| LES NOTES DE BENCHMARK

Fiscal consolidation
and economic recovery in Europe

Ireland:
the return of the Celtic Tiger

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Preface by Michel Pébereau

INSTITUT DE L'ENTREPRISE

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Preface

Much like the example set by the Baltic states, today the Irish model presents itself as a success story of fiscal consolidation in the aftermath of the 2008 financial crisis. From an economic perspective, Ireland also provides a rare example of successful internal devaluation within the Eurozone[1]. Whilst its international trade was affected by the country's current account deficit which increased before the crisis (going from 0.6% of GDP in 2004 to 6% of GDP in 2008), this deficit was reabsorbed as of 2010 and transformed into a surplus, exceeding 4% of GDP in 2013.

At this point we need to take a few steps back. At the end of 2010, Ireland was the second European country, following Greece, to seek financial aid from the IMF and the European Commission, after witnessing the collapse of its economy under the effect of the property slump and the banking sector crash. The strong performances of the "Celtic Tiger" then seemed remote: public debt increased threefold to over 125% of GDP.

Four years later, the transformation is staggering. Eleven months have already passed since the country shook off the tutelage of the Troika made up of the IMF, the European Commission and the Central European Bank; and Ireland is already considering a premature reimbursement of part of the international aid it received. Since the summer of 2013 and throughout four consecutive terms, its economy has consistently grown, driven by exports but also by domestic demand (for the very first time since 2006). GDP is expected to rise by 4.6% in 2014, which would make Ireland the best performing economy of the European Union. Unemployment rates are on the decrease. There is increasing income from taxes and the cost of government bonds on the market has plummeted, running at a lower rate than those of Italy and even of the USA and the UK.

1. Between 2006 and 2012, this devaluation is estimated at 15%.

All the while, and without denying the exceptional nature of the Irish recovery, we must refrain from being overly optimistic, as was emphasised recently by the Irish Fiscal Advisory Council (the equivalent of the French *Haut Conseil des Finances Publiques*), for three main reasons.

> Firstly, because the rebalancing of the Irish economy has barely begun. To be sure, the country's high exposure to international trade is an undeniable asset, allowing it to profit from global economic growth and thereby make fiscal recovery a bearable process. But public and private debt remain high, and the Irish economic model still relies too heavily on the presence of foreign multinationals, especially in the new technology and pharmaceutical sectors, whose volatile behaviour was highlighted by the crisis. Today, nothing can guarantee that those high pre-crisis growth rates will be back for the long-term.

> Secondly, because the unemployment rate remains high: 11% in October 2014. The threefold increase in unemployment in five years created a radical shift in a country which had seen near-full employment before the crisis. Since then, Ireland has initiated "workfare" policies similar to those of the UK, without as yet achieving the same results as its British neighbour. As a matter of fact the unemployment rate is lower in England, as it is in Wales and in Scotland: that was indeed one of the unionists' arguments during the referendum held in September 2014. Furthermore, with the drop in unemployment in Ireland came a drop in the rate of participation in the workforce, contrary to the UK which saw its rate rise.

> Finally, because the recovery of public finances is not yet complete. The Irish performance does indeed appear remarkable from a number of vantage points. The structural primary balance improved by 9% between 2009 and 2014; a full equilibrium will likely be reached as of 2014, and transformed into a rising surplus from 2015. Deleveraging will commence, as the turning point of the debt-to-GDP ratio was reached at the end of 2013. The effort carried out on the budget since 2009 has reached 30 billion euros, and public expenditure has dropped by 13.5%. Nevertheless, public debt remains high, at 120% of GDP, and public expenditure is still surpassing revenue by 7 billion euros. The Government is under strong pressure from public opinion and social partners to relax expenditure restraint, considering the up-turn in economic growth. Given the inherent limitations in every coalition, there will be an ever greater temptation to respond to this demand as the next elections draw near, and as the crisis and the efforts made to recover from it fade from voters' memories.

