fiscal Evolution of the Irish Economy, 1996–2016’, but all government services have a similarly complex and articulated structure.

Ireland’s extremely open and export-focused economy, with its tradeable sectors dominated by multinationals, allowed it to increase its trade balance after 2007, partially compensating for the fiscal consolidation begun in 2009 and intensified under the Troika, while the private sector deleveraged and restructured itself. Ireland’s experience of austerity from 2009 to 2013 is not a good example for other nations to attempt to emulate for these reasons. This unique structure, combined with a compression of borrowing costs from an ECB exercising a full backstop after July 2012, allowed GDP growth to coincide with large doses of austerity. The growth statistics, in fact, masked much of the decline in domestic demand and the large build-up of non-performing private debt in both the household and non-financial corporate sectors. So, for example, despite relatively robust growth and falling unemployment since 2012, the total impairment rate on private loans went from 12 per cent in Q4, 2010 to 25 per cent in Q1, 2016, and has been stable at this level for fourteen quarters at the time of writing.

The argument this chapter has advanced is that austerity was harmful but offset by Ireland’s extraordinary openness. Thus, despite austerity being imposed, the economy grew, thanks to extraordinary changes in the international environment. An important question arises: would the structural features of the Irish economy have been sufficient to bring about recovery
without the ECB’s policies such as quantitative easing, the series of long-term refinancing operations which increased liquidity to Ireland’s banks, and the express commitment to ‘do whatever it takes’ to save the euro, all of which have improved Ireland’s competiveness through lower interest rates, lower sovereign borrowing costs, and by weakening the euro relative to Ireland’s major trading partners, the USA and UK.

The same openness which helped Ireland survive the crisis may well prove its undoing. Four large downside risks are present at the time of writing. First, the possibility of a ‘Brexit’, where the UK votes to leave the EU. A Brexit will harm Ireland’s labour market, change the nature of the border the Republic shares with Northern Ireland, alter Ireland’s energy markets, and a 1 per cent reduction in UK GDP is estimated to lead to a 0.3 per cent fall in Irish GDP over the short term. A sharp depreciation of sterling could also hurt Irish exports (Barrett et al. 2015).

Second, the Chinese economy is undergoing large changes to its structure, with flagging industrial production, excessive household debt, and capital outflows necessitating changes to its fiscal and monetary policies. Should the Chinese economy continue to disappoint in terms of its growth rates, the outlook for Ireland, exposed as it is to the vagaries of the global economy, would diminish rapidly.

Third, Ireland is a net importer of energy, importing over 90 per cent of its energy from abroad. Low oil and gas prices are helping Irish households and firms’ profit margins, but these may well reverse. These price rises may well coincide with the changes in the UK and Chinese economies.

Finally, moving forward, Ireland’s fiscal policy choices will also be constrained by expenditure ceilings and debt-reduction targets mandated by the Eurozone but now part of the Irish legal and fiscal framework. These targets ensure the large spending increases which we saw from 2002 to 2007 above the growth rate of potential GDP will most likely not be possible, while large changes to the structure of Irish taxation will perforce be much more gradual. Bottlenecks will appear, as underinvestment in capital programmes clash with societal priorities and with the long-term transformation of the population, both demographically and spatially, and this may
necessitate larger capital investment programmes over the medium term, keeping current expenditure levels roughly constant. Either way, fiscal policy choices are effectively constrained, making the tools of macro-prudential and micro-prudential policies much more important as policy levers.

References

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