

# ETUI Policy Brief

## European Economic and Employment Policy

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### From tiger to bailout: the Irish crisis

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## Policy implications

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Ireland's deep financial and economic crisis results from failings in its growth model, policy mistakes and systemic failures within European Monetary Union. The bail-out agreement with the IMF and the European authorities and the associated austerity package will not resolve the problems faced by the country and must be renegotiated. Instead a package is needed to promote economic recovery and jobs growth involving elements including: sovereign debt rescheduling and a lower interest rate, fundamental tax reform, and an investment programme financed by the sovereign wealth fund.

### Introduction

For Ireland the signs are ominous for economic and political sustainability, even if the EU/ECB/IMF financial package itself brings some, albeit temporary, relief. Ireland is suffering from a solvency problem and more borrowing cannot fix its crisis. The fragility of the agreement was highlighted in mid-December, when the two main opposition parties, likely to form the next Government in early 2011, voted against the agreement. This paper identifies weaknesses in the 'Celtic Tiger' model in the pre-crisis period. It then shows how the crisis hit the Irish economy and discusses the failed policies adopted by the Irish Government. After setting out the details of the so-called 'bailout' agreement with the European authorities and the IMF, a series of policy alternatives are put forward that would help Ireland emerge from crisis and achieve fiscal consolidation on the basis of economic recovery, jobs growth and solidarity.

### The fragile tiger

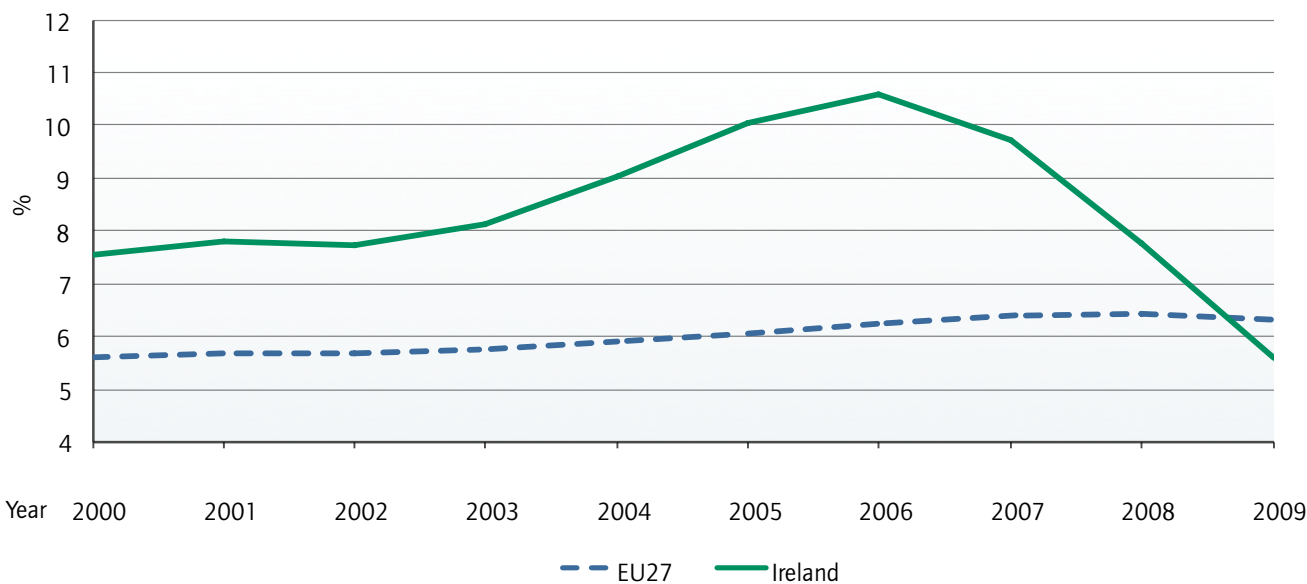
Up to 2008, Ireland enjoyed a 15-year period of high growth. In some years this was in excess of ten per cent of GDP, a remarkable figure for any advanced economy. However, while the Irish model was almost universally regarded as 'a beacon of success', there were inherent problems with this analysis. Ireland is typified by a heavy over-reliance on foreign direct investment (FDI), much of which does not constitute productive activity but is merely transfer pricing to exploit Ireland's low corporation tax rate and other tax advantages. Consequently, Irish GDP figures are not an accurate indicator of real economic

