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Bringing Domestic Institutions Back into Understanding Ireland's Economic Crisis

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Bringing Domestic Institutions Back into Understanding Ireland's Economic Crisis

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Abstract

The Irish economy has had one of the worst experiences of economic crisis within the EU since the onset of international financial crisis in 2007/8. That the crisis has an international dimension is beyond question. What needs to be explored further is the contribution of domestic political factors which weakened the capacity of the Irish political system to respond and which exposed Ireland to a worse crisis than might otherwise have occurred. Three institutional clusters are analysed: the political priorities and decision-making routines underlying the Irish growth model; the configuration of the public administration system; and the management of the domestic cost base. In all three, urgent priorities for reform are identified. The paper does not advocate reform of the electoral system, which tends to attract more media attention than is warranted. Rather, it argues that energy and intelligence needs to be devoted to reforming the quality of decision-making, limiting government's fiscal discretion, and opening up transparency in the distribution of the costs of adjustment.

Introduction

The economic crisis that originated in the US financial system in 2007 quickly radiated outwards to embrace most of the wealthier countries of the world. What caused the contagion to spread so rapidly was the fact that financial markets have become internationalized so rapidly. Countries had been motivated to free up transnational capital mobility since the 1980s by the recognition that investment flows could boost prosperity, and by a variety of incentives and pressures emanating from international institutions such as the OECD and the IMF that were committed to the merits of deregulation. The interdependence of financial markets, and their scale relative to national political systems, provided the context for the crisis (Crotty 2009).

But the global economic crisis, while inducing recession and creating major shocks for all the economies of the developed world, has been experienced rather differently in different countries. This is partly attributable to the variations in the role played by finance capital in the overall economic system. Notwithstanding some variations in financial practices, 'coordinated' capitalist economies of continental Europe tended to have more highly regulated banking sectors and lower levels of exposure to stock market fluctuations than the 'liberal' market economies, a category that includes Ireland, Britain, and the USA (Culpepper 2005; Hall and Soskice 2001). But what also needs to be taken into account is the variation in countries' domestic conditions which resulted in a greater or lesser degree of exposure to private sector indebtedness, expansion of the financial sector, and different evaluations of risk, all of which conditioned the severity with which the financial crisis eventually struck. Among the domestic factors that make a difference to outcomes are the institutional arrangements for decision-making and policy implementation, and the nature of each country's involvement with the international economy.

This is not simply a function of country size. Some of the countries that experienced particularly bad recessions during the current crisis are indeed small, including Ireland, Iceland, and the Baltic States. But if the contraction in GDP and a recession-induced increase in unemployment are the principal measures of how severely a country's well-being has been affected in the short term, what is perhaps most striking is that many other small countries such as the Scandinavian countries, but also smaller post-communist countries such as Slovakia and Slovenia, have not suffered to anything like the same degree, as Figure 1 shows. Indeed, these countries' performance is closer to that of the larger European countries such as Germany, France and the UK than to that of the more severely affected smaller economies.

Figure 1 here

Furthermore, if we look at the fiscal consequences of economic crisis, Figure 2 shows that the Baltic states and other postcommunist countries, which entered the crisis with relatively little accumulated debt, also experienced relatively low fiscal deficit crises. Countries that had long experienced difficulties in keeping their total debts within Maastricht guidelines such as Italy and Belgium were not now the most severely affected by budget deficits. A cluster of countries emerges as having a particularly severe fiscal crisis, well above European averages: these are, in ascending order of gravity, Spain, the UK, Greece, and Ireland. Maintaining borrowing requirements and refinancing accumulated debt turned out to be particularly difficult for the EU 'cohesion' economies of Spain, Greece, and Ireland, as the risk assessment agencies on which bond market investors rely began to lower their ratings for these countries' borrowing requirements. The near-crisis in the Greek sovereign debt in spring 2010 initiated a new set of challenges to the EU to review the commitment that there would never be any 'bail-out' of countries in difficulty, and to re-evaluate the nature of economic governance in the EU as a whole (Baldwin and Gros 2010; Mody 2009; Van Rompuy 2010).

Figure 2 here

This paper outlines some of the respects in which Ireland turned out to be dangerously exposed to external shocks. In retrospect it is more easily seen that policies that might merely have been unwise in the absence of economic crisis increased the risk of disastrous consequences when the international context changed. Three institutional clusters are considered here, each of which contributed to the particularly Irish experience of crisis. The first concerns the turn taken by the Irish growth model during the 2000s, centring in particular on the tax incentives underlying industrial policy and the balance struck between exporting and non-exporting sectors. The second concerns the public administrative system charged with policy coordination and expert advice. The third concerns the management of the cost base of the economy in the context of European Monetary Union.

The Irish growth model

The core elements of the Irish growth model have been in place more or less continuously since the 1960s, but it has gone through several reputational waves since then. The commitment to a low corporation tax regime as a principal means of attracting inward foreign direct investment, and charging a state agency with targeting potential growth sectors, were elements of the policy mix that have not varied fundamentally since the 1960s (Bradley 2000; FitzGerald 2000). During the 1980s, recessionary conditions generated new questions about the robustness of the measures in place to support domestic innovation and entrepreneurship. But the basic policy orientation was not only unchanged but put on a firmer footing with the completion of the Single European Market in the early 1990s. Following the stabilization of the public finances and a renewed commitment to macroeconomic stability, Ireland was particularly well placed to benefit from the surge of internationally mobile capital seeking investment opportunities within the European Union. In addition to a strong export-oriented and largely foreign-owned manufacturing sector concentrated in pharmaceuticals and information and communications technology, a new phase of development of internationally traded services, particularly computer software and financial services, began to take off. The so-called Celtic Tiger was not very Celtic at all, but the domestic spin-off growth was particularly strong during the 1990s and 2000s (Barry 1999; Barry, Bradley and O'Malley 1999; Honohan and Walsh 2002; MacSharry and White 2000; O'Sullivan 2000).

However, policy imbalances began to emerge in three areas. Firstly, the relative performance of the export-oriented and domestic sectors began to shift. FDI in manufacturing levelled off, but the availability of cheap credit that followed membership of the Euro created new kinds of incentives in the domestic economy. Inward capital flows were not directed toward the most efficient investment opportunities, but rushed into the most readily available domestic sector, which was construction activity. The Irish economy entered a classic asset price bubble. Political opinion was slow to respond, since the building industry generated so much employment, doubling between the last 1990s and mid-2000s. Rising house values were a welcome development for those already on the property ladder, while any fall in property values would create negative equity traps for the most recent entrants, mostly younger voters, the politically significant first-time buyers. Politicians had multiple incentives to keep the bubble inflating, while hoping against hope for the proverbial soft landing. Meanwhile, the conditions for a very hard fall were accumulating (Hay 2009; M Kelly 2009).

