Governing the Irish Economy: From Boom to Bust

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Introduction

During the 1990s and 2000s, Ireland experienced an unprecedented spell of economic growth and rising living standards, in a manner that became the envy of other poorer European peripheral economies. Lauded by the OECD, featuring on cover stories of *The Economist* newspaper, the 'Celtic Tiger' seemed set to rival its Asian counterparts as a global role-model. The international financial crisis of 2007/8 hit the Irish economy particularly hard, with a severe drop in growth and employment, and the sudden emergence of a sizeable fiscal deficit. By the late 2000s, it seemed appropriate to many to classify it along with southern European economies with large fiscal deficits and mounting public debt, in what some have termed GIIPS: Greece, Italy, Ireland, Portugal, Spain (Dadush 2010). This paper explores the policy underpinnings of the rapid change in Ireland's fortunes. The first two sections outline the main features of the Irish growth model, and the scale of the subsequent shock. The following section analyses the elements of domestic policy that underlie what might be seen as both a fiscal crisis and a competitiveness crisis. Finally, we wish to suggest that both the origins and the responses to economic crisis in Ireland cannot be understood without considering the varying significance of European monetary union across countries. The Irish government felt compelled to adopt a classic contractionary policy in response to the policy mistakes it had incurred. But Ireland's problems must also be understood in the context of emergent problems of economic governance within the Eurozone itself.

The Irish growth model

Irish political economy combines features of two rather distinct models of political economy. The institutional features of Ireland's systems of production place Ireland clearly within the Anglo-American liberal market model of capitalism (Hall and Soskice 2001). Industrial policy depends heavily on foreign direct investment, and tax incentives proved a crucial attraction for inward capital flows (Barry 1999). This consistent policy stance made Ireland a disproportionate beneficiary of inward investment in general and American capital in particular, following the completion of the European single market in 1992. The principal exporting sectors in the Irish economy, both in manufacturing (especially pharmaceuticals and chemicals, and information and communications technology) and services (especially software design and financial services), are dominated by foreign-owned firms (Central

Statistics Office 2010).[1] About four-fifths of all manufacturing enterprises employed fewer than 50 people in 2005, almost all of them Irish-owned. Of the larger firms, over four-fifths were foreign-owned, and they generated 93 per cent of total turnover in industry. In services, almost all firms were small or very small, often family-run; but the 2 per cent of larger firms accounted for about half of all employment and half of all turnover in the sector (Central Statistics Office 2008b). And although the domestic sector remains small by comparison, the presence of the foreign-owned sector has been credited with creating opportunities for upskilling and innovation there too (Barry, Bradley and O'Malley 1999; O'Malley and O'Gorman 2001). And Ireland rates relatively highly in business-friendly practices such as minimizing delays in transacting official business, or labour market flexibility (OECD 2007).

At the same time, as one of the most open economies in the world, Ireland also experienced incentives to manage its economic fortunes more actively than the market-conforming liberal model might suggest. This gave it something in common with the small European countries that had built up distinctive growth models during the more protectionist postwar decades. Scandinavia, the Low Countries, and the 'Alpine states' of Austria and Switzerland, had developed different variants of a similar approach whereby state management of export-oriented industrial policy secured their growth prospects, while corporatist structures facilitated domestic growth-sharing through bargained agreements rather than overt conflict (Katzenstein 1985). Thus industrial policy in Ireland depended not only on tax-friendly incentives, but also on activist state agencies to promote and facilitate investments. But Ireland's openness and its supports for lightly regulated capital and labour markets also made its industrial policy quite different from the post-war European model, and different also from the highly statist developmental strategies of Asian late industrializers, causing Ó Riain to term it a 'flexible' or 'networked' developmental strategy (Ó Riain 2004).

A persistent political bias toward concertation of economic interests is apparent in Ireland, contrasting with the British marginalization of trade unions since the 1980s (Hardiman 2005). Social partnership agreements were consistently negotiated between 1987 and 2009, and have been credited with facilitating fiscal policy adjustment out of the depression of the 1980s and

[1] The 'modern' sectors in Irish industry include NACE 20 Chemicals and chemical products, 21 Basic pharmaceutical products and preparations, 26 Computers, electronic and optical products, 27 Electrical equipment, 1820 Reproduction of recorded media, 3250 Medical and dental instruments and supplies

stable management of the rapid growth of the 1990s and 2000s (Barry 2009; MacSharry and White 2000). They also provided a mechanism for linking pay and a range of non-pay issues including changes in the incidence of taxation, minimum wages, the labour market inspectorate, contractual relations, training, and labour market activation measures (Hastings, Sheehan and Yeates 2007; Roche 2009).

The 'Irish model' became celebrated for its successes in creating very rapid growth with virtually full employment during the 2000s (Auer 2000; Daly 2005). The labour force grew rapidly partly through increases in activation rates, and partly through the influx of well-qualified workers from outside the country. Until the early 1990s, Ireland's growth profile relative to the EU average resembled that of the southern European EU cohesion countries of Spain, Portugal, and Greece, but its profile pulled away quite dramatically thereafter (Barry 2003; Bradley 2000; FitzGerald 2000). Ireland came fourth after Singapore, Hong Kong, and Japan in a rank of catch-up growth countries for the period 1960-1998, and if we remove the two city states, only Japan outperformed Ireland (Knack 2003). Economists debated whether this was attributable to a catch-up with European averages that followed from new inputs and a better policy mix, or from the discovery of an FDI-led growth dynamic that would not necessarily encounter limits based on convergence (Barry 2005; Honohan and Walsh 2002).

But the rapid turnaround in Irish growth and employment performance were very unlike those of Asian economies in one important respect: in the Asian high-growth states, the social effort involved in increased productivity was complemented or compensated by equality-increasing policies, especially in education provision and real efforts to secure equality of opportunity. In Ireland, there is some evidence that economic prosperity loosened the patterns of social mobility somewhat. But the evidence suggests that this was principally due to the surge in economic activity and tight labour markets, which caused employers to look to criteria other than conventional ones such as educational attainments that tend to favour the reproduction of class advantage (Whelan and Layte 2006). Thus it seems that social mobility opportunities were less the consequence of equality-enhancing social policy or investments in social infrastructures to promote equality of opportunity, and rather more a consequence of the volatility of the economic boom itself.

There was a continuous fall in the most extreme levels of social deprivation, but this was achieved principally through the drop in aggregate unemployment. And while the meaning of relative income poverty rates of over 20% might perhaps be questioned at a time of rising average incomes, it is nevertheless striking that the proportion of those at risk of poverty, measured as a combination of income and lifestyle deprivation, remained at a high rate in Ireland (Nolan 2009; Whelan, Nolan and Maitre 2007). Those most severely affected were households headed by someone who was not in work due to illness or disability, lone parents, and those with low levels of education and skill attainments. But more generally, the boom years also saw levels of income inequality increase as the top section of the distribution pulled away from the median. Figure 1 shows the profile of wealth and inequality across nations, showing inequality between 1992 and 2007 relatively to wealth levels in 2007.

Figure 1. Growth and inequality, 1992-2007

This indicates that while Ireland's income per capita ranked among the highest in the OECD by 2007, the average levels of income inequality over the period of the boom remained stubbornly high. Indeed, this indicator reveals that on the inequality measure, Ireland's performance is similar to that of poorer Southern European countries such Spain and Greece, and only slightly better than other liberal market economies (Britain, New Zealand and Australia), with Portugal and the USA being particular outliers in each of these groups. The size of the state, measured in terms of total public spending relative to GDP, offers some indication of government capacity to intervene on redistributive issues. Ireland is on the lower end of this distribution, but what is particularly striking is that as GDP grew rapidly, the size of the 'state effort', though growing in real terms, fell steadily, as Figure 2 indicates.