output. Ireland's Gross National Product (GNP) in current prices was just 82 per cent of GDP in 2009, reflecting very substantial dividend payments and profit repatriation by the country to foreigners.<sup>1</sup> In addition, particularly from 2003 onwards, the Irish domestic economy had become unsustainably skewed towards construction (See Figure 1).

Much of the boom itself was a function of the availability of easy credit arising from inappropriately low interest rates. The crisis has in fact highlighted fundamental flaws in the design of the Euro zone, one of which relates to the interest rate. Although monetary policy is set to suit the Euro zone economy as a whole, the interest rate set by the European Central Bank may be, as it is now clear it was for Ireland and the other periphery economies, wholly inappropriate for an individual country. This structural flaw has contributed significantly to the current debt crisis in Europe and resolving it must be a component of future reform.

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Figure 1 Value of the construction sector as a percentage of Gross Value Added



The economy was further artificially inflated during this period by a recklessly pro-cyclical fiscal policy. The State became increasingly reliant on transaction-based taxes flowing from the construction sector. Competitiveness was eroded; nominal wages<sup>2</sup> and prices<sup>3</sup> were increasing faster than in the Euro area as a whole. Ireland was in essence a bubble economy.

The boom years were a lost opportunity for significant investment in productive infrastructure. Although the capital stock of the Irish economy soared by 157 per cent in real terms in 2000-2008, housing accounted for almost two-thirds of the increase. Private investment in core productive infrastructure was described as pitiful in a report by Davy Stockbrokers.<sup>4</sup> For example, private sector net investment in the capital stock – apart from retail, storage, transportation and house building – was only €14.5bn in the eight years to 2008 (in constant 2007 prices). That equates to an increase in the volume of the capital stock of 26 per cent. Underinvestment in telecommunications is a particular concern, with Ireland lagging badly behind for a range of broadband indicators.<sup>5</sup> For example, Ireland’s fixed broadband subscription rate per 100 people is the third lowest in the EU 15.

Ireland followed the low tax/low spend neo-liberal model during the years of the Celtic Tiger.<sup>6</sup> Over the period 1995 to 2008, the level of public spending averaged 34 per cent of GDP, the third lowest average level of public spending in the OECD during this period. This was a time when Ireland had relatively low social welfare demands because of low unemployment and relatively few pensioners. Ireland failed to exploit this benign fiscal position to ramp up investment in critical areas such as education, research and development, child care and social infrastructure, important for the future competitiveness of the country and the long-term well-being of citizens.

Throughout this period, Ireland’s level of tax receipts was consistently around 10 percentage points lower than the EU 15 average. Tax expenditures (tax breaks) ballooned. A particularly egregious example was the high level of government subsidy to property development, which fuelled the construction frenzy. This frenzy, in turn, generated very high property-based transaction tax revenues which, although temporary in nature, were used as a rationale for reducing income tax and capital gains taxes. Consequently, when the economic crisis hit in 2008, the Irish tax base had been fatally narrowed to such an extent that tax receipts collapsed by a third.

### The crisis

In a vicious cycle, private debt spiralled during the boom to pay for the ever-increasing cost of housing. When the bubble eventually burst in 2008 (see Figure 2),<sup>7</sup> a large proportion of homeowners found themselves in negative equity just as many of them were losing their jobs. Since then the unemployment rate has risen from four per cent to 13.5 per cent (see Figure 3).

However, the true rate of unemployment and under-employment arising from the slump is even greater once discouraged<sup>8</sup> and part-time workers (22.6 per cent)<sup>9</sup> are included. Furthermore, the outflow of migrants has mitigated the rise in the unemployment rate. The “at risk of poverty” rate is stable at 15.5 per cent. However the consistent poverty<sup>10</sup> rate is a more meaningful indicator of the deterioration in living standards. This rate rose from 4.2 per cent in 2008 to 5.5 per cent in 2009<sup>11</sup> and is likely to increase following the cuts to social transfers announced in Budget 2011. Domestic spending has collapsed and the private savings rate has risen from four per cent to 12 per cent.

