ISSN 2443-8030 (online)

Fiscal Consolidation in Ireland: Recent Successes and Remaining Challenges

Martin Larch, Janis Malzubris and Stefano Santacroce

ECONOMIC BRIEF 011 | MAY 2016

EUROPEAN ECONOMY

Economic and Financial Affairs

European Economy Economic Briefs are written by the staff of the European Commission's Directorate-General for Economic and Financial Affairs to inform discussion on economic policy and to stimulate debate.

The views expressed in this document are solely those of the author(s) and do not necessarily represent the official views of the European Commission.

Authorised for publication by Servaas Deroose, Deputy Director-General for Economic and Financial Affairs.

LEGAL NOTICE

Neither the European Commission nor any person acting on its behalf may be held responsible for the use which may be made of the information contained in this publication, or for any errors which, despite careful preparation and checking, may appear.

This paper exists in English only and can be downloaded from http://ec.europa.eu/economy_finance/publications/.

Europe Direct is a service to help you find answers to your questions about the European Union.

Freephone number (*)**:**

00 800 6 7 8 9 10 11

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

More information on the European Union is available on http://europa.eu.

Luxembourg: Publications Office of the European Union, 2016

KC-BE-16-011-EN-N (online)
ISBN 978-92-79-54475-0 (online)
doi:10.2765/923353 (online)

KC-BE-16-011-EN-C (print)
ISBN 978-92-79-54474-3 (print)
doi:10.2765/6901 (print)

© European Union, 2016
Reproduction is authorised provided the source is acknowledged.

European Commission

Directorate-General for Economic and Financial Affairs

Fiscal Consolidation in Ireland: Recent Successes and Remaining Challenges

By M. Larch, J. Malzubris, S. Santacroce

Summary

Ireland very successfully shouldered an impressive amount of fiscal consolidation under its 2011-2013 EU-IMF financial assistance programme. After peaking at around 12% of GDP in 2009 (excluding deficit-increasing financial sector measures), the general government deficit is expected to have fallen below 2% of GDP in 2015. As a result, Ireland is now rightly considered to be a good example of how a well-designed adjustment programme can work when it is coupled with strong domestic ownership.

This economic brief zooms in on Ireland's budgetary adjustment and compares it with developments in the euro area as a whole. Our analysis also looks at expenditure by government function, a dimension that is often overlooked but which is crucial to understanding fiscal policy making. We conclude that in designing its future fiscal strategy Ireland faces important challenges, the origins of which precede the crisis. Government expenditure as a percentage of GDP rose rapidly in the early 2000s from a relatively low level, as successive Irish governments used soaring revenues from the country's over-heated real estate sector to increase expenditure on social protection.

With the bursting of the real estate bubble in 2008, Ireland launched a largely expenditure-based consolidation strategy that focused mainly on cutting the public sector wage bill and investment expenditure. While representing the largest expenditure item, social protection contributed less to the overall consolidation effort. This was a deliberate political choice and in line with the EU-IMF financial assistance programme. The Irish authorities agreed with international lenders to achieve sustainable public finances in a way that was socially fair and protected the most vulnerable. This strategy paid off. Protecting the welfare system helped to safeguard social cohesion during the sharp economic adjustment and thereby contributed to the strong sense of programme ownership.

Today, government spending as a percentage of GDP in Ireland is still below the euro area average, while the share of social protection in total primary expenditure is close to the average. Thus, other expenditure items, especially government investment expenditure, are still very much compressed. Ireland now faces a number of important fiscal policy issues and trade-offs, such as how to meet growing public infrastructure needs and how to deal with the growing budgetary pressures associated with an ageing society. Will it find new stable forms of revenue, or adjust the composition of expenditure? These challenges, which recently surfaced in the context of the country's National Economic Dialogue, a new domestic policy forum, are likely to receive increasing attention in the coming years.

Acknowledgements: We are grateful to the useful comments by Nicolas Carnot, Zoltan Gyenes, Mary McCarthy, Norbert Wunner and data analysis from Tomasz Zdrodowski.