Secondly, the easy credit conditions in a world of capital mobility facilitated the growth of the financial sector. Competition between banks for lending opportunities not only drove up the speculative bubble in property, but intensified the incentives to relax due diligence and conventional risk assessment measures. The share of the financial sector in total value-added made up 10.6% in 2007 in Ireland, compared with only 5% on average in the euro area (European Commission 2010, p.5). The expansion of lending liabilities happened with astonishing speed. Net lending by credit institutions in Ireland to Irish residents grew from 10% at the end of 2003 to 41% of GDP by the end of 2005, indicating the extent to which the Irish financial sector was able to draw on international funding – but also the extent to which it would be exposed in the event of a downturn (Honohan 2006). Growth in banking of that speed and on that scale should have rung alarm bells with the Financial Regulator. But Ireland had adopted the British and US model of 'light touch' regulation, and had split the functions of banking oversight away from the Central Bank to a new specialized institution which did little to monitor the banks' own claims that they were adequately capitalized and could ensure that risk was properly assessed. The scale of the institutional and procedural regulatory reforms undertaken after the collapse of the financial system reveals, with hindsight, how poorly managed the system had been (Central Bank and Financial Services Authority of Ireland 2010; Honohan 2010). The extent of the collapse of the Irish financial system has been revealed in stages, as estimates of the full scale of taxpayer liability crept upwards, and the cost of indirect recapitalization through government intervention in bad property loans was subject to regular upward revision.

Figure 3 below shows that Irish taxpayer liabilities for the distressed financial sector outstripped those of other countries by a significant margin.

Figure 3 here

Thirdly, the imbalances in economic activity were further intensified by government support for tax breaks to support construction activity (TASC 2010). The tax incentives that encouraged investment in property were warmly welcomed by property developers and builders. A further benefit accrued to many high-earners who were able to shield income from tax liability through tax-incentivized property investments. A strong value commitment to low personal income tax rates had taken hold within the Fianna Fáil-Progressive Democrat coalition that held power between 1997 and 2007. Buoyant revenue yields from property transactions made it possible to continue to fund tax cuts. But the increasing reliance on bubble revenues exposed the tax base to risk in the event of a downturn, even before the scale of recessionary collapse depressed other revenue sources such as income and expenditure taxes (Regling and Watson 2010, p.27).

What these developments reveal is a growing imbalance at the heart of the Irish growth model itself. On the one hand, thinking about future economic development possibilities was developing along lines of ‘the smart economy’ and ‘the knowledge-intensive economy’, and new bodies charged with supporting science and technology innovation were set up (Department of the Taoiseach 2008; Science Foundation Ireland 2009). On the other hand, basic investments in science and maths education at primary and second-level were lacking; venture capital was scarce; infrastructural investments were patchy; and investment in research and development was well below that of the leading smaller European countries, as Figure 4 below shows.

Figure 4 here

Despite the existence of supports for micro-enterprises and a proliferation of active entrepreneurship, the life-cycle of small to medium-sized domestic enterprises was alarmingly short and the capacity of the Irish economy to grow viable and especially export-oriented indigenous firms remained limited (Forfás 2008b; National Competitiveness

Council 2007; O Riain forthcoming). A basic inconsistency had developed in the policy stance toward economic growth. Powerful interests in the less productive sectors enjoyed continued political support. The more difficult and longer-term strategic investments lagged considerably.

The poor policy mix that emerged during the 2000s is often attributed to the electoral incentives to which politicians are subject. There are two respects in which this has been argued to be relevant. Firstly, the Irish electoral system, PR-STV, encourages voters to evaluate individual politicians as well as party stance (Marsh 2007). An ongoing concern is that the politicians who are most successful at the polls are the ones who devote most time to attending to local service, potentially at the expense of national policy deliberation. A further concern is that the requirement of intensive constituency service is a strong disincentive to political involvement for people who may have a strong policy motivation but who are less willing to engage with detailed local service demands.

The second consideration often held to be responsible for a poor policy mix concerns the nature of party funding. Parties benefit to varying degrees from corporate donations, but the largest party, Fianna Fáil, which has dominated electoral politics since the foundation of the state, tends to be the greatest beneficiary. Despite some reforms in scrutiny and oversight, the accountability of parties for electoral funding remains limited, leaving open the suspicion, at the least, that powerful interests play a disproportionate role in shaping the agenda of government (Byrne 2010; MacCarthaigh 2005).

The first of these explanations is problematic. The electoral system may amplify a localism that is grounded in weak local government and a strong expectation of personal involvement with elected politicians, but reforming the electoral system would not necessarily change these features of Irish political life (Bowler, Farrell and Pettitt 2005; Sinnott 2010). The quality of candidates drawn to involvement in Irish public life may have less to do with the electoral system than with the working conditions of the Oireachtas itself, and especially the Dáil, with long and late sitting hours and other family-unfriendly practices. But what may be more at issue is the poor functioning of the legislature itself, and the very weak powers it has in policy deliberation, amendment of statutes, and intensive policy scrutiny in committees. Ireland stands out as an extreme example of parliamentary weakness, compared with the spectrum of European countries (Döring 2001).

The second consideration outlined above – the insider role that powerful interests may exercise – flows directly from this feature of Irish institutional design. Governments are not readily held to account by the legislature. Questionable decision-making is difficult to challenge, and true accountability is hard to enforce. Rules about disclosure of party funding were introduced in the wake of a series of high-profile corruption scandals during the 1990s and 2000s. But the suspicion remains that they are more honoured in the breach than the observance. The Irish party system does not feature conventional political cleavages, and the largest parties have long been characterized as catch-all parties, prone to a degree of populism to build and secure broad-based coalitions of support (Mair and Marsh 2004). The permeability of the party system by powerful interests – especially of the largest party, Fianna Fáil – is not readily addressed either through reform of the electoral system or of the rules governing political donations.

A more effective remedy is likely to be found through structural reform of the functioning of the legislature itself. There is widespread agreement that there are many shortcomings in the Standing Orders, in the powers available to committees, in the capacity of the government to dominate the parliamentary agenda. But to date, there has been little willingness on the part of those who benefit more extensively from this system to undertake the serious and fundamental reform that would be required to change matters.

The full scale of the economic crisis in Ireland began to take shape shortly after a general election that re-elected Fianna Fáil to government in 2007, this time with the Greens as a minority coalition partner. Unlike other countries that had experienced major crisis, no change of government had happened that would replace those held to have been responsible for the onset of crisis with an alternative charged with cleaning up political life. The onus of responsibility is therefore likely to rest with whatever government is formed after the coming election. Whether they have the zeal to engage in real reform, or do as incumbent governments typically do, and enjoy the powers accruing to them as office-holders, remains to be seen.

Public administration and policy expertise

What the preceding overview of a poor policy mix also reveals is an apparent dearth of capacity for coherent and consistent policy-making – that is, a lack of 'joined-up government', gaps in informed technical analysis of policy sectors, and a poor capacity to anticipate adverse performance outcomes and to take precautionary action to avert or manage these.