Figure 2 Real GDP growth rate

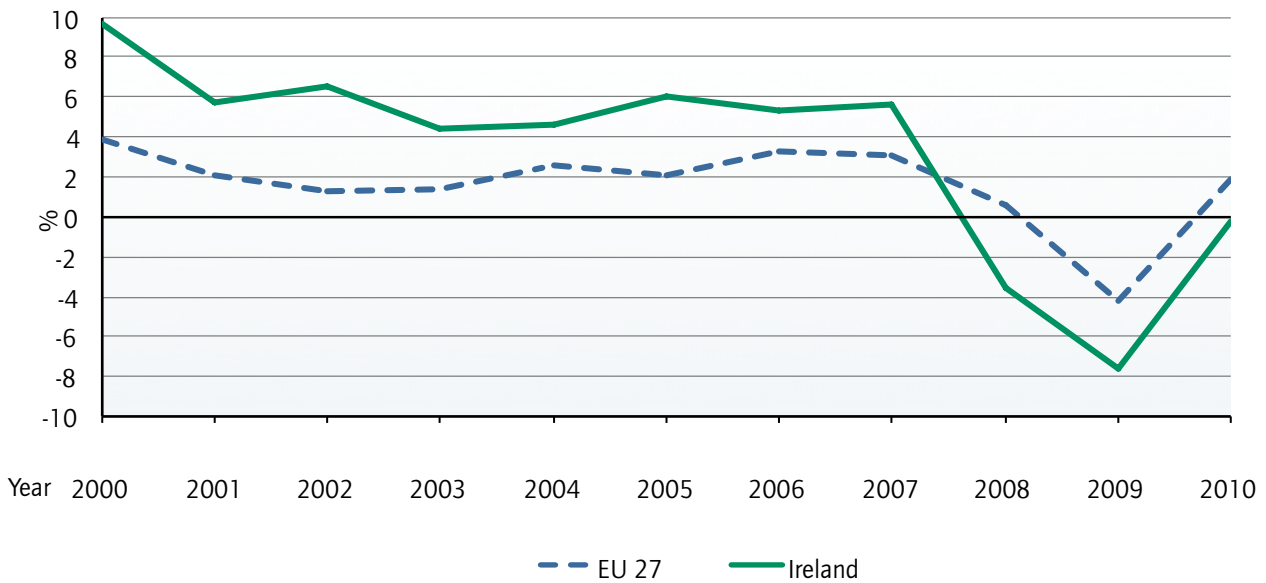
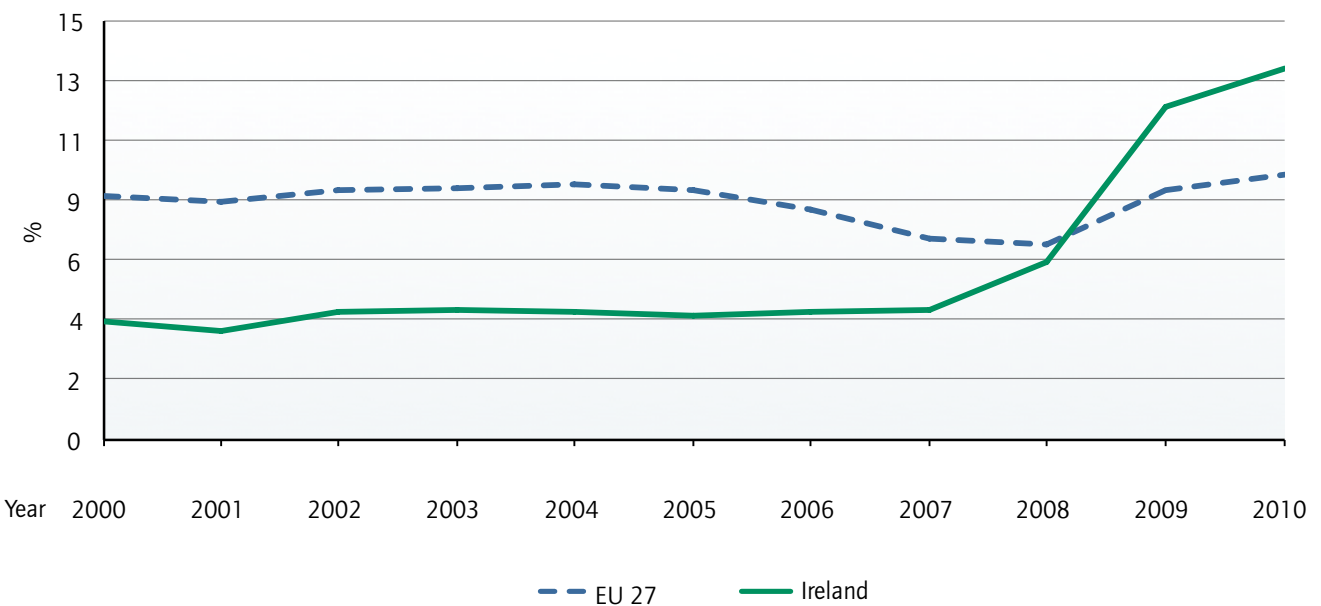