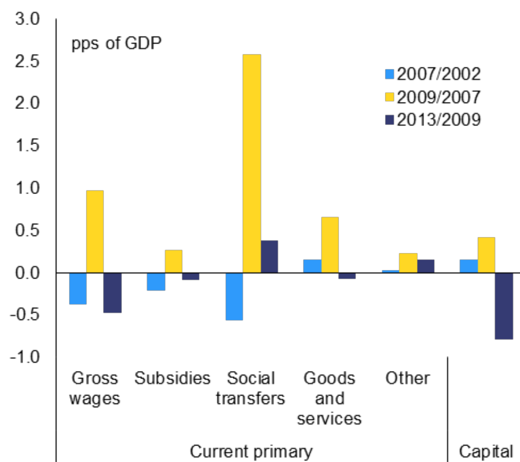
Contact: Martin Larch, European Commission, Directorate General for Economic and Financial Affairs, martin.larch@ec.europa.eu.

Expenditure dynamics in the euro area

Diversity in the run-up to the crisis

In 2002-2007, the five years preceding the global financial and economic crisis, government primary expenditure in the euro area (EA) declined by one percentage point of GDP (to 41.3% in 2007), mostly owing to a reduction of social protection spending (Graphs 1 and 2).

Graph 1: EA – change in expenditure by economic category



Source: Eurostat, economic classification

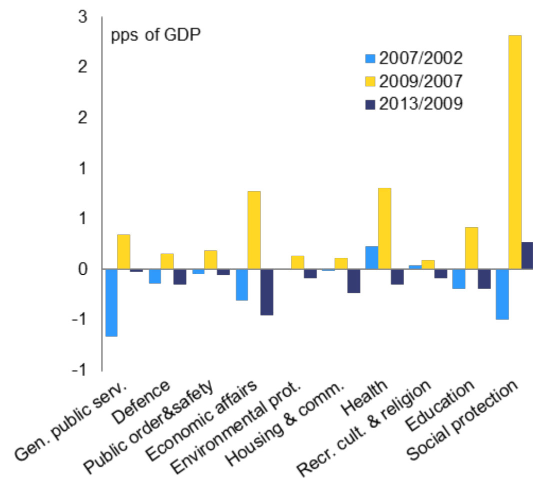
The moderate decline in the average size of government in the EA masked important cross-country differences. In some Member States, especially those experiencing credit-induced domestic demand bubbles, expenditure grew faster than nominal GDP on the back of buoyant government revenue inflows that, to an important extent, turned out to be of a temporary nature. For instance, in 2002-2007, expenditure levels increased by around 20% annually in the Baltic countries and by some 10% annually in Ireland and Spain. In the case of Ireland, revenue windfalls were largely used to finance higher expenditure on social protection.

The financial and economic crisis

The post-2007 economic and financial crisis exposed public finance problems in many EA countries. While high fiscal deficits were already an issue in some countries before the crisis, most EA economies experienced a sharp deterioration of their public finances. Revenues dropped sharply with the level of economic activity while governments 'leaned against the wind' especially with social protection expenditure (Graph 2).[1]

In 2007-2009, the primary expenditure-to-GDP ratio in the EA increased by more than 5 pps., almost half of which was due to declining nominal GDP. The rest resulted from increasing levels of social protection expenditure, followed by health and economic affairs.[2]

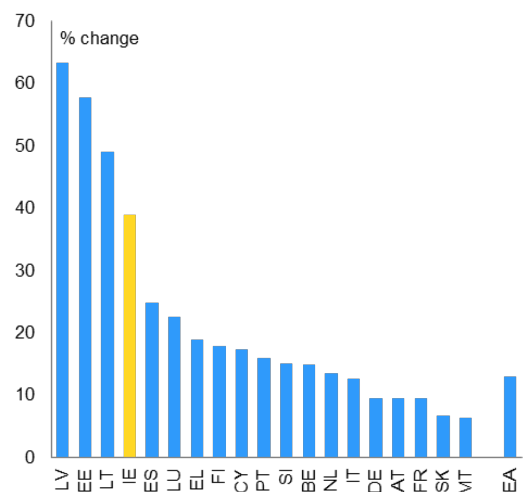
Graph 2: EA – change in expenditure by function



Source: Eurostat, COFOG classification

In Ireland, the increase in social expenditure (in percent of GDP) recorded in the wake of the crisis stands out, not least because nominal GDP dropped by 14% in 2007-2009 (Graph 3).