That being said, the Irish example offers significant lessons, as Nathanael Mason-Schuler's important monograph brilliantly exposes. I will mention four of these here:

> The first lesson is that it is possible to achieve both growth and an improvement in public finances. As this report highlights, together with the Troika, Ireland has launched a new generation of macroeconomic adjustment programs, destined not at developing but at developed countries. Within that frame, the opposition between austerity and a Keynesian growth stimulus is considered artificial. A different framework of thought is put forward in its place. It entails the outlining of a path to fiscal consolidation capable of restoring the credibility of public finances and the trust of markets, without compromising the structural reforms needed to increase potential growth rates. Ireland has created a successful juncture between consolidation and reform.

  Its budgetary adjustment program favours spending cuts, especially tougher ones (in the wage bill and social transfers), and important reforms in the management of the state and local public structures, as well as in the functioning of the banking sector. The political conditions of the budgetary recovery were one of the keys to its success. Ireland is a parliamentary republic largely dependent on coalition governments and with a political tradition based on dialog and compromise. Its fiscal consolidation was also chiefly based on a plan set out by the Irish Government in 2009. It was not enforced by the Troika.

> The second lesson we can draw, is that Ireland's recovery was supported by two pillars: businesses, notably the largest among them, and globalisation. Despite public pressures, the Government chose to work on public revenues by increasing VAT and maintaining its corporate tax at a rate of 12.5%; only the status of hybrid companies, used by some American multinationals to optimise their taxation, will soon be called into question. The challenge was to consolidate the export base and focus on opening the economy up to foreign trade.[2] The existence of a significant export industry explains a powerful current of opinion which seeks to maintain competitiveness and is therefore favourable to wage moderation. On the other hand, this moderation penalises import industries[3]: as a result, Greece has had a tougher time imposing the former.

2. Ireland's import-intensive exports reached 108% of GDP in 2012, compared to 33% of GDP in Spain, 39% in Portugal, and 27% in Greece.

3. Benefiting from a flexible labour market, Ireland saw salary rates drop by 13% between 2007 and 2012, compared to only 4% in Spain, whilst in Portugal they rose by 3% between 2007 and 2011. In Greece, salaries continued to rise until 2009, before dropping sharply - by a total of 7% between 2007 and 2011.

The Irish example therefore demonstrates the advantages, not only economic but also budgetary, of an open and globalised economy, where multipliers are in fact weaker and reductions in public spending are less of a burden on growth.

> The third lesson is that Ireland's budgetary recovery was the result of careful and committed choices, and not of an indiscriminate process of cutbacks. Three examples testify to this:

- In the area of social security spending, the unemployment benefits system underwent a reform, with a reduction in the length of time that compensation is paid out and a reaffirmation of the beneficiaries' obligations. The pension system was revised for all new public sector workers, with an increase in the minimum retirement age and a change in the system of pension calculations which now takes into consideration working-life average rather than final salary.

- To gain control over local spending, reforms will see the number of local structures reduced by almost three-quarters and the number of local officials reduced by a third.

- In order to reduce the public sector wage bill, every measure was taken: hiring and wage freezes, an increase in working hours, voluntary redundancy plans... Compared to 2009, by 2013 there was a 9% reduction in the workforce, which should reach 12% by the end of 2015. Public sector salaries, less flexible than those of the private sector, were reduced by 14% between 2007 and 2012.

> The last lesson relates to the effects of these reforms on the population. Far from being trivial, the correction of budgetary and economic imbalances had very real consequences on the daily life of the Irish people. Between 2007 and 2013, the real GDP per capita dropped by 11.7%, more than in Italy (-10.8%), in Spain (-7.8%) or in the UK (-5.8%). Combined with social benefits cuts, the wage reductions have seemingly resulted in a 15% drop in income for a wage-earner between February 2009 and February 2014[4], according to the findings of an institute working closely with labour organisations. But we must keep things in perspective. The standard of living of the Irish greatly improved throughout the 1990s. And since 2000, the total real GDP per capita increased by 7.4% (compared to 2.4% for the Eurozone). This explains why in 2013, the nominal GDP per capita in Ireland, expressed in

4. According to calculations done by the Nevin Economic Research Institute, for an employee earning around €50,000 per year.

terms of purchasing power parity, remained 17% greater than that of the French. The fact remains that in seeking to correct for past excesses, the economic and budgetary adjustments were accompanied by real sacrifice.