Figure 3 Harmonised unemployment rate



The collapse in the tax take, combined with the surge in unemployment-related public spending, has created a yawning gap in the public finances.<sup>12</sup> An Exchequer deficit of €18.7bn was recorded in 2010. Some of this gap is cyclical and can be attributed to the rise in unemployment payments, and the associated collapse in income tax and VAT. However, much of the gap is structural and would not disappear even if the economy fully recovered.

The Government's open-ended commitment to cover all of the bank losses on 29 September, 2008 has entangled the banking

debt with the sovereign debt. The official estimates of these costs have continued to rise and it was widely and publicly noted that the Government was repeatedly underestimating the scale of the losses.<sup>13</sup> An initial €4 billion estimate gradually escalated into the State committing an actual €50 billion (€34 billion of which has gone to Anglo Irish Bank).<sup>14</sup> This was before the EU/IMF bailout. In addition, as part of the EU/IMF deal, a further €10 billion is going to recapitalise the banks, while a further €25 billion has been made available to meet future funding needs. Alan Dukes, the current Chairman of Anglo Irish Bank has already stated that the €35 billion will not be sufficient as

it does not take account what will happen when homeowners start to default on mortgages.<sup>15</sup>

## The Irish response

In sharp contrast to most other advanced economies, the response of the Irish Government to the economic crisis over the last two years has been to pursue a policy of fiscal consolidation. Consolidation measures worth €14.5 billion, equivalent to nine per cent of GDP, were adopted during this period. The Government has announced that there will be a further €15 billion in fiscal consolidation over the next four years, primarily through expenditure cuts. On 7 December, 2010 a highly regressive budget was put before the Irish parliament, aimed at taking a further €6 billion out of the economy, disproportionately impacting on low income and other vulnerable groups. One example serves to highlight the regressive nature of this budget: while the announced tax changes in Budget 2011 will result in a reduction of six per cent in the net income of a single self-employed person on €15,000, a person with the same status on over €200,000 will see an increase in net income.<sup>16</sup> In addition to the fiscal measures, the minimum wage was reduced by 12 per cent: in 2009, one in twenty households with a person 'at work' were at risk of poverty and the minimum wage reduction will further increase pressure on the working poor.

As the international empirical evidence predicts<sup>17</sup> the Irish policies of extreme austerity are exacerbating the crisis in the real economy. Despite high export-related growth rates, Ireland has high levels of unemployment (almost 14 per cent<sup>18</sup>) and emigration<sup>19</sup>, collapsing demand<sup>20</sup>, stagnant growth,<sup>21</sup> and erosion in the quality of public services as a consequence of the cuts to public spending. With additional consolidation over 2011-2014, equivalent to 10 per cent of annual GDP, further stagnation is inevitable.