Figure 2. State size

These measures indicate that rapid growth and employment expansion, combined with ongoing commitment to social partnership processes, have not contributed either to a sustained reduction in domestic social inequalities or to an expansion in the extent of social or collective consumption. The expansion of public social spending that took place did not keep pace with market-driven living standards. As we shall see, the tax system favoured rather than contained the surge in higher income rewards. Redistributive spending, while it grew over time and especially during the 2000s, continued to be disbursed on a 'residual' model, involving often complex means-testing and eligibility assessments. As in the USA, tax breaks featured extensively as publicly-funded supports to the acquisition of privately enjoyed benefits in areas such as pensions and health insurance (Hacker 2004; 2006). Many aspects of service provision had long been set up in a two-tier delivery structure with public and private target clientele. But unusually, the Irish system involved considerable cross-subsidy from the public to the private sector, whereby relatively modest fees and insurance premia could ensure enhanced services – a kind of inverse configuration of welfare services, an upside-down welfare state.

The institutional inheritance of welfare provision is only understandable with reference to the long path-dependent history of the role of the Catholic Church in Irish society and the dominance of the medical profession in health care (Barrington 1987; Fahey 1992).

Explaining the policy choices made under conditions of unprecedented prosperity during the 1990s and 2000s also requires us to consider the profile of the party political system, especially the electoral dominance of the highly pragmatic right-of-centre Fianna Fáil party, with its strong financial and personal network connections to the business and construction sectors. But two other factors must also be taken into account. The first concerns the limits to the influence the trade union movement was capable of exercising. Union membership was all but non-existent in the most productive, foreign-owned sector. Trade union density declined from almost half in 1990 to a little over one-third by 2007, as the newer sectors of employment, especially in private sector services and in retail trades, proved very difficult to organize. Union membership was heavily weighted toward public sector representation. The trade union movement found it considerably easier to engage with government on deals to do with tax cuts and disposable income, than to adopt 'solidaristic' policies on improved social services, let alone to take a coherent position on issues of income distribution (Hardiman 2006). The discourse of egalitarianism was noticeably enfeebled in Irish political life, and the legitimacy of market-driven outcomes was scarcely challenged.

The second factor underlying the market-friendly features of political life in Ireland is related to the extent of its economic openness and to the way Ireland was positioned in the web of international economic relationships. Ireland's trade openness index was at almost 100% of GDP and almost 120% of GNP during the 1990s and 2000s. But what was distinctive about Ireland's position in the international economy was that was becoming increasingly exposed to three export markets, the demands of which imposed rather contradictory policy pressures on Ireland. Britain, which had been virtually the sole export destination for the Irish economy in 1960, was declining in relative importance, but was still a significant trading partner. The extent of FDI and export reliance on the US market kept Ireland attuned to the culture of American economic life. Membership of the EU had facilitated the access to the wider European market which non-European investors prized. Thus as currency stabilization and eventually monetary union moved up the EU agenda, Ireland found itself positioned between three currency zones. But the full extent of the difficulty of functioning within the Eurozone, without the possibility of an independent interest rate policy or scope for relative cost adjustment through devaluation, would not become apparent until after crisis had hit.

The Janus-faced features of the Irish model have sparked a great deal of discussion about how best it is to be interpreted. For some commentators, the extent of reliance on foreign capital investment permitted very little domestic policy autonomy, and the role of governments in supporting social partnership should best be understood in terms of the 'competition state', or even as 'corporate takeover' (Adshead, Kirby and Millar 2008; Allen 2007; Kirby 2004; O'Hearn 2001). For others, the relatively stable institutionalization of social partnership was a sign not of exploitation or subordination but of insider access to influence on the part of trade unions and civil society organizations, the 'partnership state' (O'Donnell 2008; O'Donnell and Thomas 2006). For others again, no single paradigm encompasses all the priorities, and state policy has to be understood as a complex of 'competing projects', each of which has distinctive core policy constituencies that overlap only minimally (Ó Riain 2008).

The approach of this paper draws on the classic resources of political economy, considering not only the nature of domestic interests and how they are configured in Irish society, but also the international situation of the Irish economy and the policy constraints emanating from membership of the EU and from Ireland's situation in the globalized context of production more generally (Gourevitch 1986, ch. 1; Hall 1986, chs. 8 and 9). Only in this context can we make sense of the scale of the crisis between 2007 and 2009, and attempt to trace the underlying weaknesses that gave rise to the dramatic change in economic fortunes.

Ireland and economic crisis

Between 2007 and 2009, Ireland's previously enviable combination of steady growth and virtually full employment suddenly came to an end. The economy contracted sharply and unemployment shot up, profiled in Figure 3 below. This graph provides two measures of the contraction in Ireland's growth, as the drop in GNP was more severe than that of GDP. This reflects the fact that the foreign-owned heavily export-oriented sector was less severely hit than the domestically-owned and more labour-intensive sector. The difference between GNP and GDP is principally accounted for by profits that are taxed at the low level of 12.5% in Ireland, then transferred back to the home country headquarters of the exporting form.

Figure 3. The crisis in growth and employment, 2007-9

The implications for Irish public finances were equally sudden and severe. Figure 4 shows that Ireland was in fiscal surplus when the crisis hit in 2007, but that its deficit was already more severe than Greece's by 2009.

Figure 4. General government cyclically adjusted balance as % GDP

Ireland's public debt had shrunk as a proportion of GDP during the years of very rapid growth. But the rapid accumulation of borrowing obligations for current spending quickly increased consolidated debt obligations, and the government rescue of the banking sector increased both deficit obligations and debt totals during 2009-10.

Figure 5 below shows that the European countries with the largest consolidated general government debt were Italy, Greece, and Belgium. Italy and Belgium had long found it difficult to restrain their public indebtedness, but their capacity to service existing borrowing was not in serious question. In contrast, Greece's problems with fiscal discipline were not solved by the time they were admitted to membership of the single European currency, and became worse over time. Ireland's gross government debt exposure was not among the worst in 2010. But its general government deficit was particularly problematic, and the prospects for rapid debt accumulation were clear. In addition, the government undertook to deal with the collapse of the banking sector in 2009 through the creation of a 'special purposes vehicle', the National Asset Management Agency (NAMA). This was to deal with the now severely depreciated assets of the bankrupt developer and builders, loans to whom had gravely over-extended the banks. This worsened both the government deficit and implied a greatly increased debt exposure once the NAMA process was completed.

Figure 5. Debt and deficit as % GDP, 2010

The suddenness and the severity of the economic fall from grace took many by surprise. Ireland's banks were the first casualty of the international financial crisis. But the principal explanations for Ireland's woes were not to do with the banks' exposure to risky investment products and Ireland was relatively untouched by US sub-prime lending. The main source of the Irish banks' problems was their over-exposure to property-based loans and the close personal as well as financial links between bankers, property developers, builders, and politicians, especially in the dominant Fianna Fáil party. Many commentators had warned that Ireland was in the grip of an asset price bubble – an enormous and clearly unsustainable construction boom and soaring house prices. The international crisis exacerbated but did not cause the underlying banking crisis in Ireland.

The contribution to Ireland's crisis of ruinously bad lending practices, increasing reliance on short-term international lending and over-reliance on poorly monitored loan collateral, and poor regulation of the banking sector, is by now well established (Honohan 2010; Regling and Watson 2010; Ross 2009). But analysis of both the causes and the implications of the crisis in the public finances is more contested. The orthodox interpretation is that Ireland's economic crisis was primarily attributable to loss of competitiveness. Policy recommendations by some of the most prominent economists in Ireland recommended that the principal means by which competitiveness could be restored was through a decrease in real wage levels to restore the cost base of the economy (Bergin, Conefrey, FitzGerald and Kearney 2009). From the government perspective, the most pressing consideration was to regain control over the public finances, and in particular, to break the perceived link between Ireland and Greece in the bond markets. Addressing the deficit implied some combination of spending cuts and tax increases. During 2008-10, government embarked on a series of budgetary measures that not only cut spending, but imposed direct cuts in public sector pay, with very little change on the revenue side, and it was not clear what the duration of the pay cuts was intended to be. The convergence of these interpretations resulted in a strategy of adaptation to the altered economic environment based on cost-cutting and enforced domestic deflation.