Graph 3: Growth on social protection expenditure minus nominal GDP growth (2009-2007)

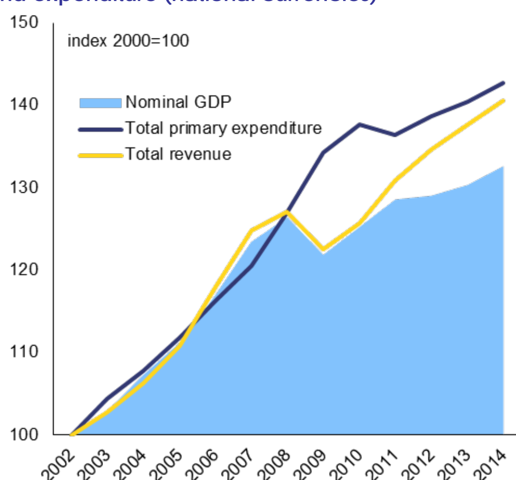


Source: European Commission

Fiscal consolidation

In most EA countries, fiscal deficits had peaked in 2009 before consolidation policies started to produce their effect on GDP ratios (Graph 4). During the fiscal adjustment phase in 2009-2014, government primary expenditure continued to rise in absolute terms, especially social transfers, although, thanks to consolidation measures, significantly less than GDP.

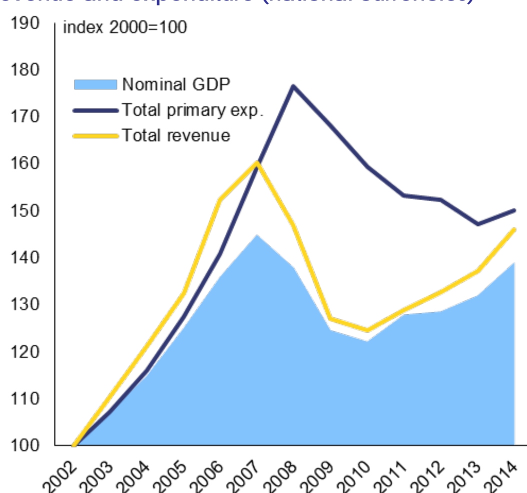
Graph 4: EA – Nominal GDP and government revenue and expenditure (national currencies)



Source: European Commission

While there is no unambiguous benchmark for assessing the precise size of fiscal consolidation, whether it is a no-policy change scenario or simply observed changes of expenditure and revenue aggregates relative to GDP, Graph 4 and 5 suggest that expenditure restraint and cutbacks played a notable role, especially in Ireland.[3]

Graph 5: Ireland - Nominal GDP and government revenue and expenditure (national currencies)



Source: European Commission

Based on past experience, the focus on expenditure is broadly what 'the doctor prescribes'. There is evidence to corroborate the view that consolidation will be more successful in terms of both bringing the fiscal house in order and supporting economic growth in the medium term if a government's financing gap is closed by compressing expenditure rather than increasing revenues (see for instance European Commission, 2007, 2015; IMF, 2010; Larch and Turrini, 2011; OECD, 2012).

This does not mean that revenues should not contribute to fiscal adjustment at all or, if they contribute, this would adversely affect the likelihood of success. Country-specific elements play a role, including in particular whether the tax burden is already high or not or whether there are rooms to further broadening the tax base.