We might distinguish two respects in which Irish policy processes have been revealed as deficient. The first is a weak capacity for making coherent fiscal policy in the context of membership of the Eurozone; the second is the organizational dispersal of policy expertise.

Fiscal policy practices

A recurring issue in Irish macroeconomic policy is the tendency to run pro-cyclical fiscal policy (Benetrix and Lane 2009; Lane 1998; 2003). During periods of economic growth, governments spend freely; when economic downturn sets it, there is no reserve to soften the impact. This leads governments to take severe measures to prevent the progressive escalation of borrowing requirements, but the spending cutbacks and increased taxation further exacerbate the impact of recession and make recovery even more difficult.

Until the 1970s, Irish fiscal policy was quite orthodox and conservative. During the 1970s, governments began to experiment with pump-priming spending measures, even prior to the 'give-away' election of 1977, and failure to reverse these trends during an international economic upturn left Ireland even more exposed than it needed to be during the downturn of the 1980s. The runaway public sector borrowing requirement then had to be corrected under conditions of recession and high and sustained unemployment. The Celtic Tiger period saw a return to the old practices of additional fiscal stimulus which amplified the effects of already super-normal growth.

The explanation for consistently pro-cyclical fiscal policy in Ireland is generally sought in the area of party politics. Short-term electoral cycles, it is held, prevail over other considerations, during the good times (Honohan 1999). Yet Irish governments have been more effective at correcting fiscal over-runs than, for example, Greek governments have been, so when it is perceived as necessary, they will incur electoral dissatisfaction to undertake unpalatable stabilizing measures.

The time-inconsistent policy preferences of Irish governments have their origins in low levels of technical analysis of the economic situation. Fianna Fáil Finance Minister Charlie McCreevy (1997-2004), famously commented on his expansionary budget measures in the run-up to the 2001 budget, that 'when I have it, I spend it'. Although he introduced some inflation-curbing spending cuts in his two subsequent budgets, this remark is revealing. There is nothing here of the prudential macroeconomic management thinking which Irish governments have been repeatedly urged to undertake by academic commentators. Simple short-term accounting practices prevail over longer-term analysis of how best to manage cyclical movements. And while it is true that Ireland ran fiscal surpluses during most years during the 2000s prior to the crisis, this could be described as accidental rather than intentional. Jim O'Leary, academic economic commentator, has noted that external observers of the Irish economic situation may have flagged some underlying weaknesses in the revenue base, but that no-one shouted any warnings, because of the net positive fiscal performance (O'Leary 2010). And yet the Scandinavian countries, which had suffered severe financial crises during the early 1990s, were committing to strong fiscal surpluses during the 2000s, as Figure 5 below shows. It is now apparent that Ireland, with its extraordinarily high growth performance during the 1990s and 2000s, should also have been taking stronger fiscal precautionary measures to manage the deflationary consequences of the return to 'normal' growth, not to mind protecting against the hazard of recession.

Figure 5 here

It would appear that similar weaknesses in technical economic analysis underlie the failure of the Irish government to take effective measures to curb the property bubble. Low interest rates, from which Ireland was benefiting due to its participation in European Monetary Union, were inappropriate to the Irish high-growth context. In the absence of any capacity to manage interest rates, the only effective measures open to government were fiscal (Conefrey and FitzGerald 2010). Yet there seems to have been little sense of how to intervene effectively; and indeed, as we have already noted, policy was enthusiastically rolled out in the reverse direction, providing fiscal incentives that further inflated the bubble.

The explanation for poor-quality fiscal management must therefore extend beyond party politics to consider the staffing and organization of the public service itself and the quality of the advice available to governments, and to the high levels of operational discretion available to Ministers that is institutionalized within the Irish parliamentary system.

Reflection on the role of the Department of Finance and the quality of its economic analysis, though not new, has gained new life in Ireland (Molloy 2010; Tutty 1994). But more broadly than this, the culture of generalism within the Irish civil service has come into some question. Like the British system, the Irish civil service has relied on competitive intake and internal on-the-job learning. But unlike the British, the Irish system has not introduced new streams of acquiring specialist expertise to remedy the skills deficiencies that a generalist system entails in a world in which increased specialization and technical competence are at a premium. There is virtually no experience of external appointment to senior positions and no fast-stream recruitment and promotion of qualified graduates. There is no specialist cadre of professional expertise available to all Departments analogous to Britain's Government Economic Service. And while the Department of Finance may recruit economics graduates, there is little or no routine professional contact between these and the economic profession in the universities and in the private sector. These deficiencies in technical expertise contribute to the very large sums the Irish government increasingly pays to private sector consultancies for policy advice. And still the Comptroller and Auditor General is able to comment, in his 2009 report, on 'the need to improve the capacity of departments to evaluate costs and benefits of proposed programmes so that evidence-based information and analysis is available to underpin decision making' (Office of the Comptroller and Auditor General 2010).

But even with a full panoply of expert advice available, the extent of the discretion available to the Minister for Finance in Ireland is considerable. This office-holder is relatively unconstrained by serious parliamentary scrutiny of budget proposals, as noted earlier, despite the publication of estimates in advance of the formal budget. Nor is the Minister seriously responsible even to the government as a whole, and even the prime minister or Taoiseach is said typically to know relatively little of the detail of what the Budget contains until it is revealed in public. The Finance Act can provide some scope for incorporating changes deemed necessary. But the consultation and consensus-seeking then operate post-hoc and selectively. The weaknesses of the institutionalized checks and balances in Irish fiscal policy have attracted adverse attention, including from senior economists in the IMF. Among the reforms proposed is the establishment of an advisory fiscal council. It may be though that EU rules to establish stronger fiscal oversight will enforce procedural changes where Irish politicians have been reluctant to act (Lane 2009; 2010; Mody 2010; Van Rompuy 2010).

Organizational fragmentation and policy coordination

Time-inconsistent policy preferences on the part of Irish governments is further exacerbated by the organizational fragmentation of the Irish public service itself, which has militated against opportunities for policy coordination. The routines surrounding cross-departmental consultation about legislative proposals and submission of plans to cabinet have changed very little over time. The traditional complaints about the civil service, that the ‘stovepipes’ of government Departments operate in relative isolation from one another, have been addressed to some degree by increased interactions between senior civil servants, and the creation of interdepartmental working groups and task forces coordinated by the Department of the Taoiseach for particular purposes. But these tend to be ad hob measures, partial remedies for structural features that are not significantly altered once the temporary coordinating apparatus lapses.

The Irish public service has not escaped the influence of New Public Management thinking, which resulted in wholesale reorganization of policy planning and service delivery in many areas of the British public service. But in the absence of a strong political driver, many of the changes had a limited range, and even measures addressing performance monitoring and service delivery were much more superficial than in other Westminster-type systems (Hardiman and MacCarthaigh 2011 forthcoming).

One of the striking features of Irish public administration has been the rapid growth in the number of state agencies, particularly in the period since 1990, as Figure 6 shows.