But it would be misleading to conclude from this that the problems of Ireland and Greece were analogous. Ireland had indeed suffered both a fiscal and a competitiveness crisis.

Disentangling these, and tracing the links between them more clearly, sheds new light on economic governance patterns in Ireland in recent decades.

Pathways to Crisis

The fiscal profile

A fiscal crisis implies a gap between public spending and state revenues: it is not a priori an issue of over-spending, but of a mismatch between spending commitments and the capacity to fund them. The historical profile of revenue and expenditure in Figure 6 shows that the large deficits of the 1980s had not only been stabilized, but by the mid-1990s were replaced by fiscal surpluses, in the context of a very rapidly growing economy. The devastating fall-off in revenues and the soaring increase in expenditure graphed here are exaggerated by the fact that GDP itself shrank by some 15% between 2007 and 2009.

Figure 6. Ireland's fiscal profile, 1981-2007

But what Figure 4 also suggests is that that there were underlying weaknesses in both revenue-generating capacity and in spending patterns in Ireland. The impact of the crisis that had its origins in international conditions was intensified by weaknesses in domestic economic management.

Figure 7. The composition of taxation in Ireland, 2001-2010

Figure 7 above shows that the volume of tax revenue shrank rapidly with the onset of crisis. But long before the crisis hit, the composition of revenue had become ever more exposed to property-related sources, whether in the form of stamp duty (transaction tax) or capital gains tax. At a time of severe asset-price inflation, increasing reliance on such a volatile base was problematic. And property-related investment incentives that were constructed through the tax code further fuelled the asset-price bubble while it was at its peak (TASC 2010). Despite the turn toward tax simplification and creation of a broad tax base in the late 1980s, Irish policy-makers had a persistent tendency to use tax incentives to shape behaviour. Although these started to be reversed again in the mid-2000s, they were very costly (Callan, Walsh and Coleman 2005). And the long-standing reliance on low corporation tax remained a fixed commitment for all governments (Hardiman 2004).

Meanwhile, the significance of personal income tax in the overall revenue mix – that 'great engine of finance', as Gladstone termed it – had been permitted to decline. Fianna Fáil, in coalition with the liberal Progressive Democrats, had embarked on a more vigorous programmes of tax reduction in 1997. Minister for Finance Charlie McCreevy evinced a strong ideological commitment to reducing the incidence of personal income tax: it was he who reduced the top rate of tax and halved capital gains tax between 1997 and 2003, measures which not only benefited higher earners disproportionately, but which also introduced a sharp increase in disposable incomes at just the time when access to cheap credit suddenly widened, with the advent of the Euro.

The social partnership based pay agreements had also come to centre on tax concessions in exchange for wage moderation. This produced real benefits for trade union members in the form of increased personal disposable income. The tax burden on all forms of household and at all wage levels became steadily lighter to the point at which Irish employees were among of the most lightly taxed in the whole OECD, outdone only by Korea and Mexico (OECD 2009, p.51). Yet the revenue stream was not yet visibly compromised. New revenue sources were sought in so-called 'stealth taxes' – indirect taxes such as VAT, and fees and charges for public services. Indirect taxes tend to be inequitable in their impact on household budgets; they add directly to inflationary pressures, as they increase the costs of a host of everyday transactions. For several years though, it seemed as if Ireland could have it all: lower direct taxes as well as increased spending, all fuelled by a spell of very rapid growth. And so the Irish revenue base was systematically weakened, through the scale of tax expenditures, increased dependence on property-related transactions, and decreased reliance on direct income taxation.

Pro-cyclical spending policies

Irish tax policy during the 2000s fed into inflationary pressures, both directly through consumption and transaction taxes, and indirectly through the incentivizing effects on the construction boom. But this was not balanced by spending policies that would contain such pressures. Rather, Ireland has experiences a consistent bias toward pro-cyclical spending policies, notoriously captured by Fianna Fáil Finance Minister Charlie McCreevy's comment in the early 2000s that 'when I have it, I spend it'. During periods of rapid growth, governments have tended to increase spending, and especially current spending; in a downturn, they are left with little option but to impose contractionary measures to contain the emergent deficit (Lane 1998; 2003; 2009). Public spending increased rapidly in the late 1990s and especially in the run-up to the election of 2002. Following another Fianna Fáil-dominated electoral victory, McCreevy sought to control spending commitments somewhat; but electoral unpopularity quickly resulted in a resumption of a more relaxed stance on expenditure.

Ireland, unlike Britain, was part of the Eurozone system of fiscal discipline form 1992 onward. Conformity with the conditions of the Stability and Growth Pact was meant to be domestically enforced and subject to sanction by the European Central Bank. However, it quickly became apparent after 2000 that the era of cheap credit, one of the anticipated benefits of the single currency, was a potent force for destabilizing fiscal disciplines in countries with growth rates that were more buoyant than the large core economies of Germany and France.

The domestic institutional context of budget formation varies across European countries. Hallerberg, Strauch and von Hagen suggest that there are two modes of achieving stable fiscal policy: one based on bargained pre-commitments by coalition partners binding government to specific targets, the other based on strong and autonomous decision-making by the finance minister (Hallerberg, Strauch and von Hagen 2007; Hallerberg, Strauch and von Hagen 2009). The latter model is more characteristic of the executive-dominated policy-making processes of Britain and Ireland, notwithstanding Ireland's greater propensity to form coalitions. But what is not captured by the model is the variation within liberal market economies in the political motivation for ministers to engage in tight budgetary controls. And indeed Britain, despite having independent control over monetary and exchange rate policies, and an independent central bank from 1997 on, incurred a growing fiscal liability throughout the 2000s and found itself by 2010 among the four European countries with the highest fiscal deficits. In Ireland, too, the autonomy of the finance minister permitted a good deal of leeway, but was not conducive to running a consistent counter-cyclical stance. Periods of fiscal surplus were relatively short-lived and proved vulnerable to electoral pressures for increased spending during an upturn.

Real public spending continued to increase until the crisis was well under way. At that point, the Fianna Fáil-Green coalition government that had taken power in 2007, just before the crisis broke, began its corrective measures. Once convinced of its necessity, the government possessed the institutional resources to take strong and decisive action. But once again, the government adopted a fiscal stance that intensified the underlying cyclical trend in the economy. This time though, the pro-cyclical approach was contractionary in its effect. Arguing that the revenue base was now too precarious to attempt to increase taxes, and against the recommendations of the recently published Commission on Taxation report, the government sought to implement its fiscal adjustment entirely through spending cuts (Commission on Taxation 2009).

The institutional processes of budget formation in Ireland had been strengthened as a consequence of its membership of the Euro, since the European Central Bank, under the terms of the Stability and Growth Pact, required systematic reporting on budget targets and multiannual forecasting. And the political autonomy available to the Minister for Finance, similar to the British system of strong executive dominance, should have entailed a strong capacity to adhere to a coherent fiscal stance. But in fact it is clear that Ireland followed a markedly expansionary fiscal policy in aggregate over the period 1992 to 2003 (Hallerberg et al. 2009, p.180). Under conditions of extraordinary growth, Ireland might have been better advised to accumulate large fiscal surpluses, as was the case in Sweden. But domestic factors pushed in the opposite direction. Short-term electoral pump-priming prevailed over longer-term planning that would resist such populist pressures (Hardiman 2009).