The Irish experience: the specifics of a remarkable success

More social protection in the run-up to the crisis

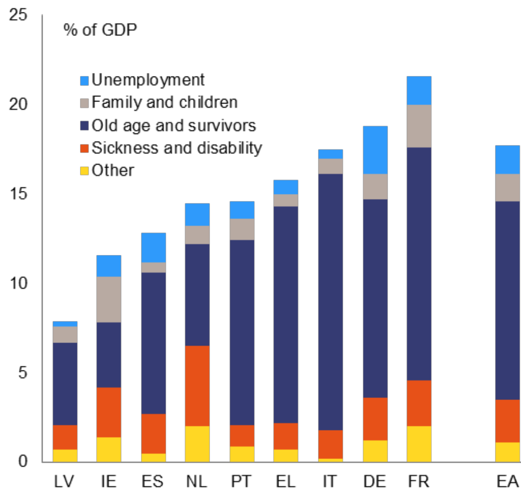
In the years preceding the financial and economic crisis Ireland's expenditure dynamics was similar to that of the EA as a whole, but higher in magnitude and with some important specificity. First and foremost, at 34.1% of GDP in 2002, Ireland's total government primary expenditure was well below the EA average of 42.1% of GDP. The main difference was in social spending, due to large reliance on private pension schemes and a relatively young population as compared to other countries (Graph 6).

However, on the back of strong government revenue inflows from the real estate boom, social protection expenditure and the public wage bill were the main driver behind a 2.9 pps increase in the primary expenditure-to-GDP ratio between 2002 and 2007 (Graphs 8 and 9). In contrast to the EA trend, the Irish government decided to expand its role and size especially in welfare, from a comparatively low level.

The pre-2007 expansion of social expenditure was led by increasing social benefits rates (Graph 7). Using data on beneficiaries from the Annual Statistical Information Reports of the Irish Department of Social Protection[4], benefit rates are estimated to have increased by more than 9% annually between 2002 and 2007 (or some 38% in real terms over the same period). Significant increases of benefits per beneficiary can be found across all main social welfare programmes, in particular on sickness/disability, family/children[5]

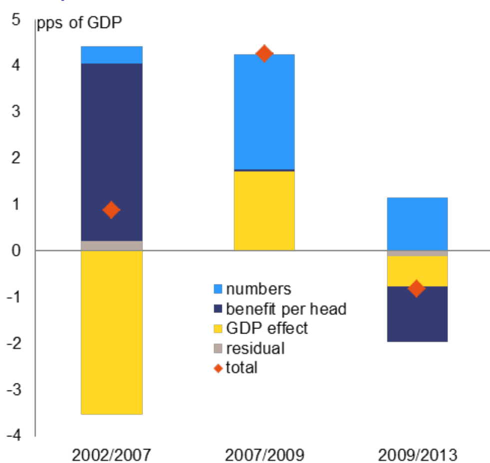
and old age/survivors; in the area of family/children these included Child Benefit and Family Income Supplement payment increases. The number of beneficiaries also increased mainly through old age/survivor pension beneficiaries, disability allowance and illness benefit recipients, which also points to a softening of eligibility criteria.[6]

Graph 6: Selected countries: social protection expenditure in 2007



Source: European Commission

Graph 7: Ireland – contributions to the change in social expenditure

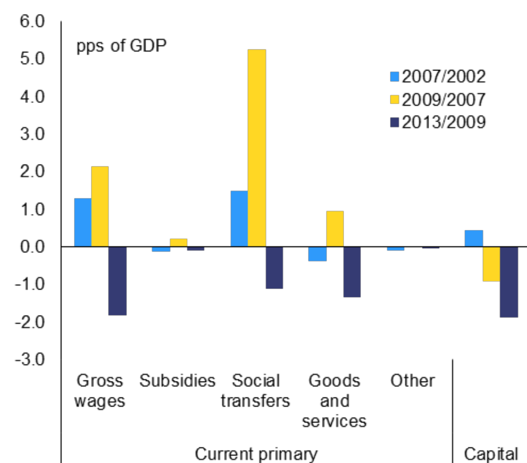


Note: the category "residual" includes changes other than in number of beneficiaries or in benefit rates, such as changes in eligibility or changes in the composition of recipients.
Source: European Commission. Annual Statistical Information Reports 2002-2013 (Department of Social Protection – Ireland).