Figure 6 here

The rate of agency creation outstripped the rate of agency termination or merger by a considerable margin. The functional activity that showed the most marked increase was that of service delivery, as Figure 7 shows. As regulatory activities expanded, so also did the number of agencies carrying out regulatory functions. And there was also a sharp rise in the number of bodies with either statutory or non-statutory public functions devoted to advising government, being available in a consultative capacity, or representing various civil society interests to government.

Figure 7 here

But these trends should not be taken as evidence of any hiving off of core state activities into independent agencies, as New Public Management would advocate, since core civil service staffing was not reduced, nor were budgets or central decision-making delegated. Some agency creation clearly stemmed from the need to increase policy capacity in specific areas and to expand the range of specialist expertise working in a dedicated way – agencies devoted to industrial policy, for example, show this kind of pattern (Hardiman and MacCarthaigh 2010; Ó Riain 2004).

But this is far from the only reason why new agencies are established. The OECD review of the Irish public service, published in 2008, commented that among the most common reasons for setting up new agencies were the perceived value of signalling and embodying new policy priorities; involving stakeholders; providing executive bodies with managerial flexibility; bringing in specialised skills; allowing more performance focus; and responding to European Union requirements related to the independence of regulators (OECD 2008, pp.297-8). It concluded that the principal reason why government ministers created such a large number of new agencies in Ireland was to make it possible to employ more staff, often more specialized staff, without appearing to breach limits on core departmental civil service numbers (OECD 2008: 295-8). This would appear to signal a perceived dearth of appropriate skills available within the core civil service itself. Indeed, the scale of expenditure on private consultancy fees has occasioned comment on more than one occasion by the Comptroller and Auditor General, most recently in connection with expenses arising from managing the banking crisis (Office of the Comptroller and Auditor General 2009, pp. 69-71). Yet the problems of appropriate skill recruitment and deployment have never seriously been tackled.

The problems for policy coordination between Departments and agencies that are generated by organizational fragmentation are considerable. The OECD report commented critically on the absence of guiding criteria governing organizational reform in Ireland. And although Ireland had experienced several waves of political interest in public sector reform, by 2010 it was only beginning to start on the process of organizational review, prompted as much by considerations of financial stringency as by the 'public sector transformation agenda' (Report of the Special Group on Public Service Numbers and Expenditure Programmes 2009).

Managing the cost base

The capacity of the Irish economy to grow its way out of recession and to begin to create employment opportunities again is said to be impaired not only by the scale of the fiscal crisis and the related liabilities on the public purse incurred by the need to rescue the financial system, but also by the decline in competitiveness that took place since about the year 2000. A standard way of measuring competitiveness is to compare unit labour costs, and Figure 8 suggests that Ireland lost competitiveness more rapidly than the Mediterranean EU cohesion states.

Figure 8

The rate of increase of employee pay therefore tends to be the primary focus in considering the underpinnings of competitiveness (European Commission 2010, p.32). Regling and Watson noted that:

> Compensation per employee, which had grown more or less in line with the euro area average until 1996, increased at two to three times the euro area average from

> 1997 to 2008. In nominal terms, annual gross wages in Ireland in 2007 were the highest in the euro area except Luxembourg (Regling and Watson 2010, pp. 21-2).

The most common inference to be drawn from these trends is that employee wages had gone on a runaway upward trend. In a situation of both fiscal crisis and recessionary conditions, the focus therefore tends to be on wage growth as both the source of the problem and the heart of the solution. There are three reasons why reducing nominal wages may be held to be necessary in these conditions. Firstly, when applied to the public sector, it offers a relatively simple way of relieving pressure on the public sector pay roll. Secondly, it seems to represent a logical approach to regaining competitiveness in export markets, because in a monetary union where it is not possible to devalue the currency, 'internal devaluation' is the only relative cost adjustment mechanism. And thirdly, the contention is sometimes put forward that at a time of consumer price deflation, wages should not be downwardly sticky but should follow price trends and yet would still maintain real living standards.

Each of these analyses is problematic, and conflict over how they were to be understood and acted upon proved the breaking point for the institutions of social partnership in 2009, after over twenty years of institutionalized wage bargaining. It might even be said that the tensions that resulted in the end of centralized wage setting owed their origins to the early 2000s. For what is at issue is not a simple clash over the rate at which employee pay is set, but a broader set of interactions between pay, productivity, inflation, and credit, all of which shape the cost base of the economy. The origins of Ireland's loss of competitiveness cannot be understood without considering all these contributory factors, and any revival of consultative processes will be unable simply to revive the old model and will be obliged to invent new processes that take account of all these factors.

An exclusive focus on employee pay compensation is problematic for a number of reasons, quite apart from the concerns about removing purchasing power and therefore demand from the economy, and shrinking the revenue base from which corrections to the public finances must also come. Firstly, the other domestic drivers of employee pay rates need to be taken into account. We would expect that pay rates would be pushed upward under conditions of near-full employment and in sectors where skills were at a premium; this was indeed apparent in sectors such as construction and ICT. This would normally be expected to act as a brake on the expansion of these sectors. But in the context of the cheaply available credit that flooded the economy, the inflow to funds to new projects was not curbed in the ordinary way. Furthermore, the fiscal incentives behind the property boom actually intensified its effects instead of curbing it. Among the consequences of this was that the trend in unit labour costs lagged the trend in house prices. A growing portion of the Consumer Price Index was accounted for by the cost of housing itself. The upward surge in the cost of land and of property contributed significantly to inflation and therefore to the upward pressures on employee wages (ICTU 2010). Meanwhile, domestic inflation rates were further intensified by pro-cyclical government spending and a heavy reliance on indirect taxation (Hardiman 2004).

Secondly, in the exporting sector of the Irish economy, neither unit labour costs nor overall cost competitiveness of goods and services was significantly impaired in export markets during the 2000s (Breathnach 2010). This is largely explained by the capital intensity and buoyant profitability of the manufacturing export sector, where pay increases were more than matched by productivity increases. But it raises a question over the rationale for wage-cutting in these sectors.

Thirdly, discerning the relative cost components in the domestic sector is more complex. Productivity in the domestic manufacturing sector was lower than in the exporting sector, and the capital intensity is lower too. But the pressure to raise prices in the context of a buoyant market is not solely attributable to wage cost pressures.

In the private sector services sector, it is more difficult to assess the relationship between costs and productivity. But here also, the argument has been made that wage inflation was far from being the sole determinant of changes in unit labour costs. Prices for consumer goods, or intermediate inputs to businesses such as rents and energy costs, were also significant contributors to input costs to the domestic business sector. A survey of retailers did indeed find that a key driver or rising costs was the increasing cost of labour, which respondents attributed to a variety of factors including high labour market demand, the relatively high minimum wage, and the need for security personnel in Dublin outlets. But they also replied that there were other factors that were also very important to them, including high operating costs especially concerning property and utilities (energy, waste, etc.). They commented that local services, including professional fees, were particularly costly. Indeed, legal fees were identified as being almost double those in Belfast and about 50% more expensive than in London (Forfás 2008a, pp. 9, 16, 25).