Competitiveness challenges

Competitiveness has many contributory elements to it: supply-side factors in areas such as education and skill attainment contribute to competitiveness; so also to infrastructural investments in transport, broadband connectivity, energy costs. In many of these areas, Ireland has particular weaknesses (National Competitiveness Council 2009). What we wish to consider here though is the the cost base of the Irish economy, which suffered a deterioration over time relative to the core European economies, as Figure 8 below shows.

Figure 8. Harmonized competitive indicators

The factors contributing to relative competitiveness gains or losses have to be considered carefully. We wish to consider not only domestic wage competitiveness, but also the range of other factors that determine the cost base, not least of which is government's macroeconomic stance. Figure 8 captures broad-based changes in relative domestic costs and the real effective exchange rates obtaining between members of the single European currency. The figure indicates that Ireland, along with Spain, and closely followed by Greece, had experienced the most marked relative deterioration in relative cost structures. In contrast, Germany's relative cost base had been held firmly under control, even during the unstable conditions of 2002-3. Within the Eurozone of course, the smaller, weaker countries were unable to alter their relative exchange rates to recover competitiveness; equally, Germany was now unable to do what it had frequently done in the past, and revalue its currency relative to others. Within the 'one size fits all' currency regime, inability to adjust through relative cost changes was likely to result in increased domestic unemployment.

The role of wages in the total cost base of Irish economic activity is highly differentiated because of the structure of the economy. Yet although there are no formal mechanisms for extending the coverage of pay agreements, pay deals were capable of penetrating more extensively than the numbers might suggest. Union membership comprises some 34% of the labour force (Central Statistics Office 2008a). Union membership is perhaps at 80 per cent in the public service, which means virtually 100 per cent coverage. Membership was about 15 per cent in the private sector; firms in which there was at least some union presence were likely to observe the terms of pay agreements for all their employees. Virtually none of the most profitable, export-oriented firms, either in manufacturing or services, was unionized, yet the foreign-owned companies tended to shadow the terms of the pay agreements, while also varying pay rates through bonuses and other flexible adjustments methods (D'Art and Turner 2005; Gunnigle, Collings and Morley 2005; Roche 2001). Some sectors that might otherwise be difficult for unions to organize were subject to mandatory industry-wide agreements – most strikingly in the construction industry. And when issues arose concerning the monitoring and implementation of statutory labour market protections, the unions pressed the issue through social partnership networks to ensure better monitoring of compliance standards. Thus the governance of the labour market was more pervasive than might first seem to be the case (Hardiman 2006).

For all that, aggregate unit wage costs in Ireland did show some relative deterioration, as Figure 9 suggests. The effects were unevenly felt, since in the modern, export-oriented sector, labour costs constitute a relatively small portion of total costs; the capital intensiveness and high productivity levels of both manufacturing and services meant that unit labour costs were not problematic in most exporting sectors (Breathnach 2010).

Figure 9. Unit wage costs

Social partnership institutions provided the context for pay bargaining continuously between 1987 and 2009. Both union and employer representatives had been committed during the 1990s to securing the conditions for Euro membership; the Maastricht criteria were internalized into domestic political priorities. Within the trade union movement, public sector unions were particularly strong. Over the decades had acquired a complex set of differentials and relativities that were capable of generating recurrent cycles of pay claims above and beyond those agreed by the partnership process. A 'benchmarking' agreement in the early 2000s aimed to bring these 'special' pay claims to an end and to secure industrial peace in the public sector. But the efficiency arguments for the agreement were less clear. Thus by the late 2000s, there was some evidence, albeit contested, that any misalignment between public and private sector pay now tended to favour the former, particularly at the top (Kelly, McGuinness and O'Connell 2009).

As domestic inflationary pressures began to gather pace in the early 2000s, employers sought to build in new safeguards against inflationary wage demands by strengthening the role of the overseeing National Implementation Body. The economic governance capabilities of social partnership were not put to any severe test until 2008/9. Until then, buoyant growth meant that hard distributive trade-offs could still be accommodated, and higher spending and lower taxes could, for the time being, be sustained. But the foresight capacities of social partnership institutions proved quite limited, and the challenge of negotiating a deflationary pay deal under extreme pressure during 2009 proved extremely difficult, particularly when government imposed a series unilateral public sector pay cuts as part of its deficit-reducing strategy. Yet although widespread anger at government policy occasioned street protests, reliance on consultative processes remained strong, and government continued to make efforts to secure bargained union acquiescence to its fiscal strategy.

Relative competitiveness encompass more than wage costs though. Neither unit wage costs nor relative exchange-rate-based competitiveness measures can be understood without understanding government's own contribution to inflationary pressures. Government reliance on consumption and non-income based taxation, and government unwillingness to take measures to control the explosion in property prices, combined to push up the cost base of the Irish economy. This in turn drove wage demands among employees who, in spite of rising real incomes, found the cost of housing rising out of reach, even for dual-earner households in the ever-expanding outlying commuter belt. Thus the Irish domestic cost base of production was driven by problems with controlling spending, and as in Spain, a house price boom injected inflationary expectations into the system.

The European context of economic governance

We have considered the domestic origins of Ireland's economic crisis, in particular the respects in which pre-existing policy and institutional weaknesses paved the way for a fiscal crisis and for a competitiveness crisis. But we cannot consider the decline in the relative competitiveness position of Ireland, Greece, Spain and Portugal, without reflecting on the other side of the comparison, which is the relative competitiveness gain experienced by Germany since 1998.

The domestic origins of different 'pathways' to economic crisis therefore have to be placed in the context of the design of the Euro itself. The adoption of the Euro was a 'political' project from the outset, in the sense that a system of rules were created through treaty agreements that was intended to foster the development of greater convergence at the level of domestic economies. During the 1970s and 1980s, closer European integration came to seem all but inevitable as a solution to the uncertainties and the conflicts of national interest – especially between France and Germany – associated with managed exchange rates. Against those who held that real convergence between European economies was a prerequisite of a viable European currency, the view prevailed that nominal unity through a shared system of money would enforce closer alignments of policy and of economic performance (Marsh 2009).

But two major design problems made this difficult. The first is that while Germany retained its capacity to discipline domestic costs effectively over time, the same was not true in other Eurozone member countries, with very different political institutions and organized interests. Inflation control had long been prioritized in Germany through the role of its strong and independent Bundesbank, and the signalling mechanisms from the Bank that any relaxation of fiscal disciplines, or any sign of inflationary wage settlements, would be controlled through increases in interest rates (Franzese and Hall 2000; Hall 1994). The second problem was that the ‘one size fits all’ interest rate regime proved woefully unsuited to countries with very different growth rates, and interest rates were set low to benefit the needs of the largest states. Convergence on low Germany interest rates was one of the signal benefits expected to result from Economic and Monetary Union (EMU). But the unanticipated consequences of EMU for the smaller and more peripheral Eurozone countries was that credit was suddenly much cheaper than their higher growth potential would warrant. Ireland and Spain in particular both experienced a massive surge in availability of consumer credit. Lacking the capacity to increase domestic interest rates, national governments proved unable or unwilling to exercise fiscal disciplines on a scale that would have made any appreciable difference. The tsunami of low-interest credit was particularly problematic for the ‘cohesion’ states of southern Europe and Ireland (Blavoukos and Pagoulatos 2008).