## The 'bailout'

The misnamed 'bailout' announced on 28 November 2010 symbolises the utter failure of Ireland's banking policies. The original bank guarantee of September 2008 was for two years. The largest amount of the banks' bond funding was scheduled to mature at the end of September 2010, in advance of the expiration of the guarantee. A wall of cash was due to be rolled over, equivalent to €30 billion of government-guaranteed bank debt. Critically, however, the banks were unable to obtain new funding on the market and became almost totally reliant on the willingness of the European Central Bank (ECB) and the Irish Central Bank to provide liquidity. This in turn damaged the market perception of Ireland, and the sovereign temporarily withdrew from the bond markets as bond spreads worsened.

By November, the ECB's exposure to Irish banks had reached almost €130 billion. The ECB appears to have made the decision that the situation was unsustainable and needed to be resolved decisively. In this context, the ECB seems to have pressurised

the Irish Government to request a lending facility (bailout). It was reported that initially this pressure was resisted<sup>22</sup>: the Irish Government were reluctant to access a bailout fund, in part because the sovereign was financed up to the middle of 2011 and in part because of the inevitable political fallout. Ultimately, however, the Government acknowledged that a deal was being negotiated and agreed to what was announced as an €85 billion EU/ECB/IMF bailout package.

The package was constructed as follows: The announced loan facility was actually for €67.5 billion,<sup>23</sup> with €22.5 billion coming from the IMF, €22.5 billion from the European financial Stability Facility (EFSF), and €22.5 billion from the European Financial Stabilisation Mechanism (EFSM). The Irish Government will itself be contributing a further €17.5 billion from the National Pension Reserve Fund (the sovereign wealth fund) and from liquid assets. Fifty billion euro of the facility is allocated to cover government borrowing requirements for the next three years, with the remaining €35 billion allocated to the banks. Of the €35 billion, €10 billion is being drawn down immediately to recapitalise the banks, with a further €25 billion held in reserve to be used as needed.

The terms of the deal are very negative for Ireland: both for economic recovery and for the well-being of its citizens. It is a deal designed to protect the European banking system and to buy time for Europe, rather than to assist Ireland as a member of the euro area in dealing with its solvency issues. If implemented, it will at best consign Ireland to economic stagnation for some time to come, and may force a unilateral default of the unsecured banking and/or sovereign debt.

This becomes clear if one examines a number of the deal's elements. First, motivated by fears of contagion in the European banking system, the ECB insisted that all the senior bondholders are fully protected whatever the costs. Second, the average interest rate stands at a punitive 5.83 per cent. This interest rate is almost certainly unsustainable<sup>24</sup> given the debt-GDP ratio will stabilise at over 110 per cent, and up to 125 per cent if the Government's projected growth rates fail to materialise. The IMF and the European Commission's growth projections are much less optimistic than the Government's.

Third, the Memorandum of Understanding with the European Union and the IMF requires that Ireland implement fiscal consolidation equivalent to ten per cent of GDP in the next four years, consequently very low growth rates for this period can be assumed. A final element of the deal is the requirement that Ireland run down its sovereign wealth fund to recapitalise the banks. This requirement will have profound negative implications for Ireland's flexibility to stimulate the economy through targeted investment and will make recovery very difficult in the short to medium term.

## Policy implications – a new deal

Ireland's problems are primarily home grown; but the crisis has highlighted fundamental flaws in the design of the euro area.

In the absence of a full fiscal union, such as exists in the United States, these flaws are inherently destabilizing. This basic flaw in the euro area system has contributed significantly to the current debt crisis in the European periphery, and resolving this structural flaw must be a component part of future reform. Recent proposals arguing for the introduction of Euro-bonds are welcome in this context.<sup>25</sup>

More immediately, a viable recovery strategy for Ireland will almost certainly need to include a renegotiation of the EU-IMF agreement. A loan facility is an appropriate solution for a liquidity crisis, but unfortunately Ireland is not facing a liquidity crisis. Because of the requirement to shoulder the banking debt along with the sovereign debt, Ireland is now facing a solvency crisis. The Government's open-ended commitment to cover all of the bank losses needs to be reversed and as part of this renegotiation Ireland must seek to push for a write-down of at least a portion of the banking debts. Alternatively, the bank debt could be exchanged for equity stakes in the Irish banks.