The relationship between cost inputs and productivity are especially difficult to estimate in the public sector. Comparisons of the relative earnings of private and public service employees are bedevilled by considerations of the age and skills profile of each. But the principal changes to the terms and conditions of employment in the public sector were political decisions, in the form of Review Body reports on higher civil servants, and the 'benchmarking' of other public sector pay rates. Neither of these processes was tied to formal productivity measurements. The true scale of relativities between public and private sector remuneration remain contested (E Kelly, McGuinness and O'Connell 2009; O'Leary 2002).

In summary, nominal unit labour cost compresses a variety of contributions to competitiveness into a single measure. The capital intensity of production, and the extent of self-employment and especially professional self-employment, affect measures of productivity. The volume of credit available in the economy and the way fiscal policy is used either as a countervailing or augmenting influence may have a significant effect on the changing relative costs of factor inputs. In a comparative analysis of the EU member states that had suffered the greatest competitiveness losses, a European Trade Union Institute economist concluded that changes in competitiveness were dominated by the product market, not the labour market, as illustrated in Figure 9.

Figure 9 here

The implication is that in the business sector, attempts to improve international competitiveness should focus on non-wage costs to firms as the primary target of policy intervention (O'Farrell 2010, p.21).

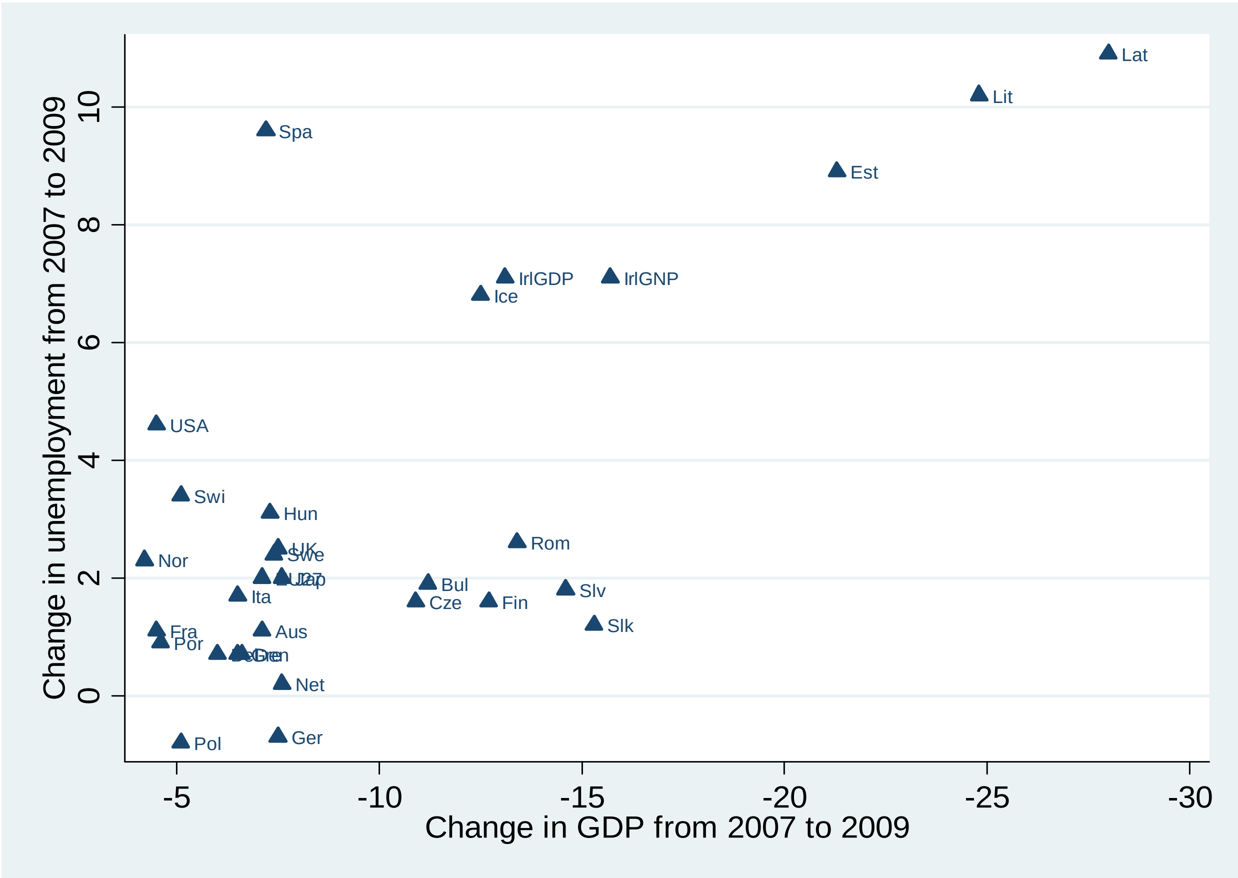
Insofar as Ireland is also identified as having a problem with labour costs, it is of course impossible to soften the adjustment costs through a competitive devaluation; the dominant solution advocated across the Eurozone is to implement a form of 'internal devaluation'. Unlike currency devaluations, which impose relative losses of purchasing power on everyone, the impact of relative labour cost adjustment falls mainly on employees. And because the government does not have much purchase on private sector wage-setting, a disproportionate adjustment is forced upon those who are in public sector employment, and those in receipt of state transfers among whom are counted many of the most vulnerable. Direct budget-based spending cuts of this sort are a relatively crude instrument whose consequences can be difficult to legitimate with reference to conceptions of equity or distributive justice. In the absence of sustained and visible measures to spread the costs of adjustment in other ways, such as addressing the various other contributors to competitiveness, and reforming the incidence of taxation to ensure appropriate compliance from all revenue sources, broader concerns may well arise about the political sustainability of a prolonged strategy of fiscal austerity.

Conclusion

This paper has argued that the Irish experience of financial crisis has quite straightforward origins: it was a conventional, 'plain vanilla' kind of banking over-reach, when an unrestrained asset price bubble was unexpectedly burst by factors beyond domestic political control. But several other contributory factors must be taken into account to understand why it is that Ireland experienced the crisis in such a severe form, with such a dramatic loss of growth capacity and such a sudden surge in unemployment. Three factors have been identified. The first concerns the distortions that had accumulated in the Irish growth model itself, with an over-reliance on construction and an incapacity to manage the flow of cheap credit that followed from Eurozone membership. The second concerns the laxity of fiscal policy, grounded in weak political oversight of policy-making priorities and a dispersed and poorly coordinated public administration system. The result is a large measure of institutionalized autonomy for the Minister for Finance with few restraints on pursuit of pro-cyclical measures. The third factor was the loss of control of the domestic cost base. Employee wages form part of this, but are not necessarily the driving factor nor even perhaps the most important element.