The implication is that fiscal crisis and competitiveness loss are not problems that exist in Ireland in isolation. Stable solutions ultimately imply some reconsideration of the design of the Eurozone itself. For Ireland, the experience of both a fiscal and a competitiveness crisis is very painful. For any individual country, with a particular profile of borrowing requirements and of both private and public debt burdens, the need to secure loans on international markets brings with it subjection to risk assessment of its sovereign debt liabilities on the part of the international ratings agencies. Thus the most vulnerable countries are constrained to adopt those policies that will secure their credibility with the bond markets. This has required strategies for reducing government borrowing requirements that have centred on visible spending cuts, combined with promissory action to reduce costs to improve export capabilities and alter their balance of payments profile. Ireland proved to be able to implement measures that restored the confidence of the markets in government’s seriousness of intent. Yet the foundations of the Euro had been badly shaken by the near sovereign debt default by Greece in mid-2010, and by the realization that the governance mechanisms of the Euro continued to be so heavily reliant on German goodwill. It remained unclear whether the conventional remedies of deflation and painful domestic devaluation would be politically tolerable if imposed as severely as seemed to be required. And while it appeared to make sense for each country, considering its own options under pressure from bond markets, to adopt a conventionally deflationary stance, this ran counter to the ongoing need to address structural trade imbalances across Europe as a whole and the need to re-establish conditions for renewed growth in demand to generate economic recovery.

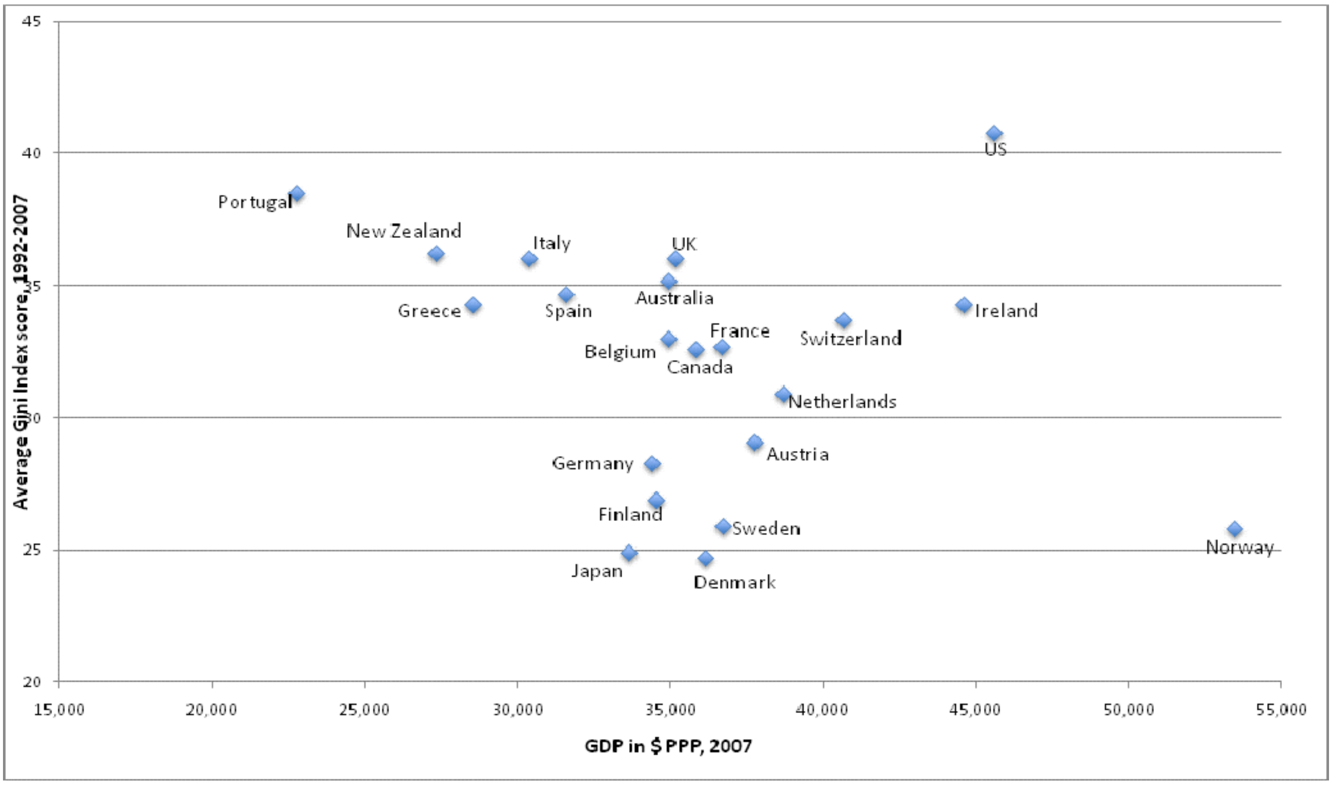
Conclusion

The sudden and calamitous end to Ireland's phase of relative prosperity came as a shock. In retrospect though, the institutional configurations and policy choices were already in place that made the Irish reaction to crisis all the more severe. The liberal structure of the economy, combined with the small-state propensity to seek protective policy solutions, stood in uneasy relationship to one another. Ireland's development stance based on FDI meant that a major plank of tax policy, the rate of corporation tax, was non-negotiable for any party in power. A business-friendly legal environment provided additional encouragement to foreign investment.

But much of the economic activity of the 2000s was based on the domestic sector, including an unsustainable reliance on construction. Tax incentives favoured property-owners, developers, builders, and bankers, who were in turn stong supporters of Fianna Fáil. The reliance on 'light-touch regulation', and trust in banks themselves not to over-extend themselves, proved fatally flawed policies.

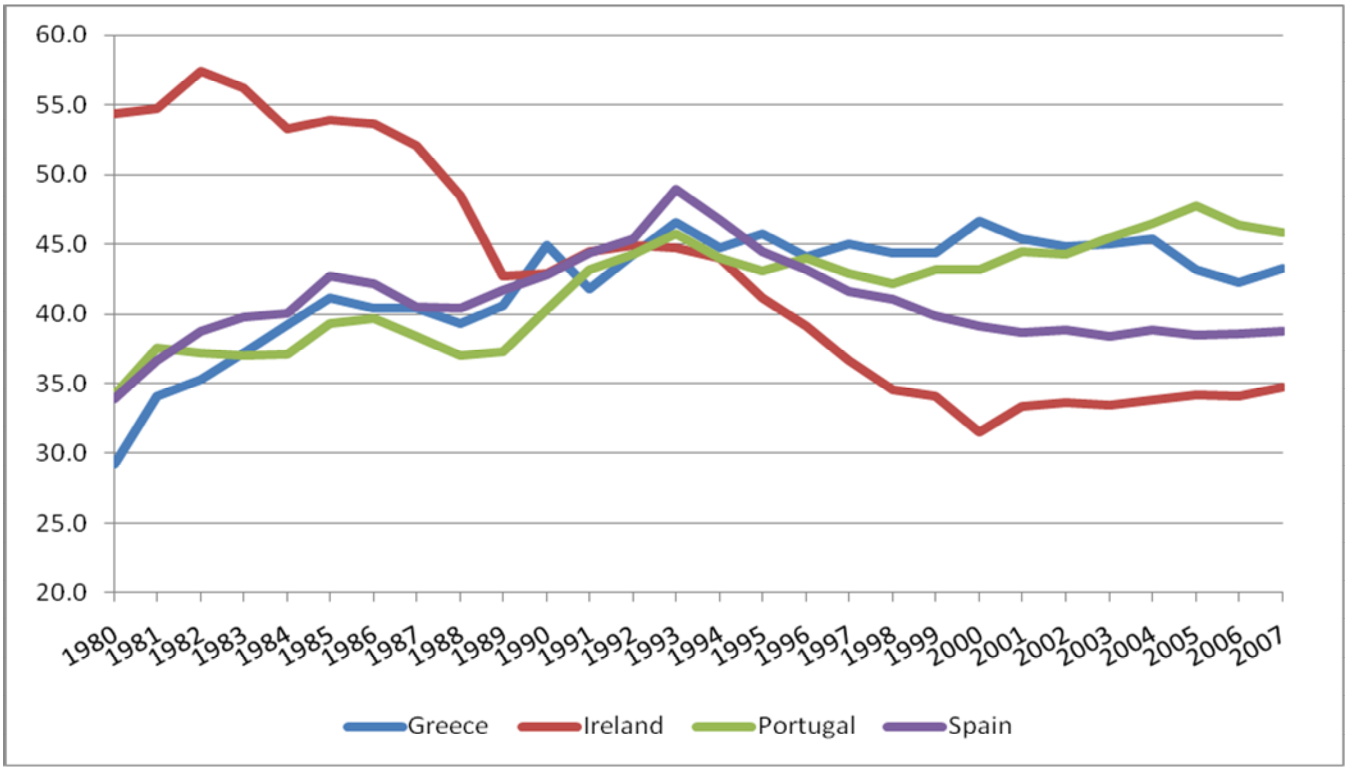
The fundamental change in economic governance conditions during the 2000s was the existence of the Euro. Within a single currency regime, where the only policy choices under domestic control are fiscal policy and relative cost adjustment, Ireland proved signally weak at both. Ireland could and did undertake remedial fiscal action from 2008 on. But the structural conditions of the Eurozone itself meant that Ireland would depend, as ever, on external drivers of demand to generate the conditions for the resumption of domestic growth.