The Irish population deserves all the credit for accepting these sacrifices and thus lightening the load of future generations. The country's exceptional resilience over the past five years can largely be explained by cultural and historic factors. It also displays the virtues of accountability and compromise on the part of social partners, and a commitment to clear and effective political discussion.

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Summary

Compared to other Eurozone economies, Ireland is a small country, with a GDP of close to 170 billion euros, an active population of around 2 million people, and a public debt of approximately 180 billion euros. **The outstanding economic success of the "Celtic Tiger" in the 1990s,** which obscured growing economic disparities, **could only be mirrored by its spectacular downward spiral during the economic crisis,** that saw the housing bubble burst as of 2007, and the total collapse of the banking system and public finance. Experiencing a brutal recession (Ireland was the first European country hit by the recession) as well as a massive banking crisis, Ireland saw its nominal GDP shrink by almost 20 %, its public debt increase threefold (surpassing 120 %), its unemployment rate almost triple (peaking at 15 % in 2012), its level of poverty go up, and Irish emigration, which had disappeared with the growing economy, reappear. Following Greece, in 2010 Ireland was forced to seek urgent international financial assistance from the European Union and the IMF (for a total of 67.5 billion euros) and commit itself to a drastic readjustment program before the Troika.

Nevertheless, Ireland is on a mission to regain financial sovereignty: it was the first country to abandon the financial assistance program in 2013, with results described as "impressive" by the Troika . The fiscal consolidation, launched in 2008 and concerning 32 billion euros (or close to 20% of its GDP), resulted in an increase in the structural budget deficit of 9 percentage points of GDP compared to the beginning of the crisis. The objectives which the Government set down with the Troika have been maintained. The adjustments are bearing fruit: the progression of public debt in the GDP grew to a halt in 2013, the public deficit is approaching the 3% threshold which should be attained in 2015, the unemployment rate has been decreasing since 2012 and should reach 10% in 2015, and growth returned as early as 2011; in 2014, Ireland should be seeing one of the strongest growth rates in the Eurozone (with a projection of 4.7 % in 2014 and 3.9% in 2015, according to the 2015 Budget presented in October 2014). But economic frailties persist: Ireland has not regained its pre-crisis level of activity, and public and private debt remain a heavy burden. Greatly impoverished, the country has seen the return of mass unemployment, which has hit young people especially hard (with rates of around 30%), and left a society weakened by the crisis

and the fiscal austerity measures, with growing social disparities (20% of children live in households where neither parent is working) as well as territorial divisions between Dublin and the southern regions of Ireland.

Fiscal consolidation is not yet complete but it is on the right track. The program, both wide-reaching and sustainable, strongly favours spending cuts (2/3 of the budget consolidation), focusing on the toughest areas like the public sector wage bill and social benefits. The carefully designed fiscal measures favour the broadening of the tax base and budgetary performance (a two-point increase in VAT). The Irish Government refuses to make changes to its symbolic corporate tax rate (12.5%), a decision seen as non-cooperative and disputed by some European partners, and is generally shielding businesses from new tax measures, placing its bets on supply policies to regain economic momentum. Since a sustainable recovery of its public finances cannot be achieved without a return to growth, Ireland's Government is giving an important place to structural reforms. This is being done in order to improve funding for the economy (whose extreme financialisation was also its downfall), to improve the functioning of the labour market and the vocational training system, and to regain competitiveness in Irish exports which had been the driving factor of Ireland's growth in the 1990s. The state itself has undergone substantial reform: the workforce has been cut by almost 10%, there has been large-scale use of e-government systems, and a widespread territorial reform was implemented in 2014.