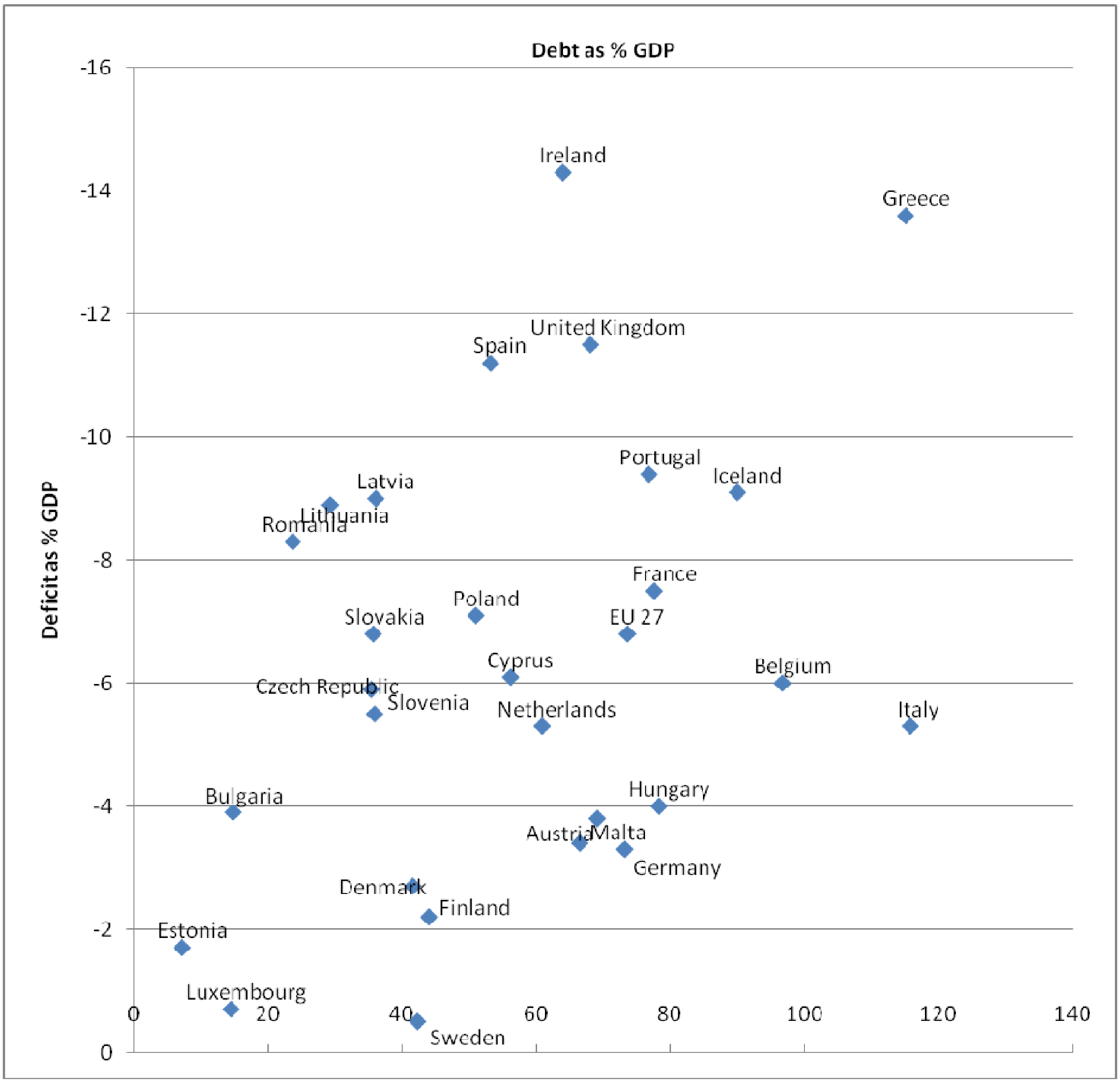
Ireland’s membership of the Eurozone resulted in lower interest rates than were appropriate for an economy still on the upward curve of ‘catch-up’ economic growth. Along with the problems of managing a boom, Ireland was obliged to learn how to run macroeconomic policy within a single currency zone, where a premium is attached to domestic relative cost adjustments and in which considerably more activist fiscal policy is therefore required. The challenges proved overwhelming, and not only to Ireland. And yet in the absence of the protective cover of Eurozone membership, the consequences of the crisis would clearly have been yet more damaging, as the collapse of the Icelandic economy suggests. Domestic economic crises across Europe have refocused attention on the EU capacity to provide a coherent coordinating framework. But only domestic political actors can undertake the systematic reform of the domestic institutional weaknesses revealed by the crisis.

Figure 1. Change in GDP and change in unemployment, 2007-2009



Source: EU AMECO, unemployment and GDP data, May 2010

Figure 2. Debt and Deficit as % GDP, 2009



Source: Eurostat

Figure 3. Euro-area public interventions in the banking sector, % GDP

	Approved	Effective
Austria	32.8	8.7
Belgium	92	26.7
Finland	27.7	0
France	18.1	5.6
Germany	24.4	9.1
Greece	11.4	4.6
Ireland*	231.8	229.4
Italy	1.3	0
Netherlands	52	25.4
Portugal	12.5	3.3
Slovenia	32.8	0.4
Spain	12.1	5
Euro Area	25.4	11.5
EU27	31.2	12.6

* Mostly guarantees on bank liabilities

Approved: Amounts approved in state aid decisions by the Commission under State aid rules. Effective: Amounts from schemes effectively implemented, for example capital effectively injected in banks or State guarantees effectively granted to banks on their issuance of liabilities.
Data covers approved measures from June 2008 to 17 July 2009 and effective measures from June 2008 to mid-May 2009.