Figure 1. Growth and inequality, 1992-2007



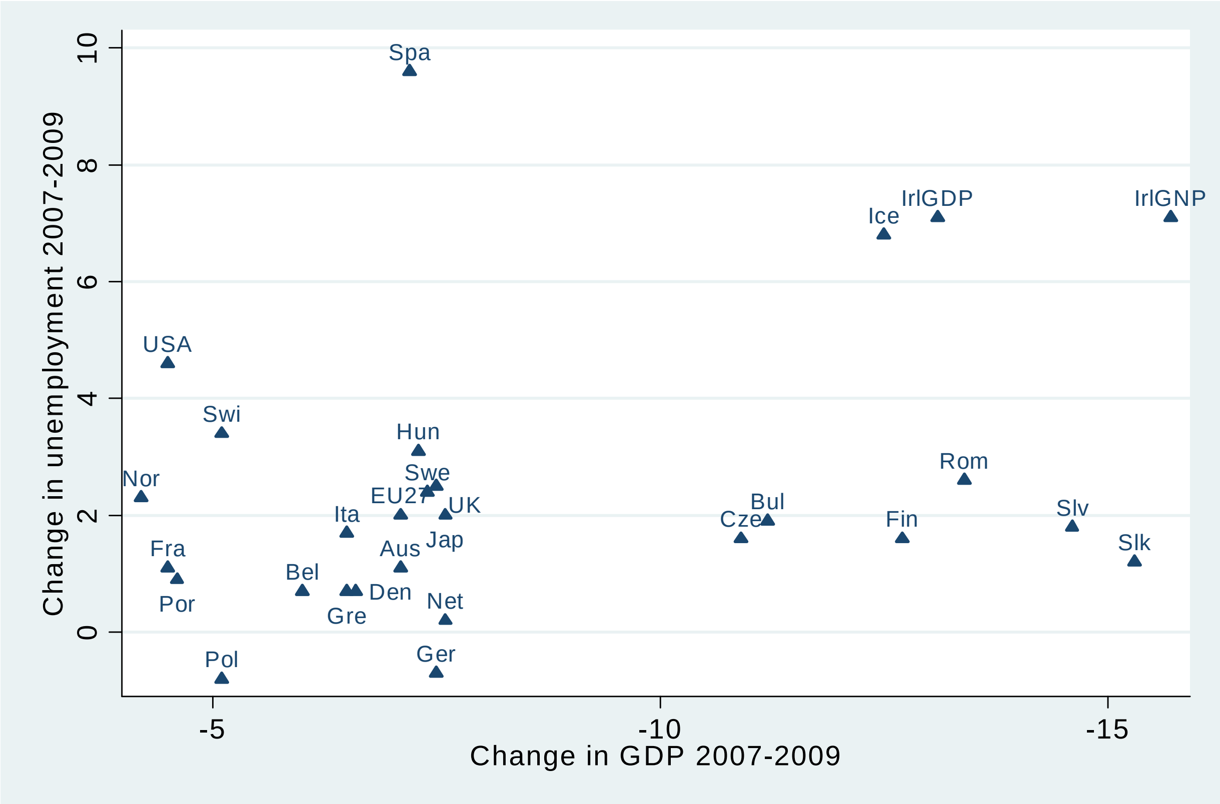
Source:

Figure 2. State size



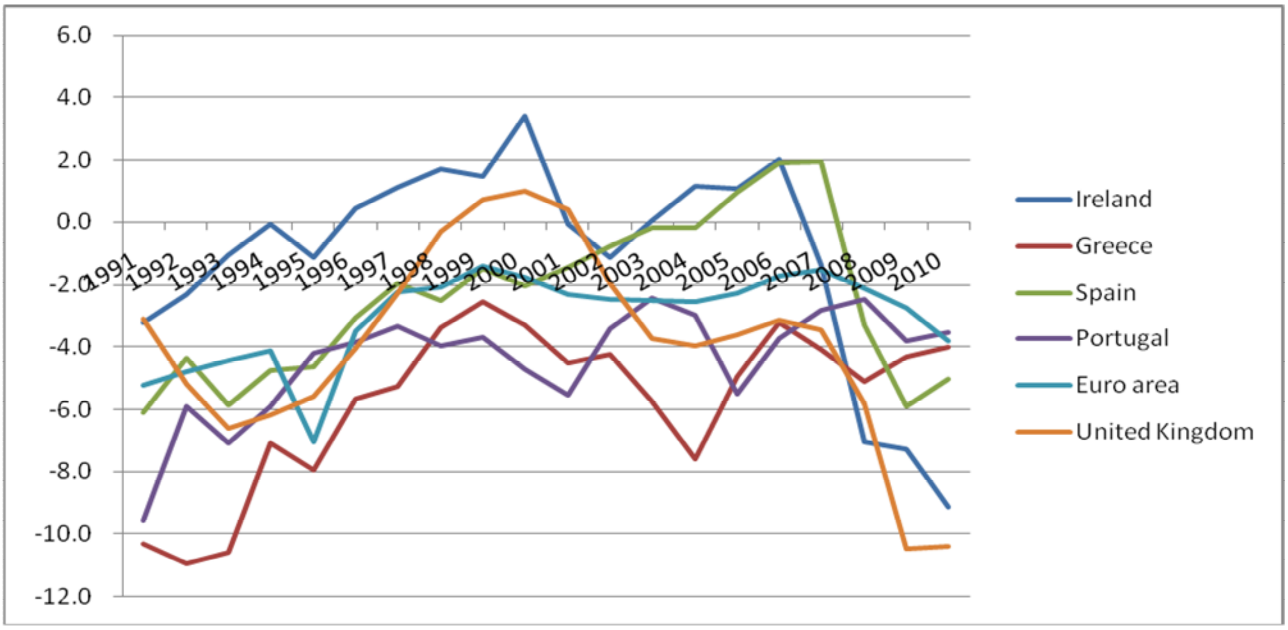
Source:

Figure 3. The crisis in growth and employment, 2007-2009



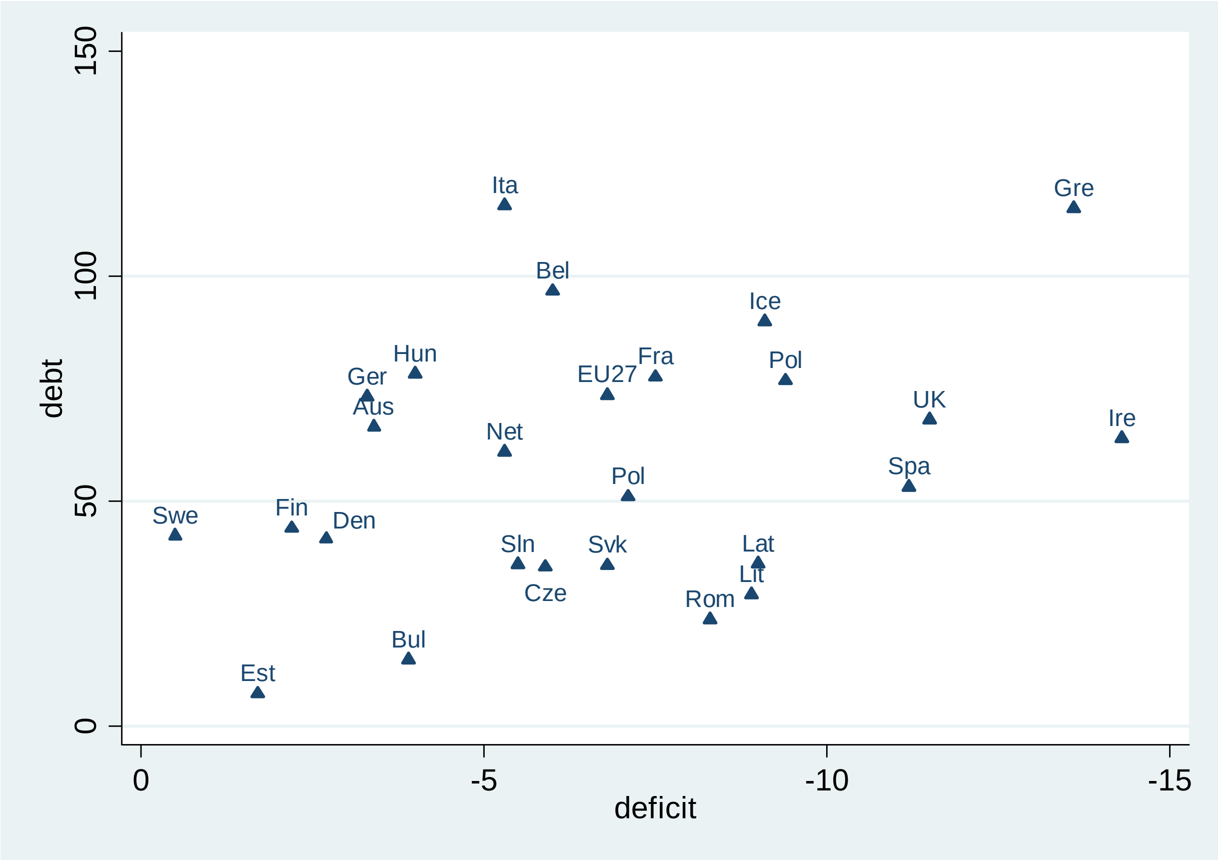
Sources: Eurostat, Irish Central Statistics Office

Figure 4. General government cyclically adjusted balances



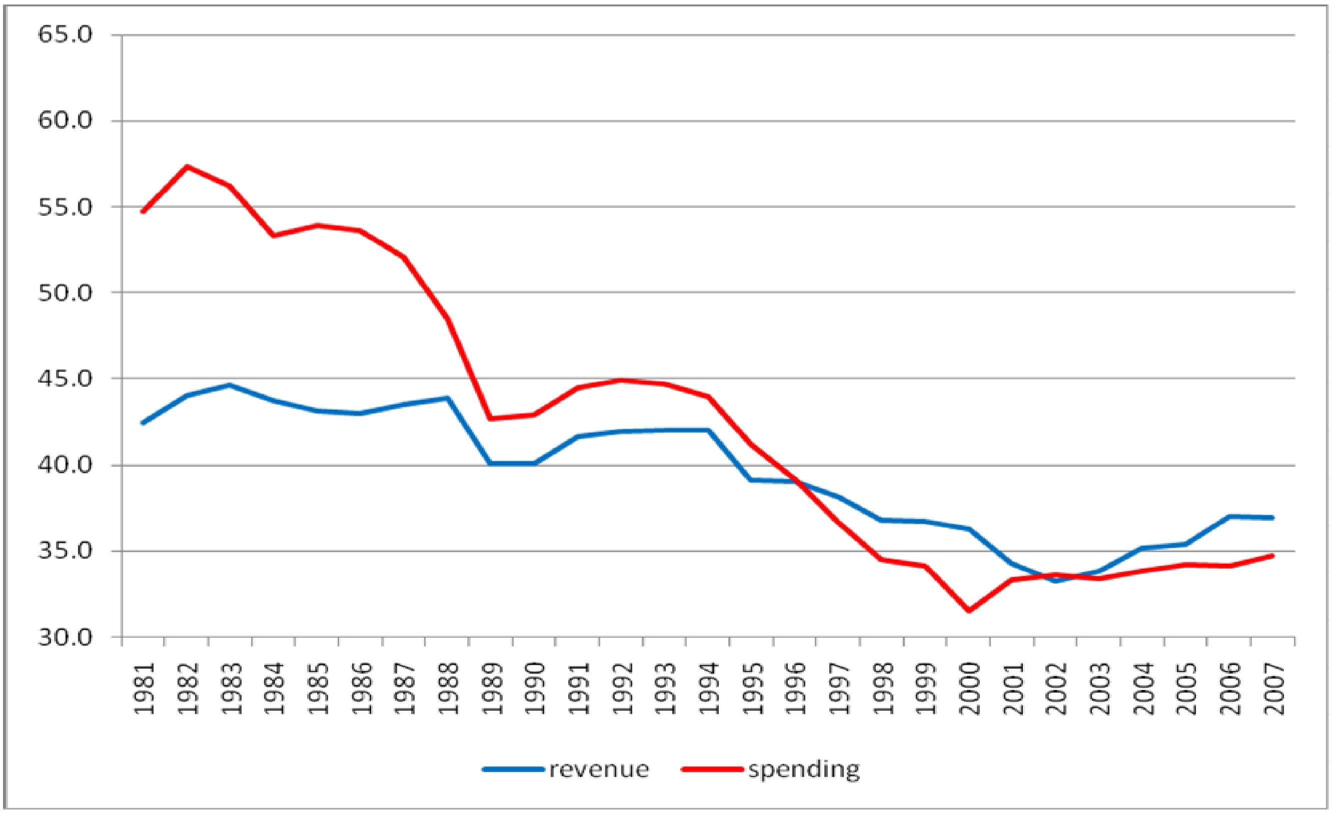
Source: OECD Economic Outlook 85 database