A reduced interest rate is the second needed element of a renegotiated deal. The EU and the ECB are understandably preoccupied with the perceived dangers to the European credit system and are resistant to countenance restructuring the debt burden. But, if Ireland is unable to generate the growth needed to service the debt then some form of debt restructuring is inevitable one way or the other, and the only way the EU/IMF can avoid a disorderly restructuring is to offer a reduced interest rate.<sup>26</sup>

Finally, the extreme austerity outlined in the EU/IMF memorandum of understanding will inhibit recovery. The timeline for reaching Stability and Growth Pact compliance must be treated more flexibly.

Debate around the controversial 12.5 per cent corporation tax rate has to be located within the context of the creation of a full fiscal union. Some of Ireland's European partners have lobbied hard for an increase in the Irish corporation tax rate. By some estimates, the effective rate of tax paid by certain multinationals based in Ireland is as low as three per cent. In the longer term, and in the context of a re-evaluation of industrial policy and a major restructuring of the Irish economy, this totemic rate should be re-evaluated. But such is the structure and fragility of the Irish economy at this present juncture, that a rise in the corporation tax rate might turn Ireland's recession into a full blown depression were it to cause a flight of multinationals out of Ireland.

Ireland must tackle the deficit, but do so in a way which generates economic growth as well as jobs. The current policy of extreme austerity is exacerbating the crisis in the real economy, just as predicted by international empirical evidence.<sup>27</sup> The memorandum of understanding requires Ireland to run down most of its Sovereign Wealth Fund to recapitalise the banks. It is now imperative that what remains of the Sovereign Wealth Fund should be used to fund an investment programme designed to foster jobs and growth along the lines of the Economic Recovery Fund proposed by TASC.<sup>28</sup> This would include establishing a credit guarantee scheme for small and medium enterprises and

to invest in strategic infrastructure, for example next generation broadband and renewable energies. As a result of the boom and bust there will be a massive oversupply of certain skill sets for the foreseeable future, requiring a large scale programme of education and up-skilling. The Fund should be used to provide such a programme to avoid a large cohort of young people being condemned to long-term unemployment or emigration.

Investing in jobs and demand will itself start us on a path to fiscal consolidation – but, as the analysis presented in this paper makes clear, fundamental reform of taxation is also required. Much of the structural deficit has its source in the hollowing out of the tax base and the overreliance on transaction-based taxes. When the economy collapsed in 2008 these revenue streams dried up; the tax take fell by one third in just two years. It is important that the tax system be rebuilt on more sustainable foundations. Beginning in 2011, significant reform of the immensely inequitable system of tax expenditures (tax breaks) is in fact finally underway, but it needs to be accelerated. Other obvious areas for reform include the introduction of a recurrent tax on property, both immovable and liquid assets, and the introduction of equality-proofed water charges. These taxes would raise considerable revenue while doing less damage to the economy than other forms of taxation.<sup>28</sup>

Ultimately, the threat of Irish insolvency and debt restructuring can only be resolved through a viable strategy to accelerate growth, combined with a reduction in the scale of the debt repayments. The crisis cannot be allowed to drag on until 2013, and must be resolved decisively in the next twelve months. The solution must demonstrate that solidarity remains an EU core principle (which can be drawn on in return for compliance with democratically and evenly applied rules), and must recognise that elements in the current structure of the Euro zone create instability and require substantial reform.

## Notes

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- 6 McDonnell and McCarthy (2010). An Initial Discussion on Public Expenditure: Rationales and Constraints. December, TASC Discussion Paper Series. <http://www.tascnet.ie/upload/file/DPE%20Rationales%20and%20Constraints.pdf>

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- 8 Discouraged workers are persons who want a job (and have looked for it in the past 12 months) but are not looking now because either no jobs are available or there are none for which the worker qualifies. Discouraged workers are not included in the computation of unemployment statistics.
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