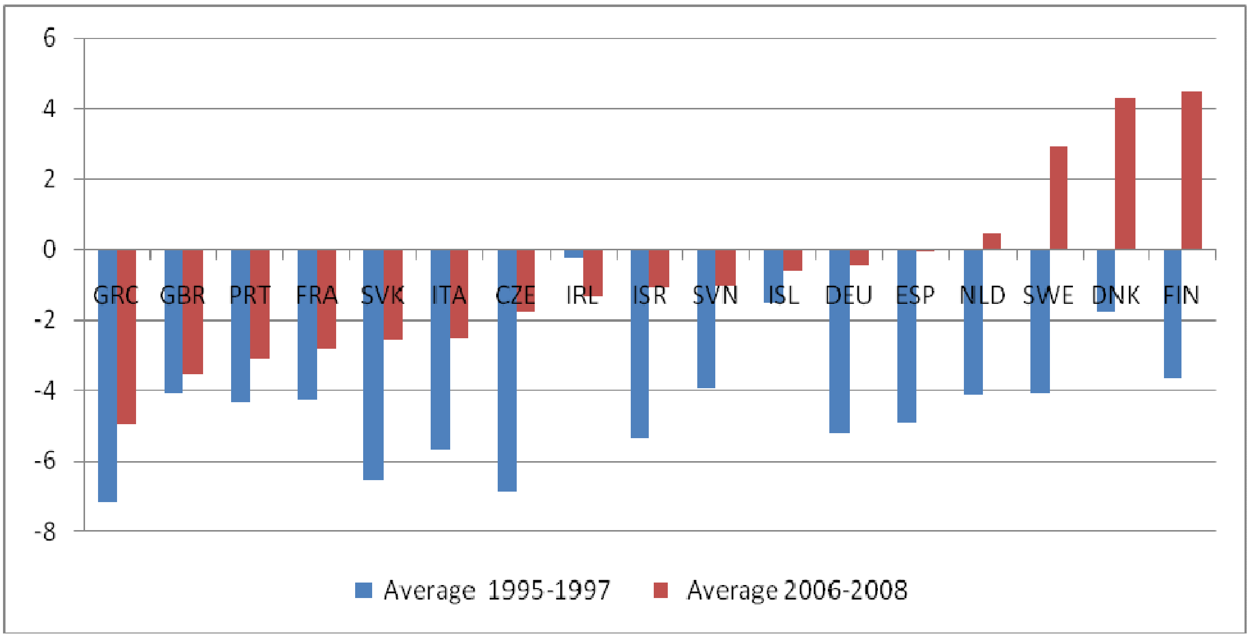
Source: European Commission. 2010. *Annual Report on the Euro Area 2009: European Economy 6,* Table 2.1, p.46