Figure 5. Debt and deficit as % GDP, 2010



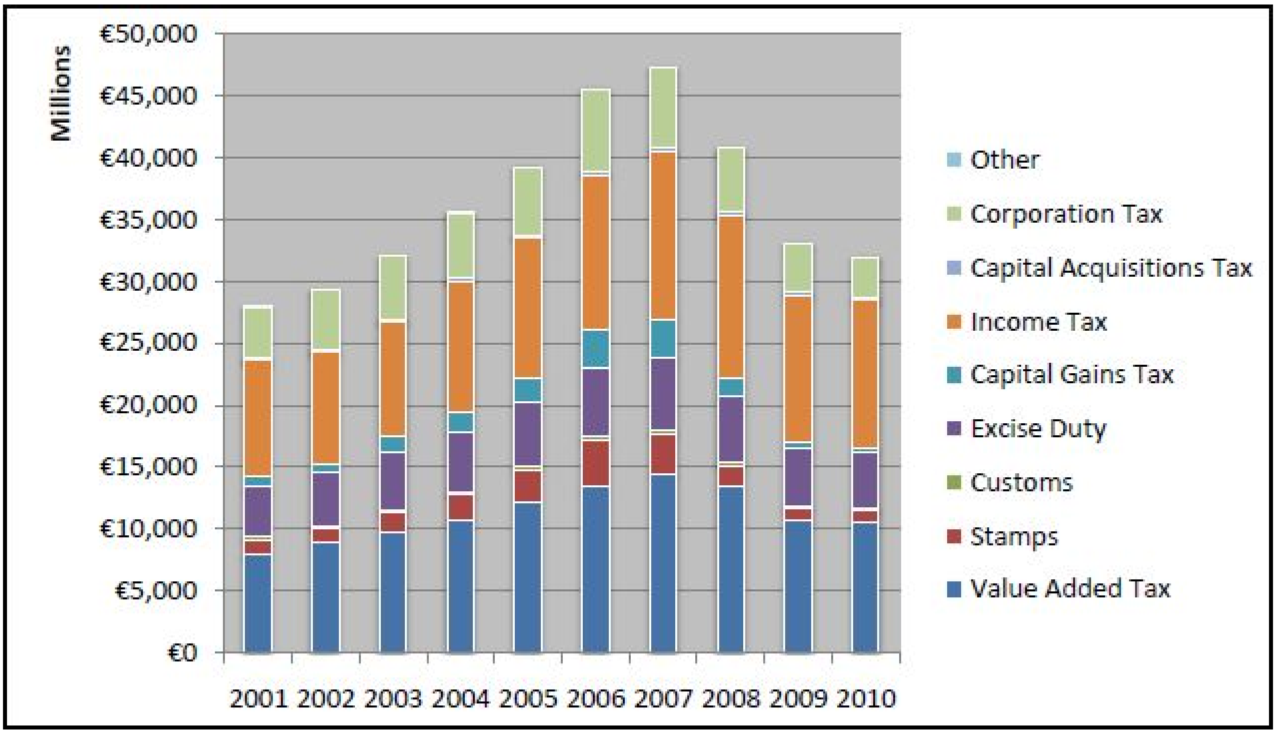
Source: General government deficit, general government debt, Eurostat.

Figure 6. Ireland’s fiscal profile, % GDP, 1980-2007 (2010??)



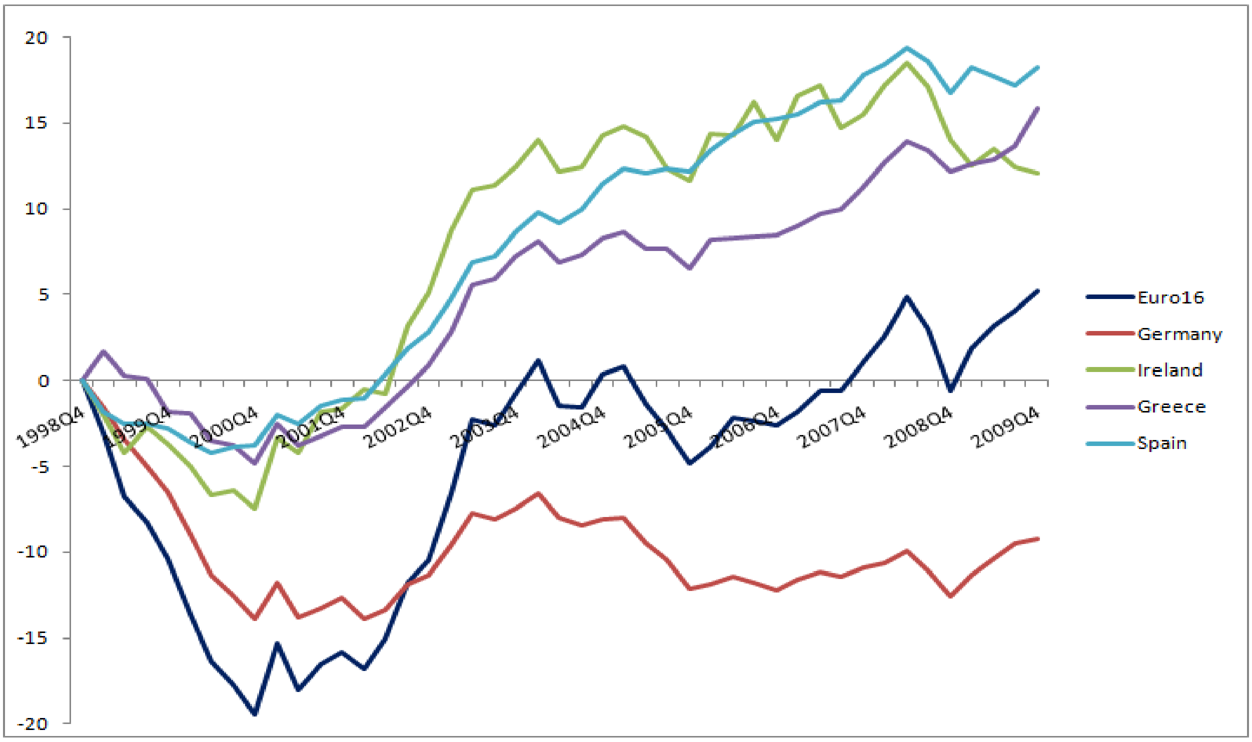
Source: OECD Economic Outlook 82

Figure 7. Composition of taxation in Ireland, 2001-2010



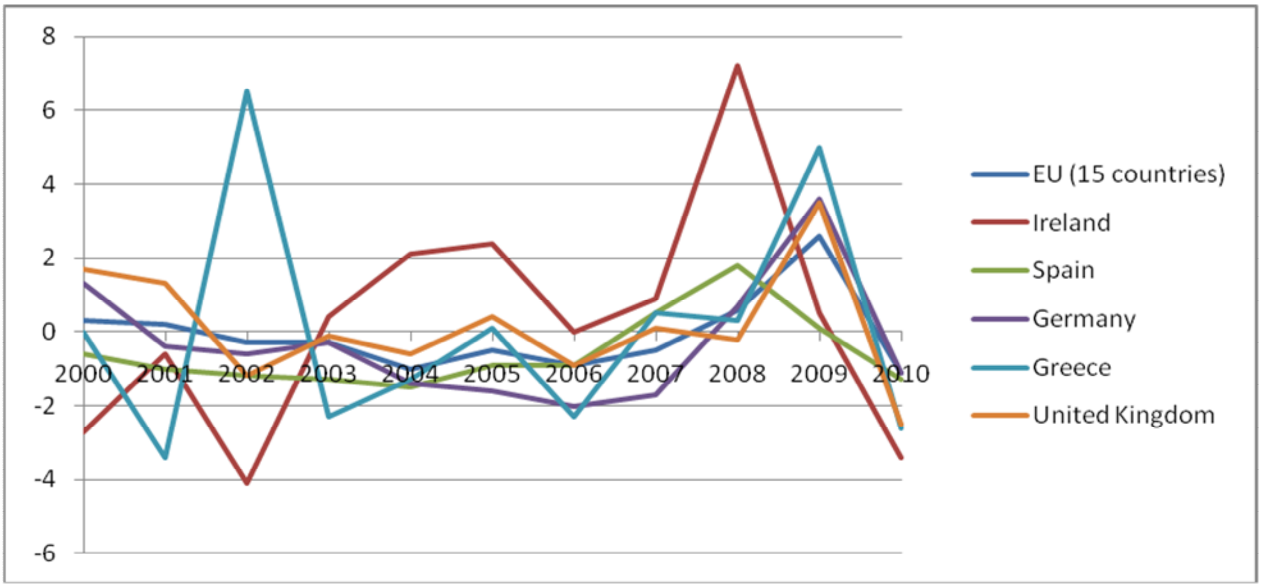
Source: (TASC 2010, p.12)

Figure 8. Harmonized competitiveness indicator, % change, Q4 1998=100



Source: European Central Bank

Figure 9. Unit wage costs



Source Eurostat. Growth rate of the ratio: compensation per employee in current prices divided by GDP in current prices per total employment

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