Ireland's rebound was only possible in seemingly exceptional political conditions: a proficient use of clear and effective communication of the part of the Irish Government regarding the crisis, a sense of urgency surrounding the reforms and a relative tolerance for austerity, which makes Ireland an exception with regards to other European countries. Even the multiple political shake-ups - the historic change in power which came about in 2011, with severe consequences for the party in power since the 1990s (*Fianna Fáil)* and the arrival of a new coalition which brought together the centre-right and Labour parties - never made a dent in the succeeding governments' determination to pursue the reforms. Deemed credible by their European partners and by the Troika, in 2013 they successfully renegotiated the terms of the assistance provided in 2010. Compared to other European countries engaged in the financial assistance program, the Irish have been able to accept difficult sacrifices, and have shown an exceptional determination to overcome the crisis as well as a relative tolerance towards austerity. Both the Government and workers' organisations, especially those of the public sector, have honoured Ireland's social tradition by resolving to negotiate and thereby maintain a relatively serene social climate. Nevertheless, as the economic and financial risks diminish, and with good news regarding the country's economic and fiscal position in

2014, the social and political consensus is waning. The coalition in power since 2011, made up of *Fin Gael* (centre-right) and Labour, is growing ever weaker as fiscal consolidation advances, while the Labour party is internally divided, notably on the topic of health and education funding. With concern to the resigned impatience of the Irish people, who have been tolerating fiscal austerity measures since 2008, the Finance Minister Michael Noonan quoted the Irish poet Yeats during his 2013 Budget presentation: « *Too long a sacrifice can make a stone of the heart* ». Even if it meant starting redistributing the fruits of an incomplete fiscal consolidation. The 2015 Budget, presented by the Irish Government in October 2014, marks a symbolic end to austerity with a slight increase (+ 0.5 billion euros), thus benefiting from an improved economic situation which has made it easier to reach budgetary targets.

The characteristics of the Irish fiscal consolidation program

Factors of success
A global recovery, public finances and structural reforms: An apt and long-term combination of fiscal consolidation measures and far-reaching structural reforms (notably regarding the labour market and the vocational training system), both in accordance with the seriousness of the crisis in Ireland.
A significant fiscal consolidation program: A plan favouring effective expenditure efforts (including on normally rigid expenditures such as social benefits and the public sector wage bill); in terms of revenue, a focus on a broadening of the tax base and less distortive taxations (increase in VAT, new property taxes, no change in the Irish corporate tax rate); a constant effort at fiscal consolidation spread out over time (with an average of almost 1 percentage point of GDP in structural adjustment). A governmental organisation in favour of fiscal consolidation (prominent position of the Finance Minister, in tandem with the Minister for Public Expenditure and Reform).
A national rebound in a state of relative political and social consensus: A capacity to establish agreements between political parties (in a coalition government) and with social partners (notably public sector organisations) in order to ensure participation in the consolidation program. Ireland's path to recovery was not undermined by the 2011 government handover (and the historic defeat of the party in power since the 1990s).
Areas for concern
The economic crisis has brought long-lasting impoverishment to Ireland: Aside from the irretrievable losses resulting from the economic crisis, long-term effects on the Irish economy and its society. Although Ireland beat the recession as of 2011, its potential growth (in terms of human and productive capital) could experience a lasting vulnerability.
When will Ireland's public finances find themselves outside the danger zone? Need to pursue long-term budgetary adjustment considering the level of public debt. Both the political consensus regarding the rate of fiscal consolidation and the unity of the coalition in power (centre-right and Labour) are showing signs of weakness.
Will Ireland regain a strong and sustainable growth? Persistent macroeconomic weaknesses and vulnerabilities in the financial system; question marks remain regarding new areas of growth for Ireland.