Figure 4 Gross domestic expenditure on research and development, % GDP

Source: OECD Factbook 2010, OECD.Stat Extracts, http://stats.oecd.org/Index.aspx

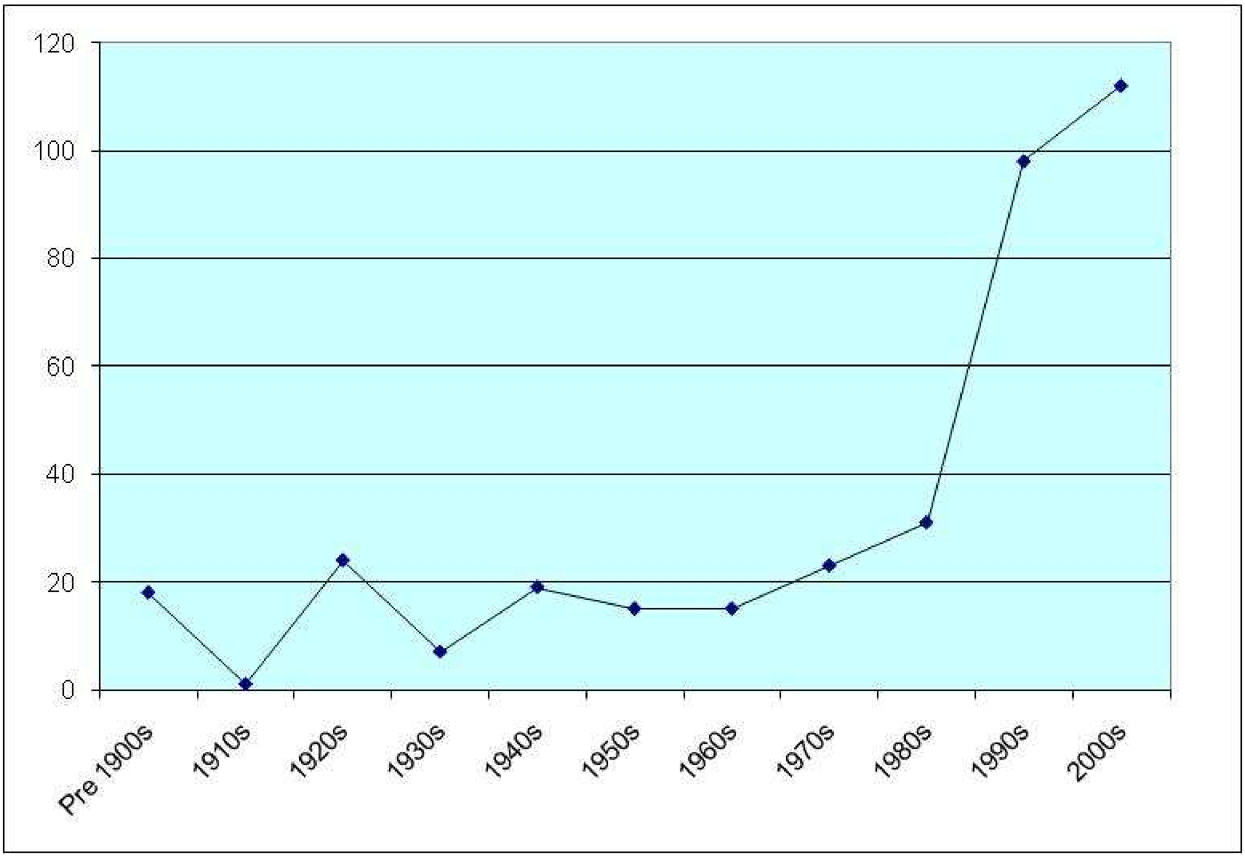
Accessed September 2010

Figure 5. General government net borrowing/net lending



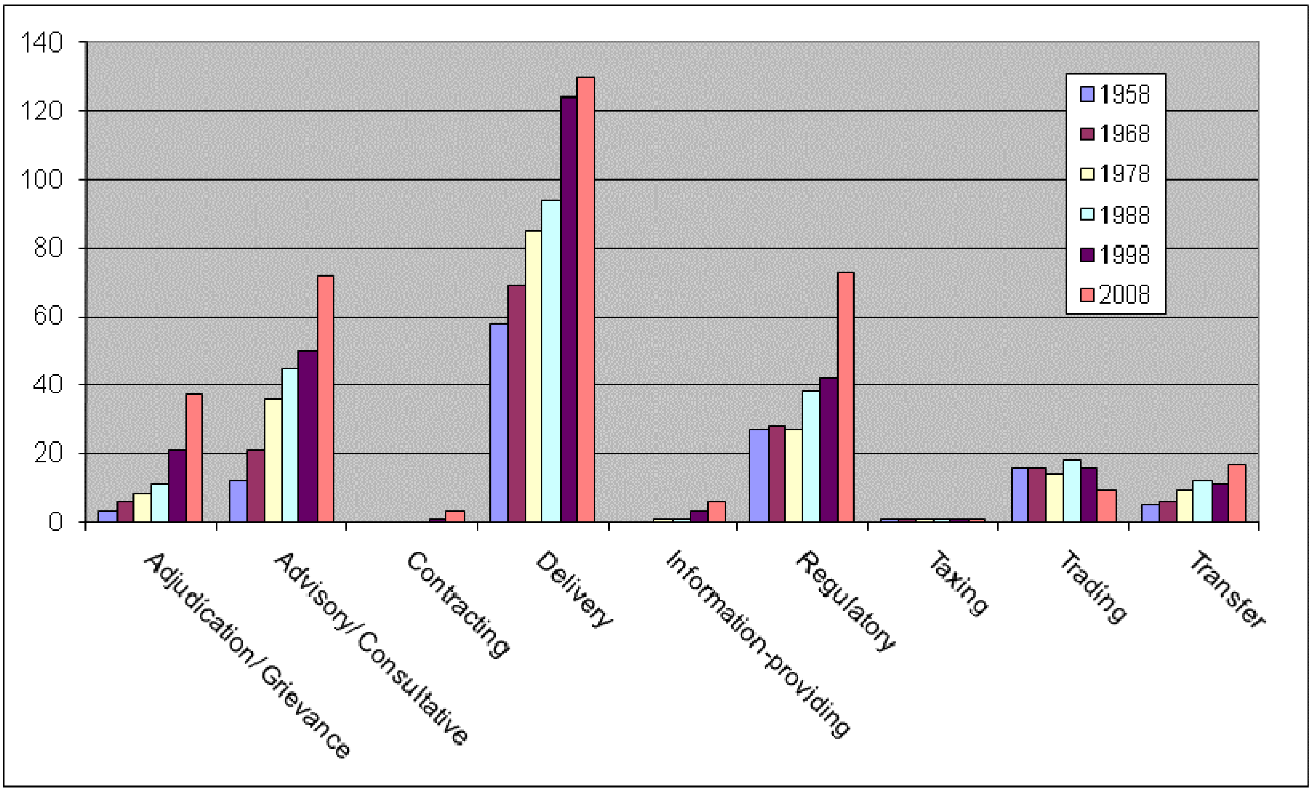
Source: OECD Factbook 2010, OECD.Stat Extracts, http://stats.oecd.org/Index.aspx Accessed September 2010

Figure 6. New state agencies by decade



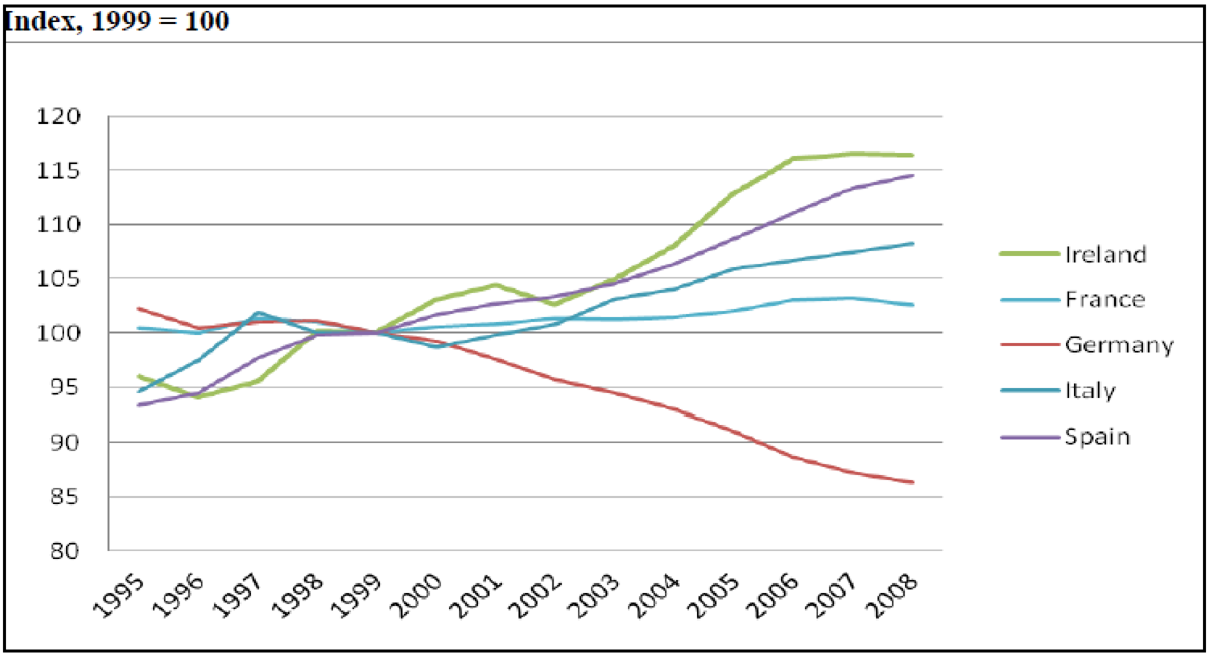
Source: Mapping the Irish State database, http://geary.ucd.ie/mapping (Hardiman, MacCarthaigh and Scott 2010)

Figure 7. Number of state agencies by function, 1958-2008



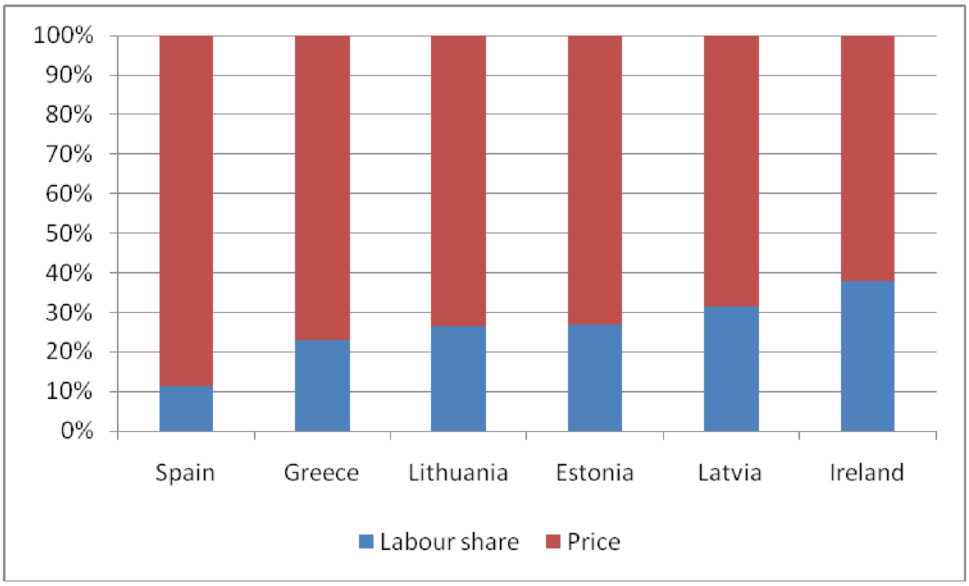
Source: Mapping the Irish State database, http://geary.ucd.ie/mapping (Hardiman et al. 2010)

Figure 8. Relative unit labour costs compared to the Euro area



Source: (Regling and Watson 2010, p.22)

Figure 8. Components of loss of competitiveness



Source: (O'Farrell 2010, p.20)

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