By using Eurostat data on pension beneficiaries and the number of unemployed, and by approximating recipients of family/children social benefit by the 0-14 age cohort, we can compare Ireland's social expenditure composition and evolution with those experienced by the main EA countries.[7] In terms of function, the significant increase in the family/children payments per capita originated in benefit rates which are high compared to other EA Member States, even when adjusted for price level differences, and including countries with a notoriously generous welfare state.

Unemployment benefits also appear to have been relatively generous compared with the EA average in the run-up to the crisis, but benefit rates remained fairly stable or rather diminished after the real-estate bubble burst.[8] Old age/survivor pensions per head also increased till 2009 but remained below the EA average.

Graph 8: Ireland - change in primary expenditure by economic category

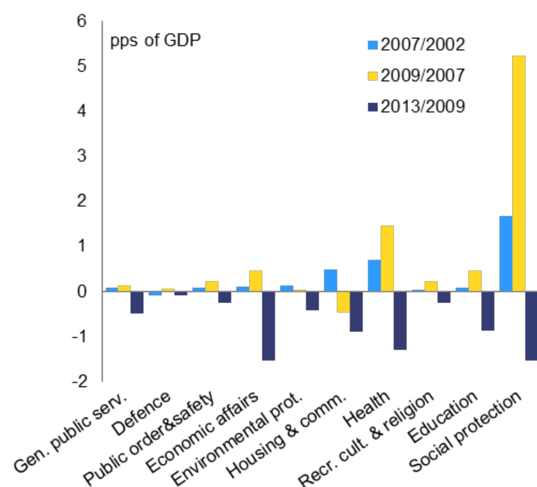


Source: European Commission

Switching to crisis mode

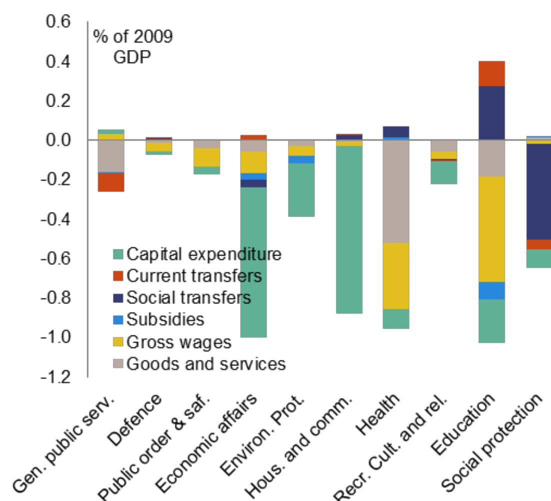
As discretionary expenditure levels serve as automatic stabilisers – they are kept steady while economic output contracts – primary expenditure-to-GDP continued to increase by more than 10 pps in 2007-2009. The lion's share of this increase in the GDP ratio, namely 6.3 pps, was due to the sharp drop in the denominator. Combined with the decline in revenues, this resulted in the general government primary balance moving from a small surplus of 1.3% of GDP in 2007 to an underlying deficit of 11.8% of GDP in 2009.[9]

Graph 9: Ireland – change in primary expenditure by function



Source: European Commission

Graph 10 Ireland – Primary expenditure adjustment in '09-'13



Source: European Commission

The increase in primary expenditure during this period was mostly due to a rise in expenditure on social protection followed by that on health (Graph 9). The increase in these expenditure items resulted from both an increase in personal social benefit rates (in particular in sickness/disability and old age/survivors) and a surge in the number of unemployed (+167%), who were eligible for public social and health services. Cuts (relative to GDP) in expenditures on housing and community services - mostly capital expenditure - were the first response on the expenditure side to the acute fiscal crisis (Graphs 9 and 10).

Protecting the most vulnerable during the crisis

The adjustment of primary expenditure began in 2010 with reductions across virtually all functional categories (Graph 9 and 10). Among these functional categories, the burden continued to fall mainly on capital spending and the public wage bill (Graph 8). The main reductions took place in economic affairs (mainly transport), health, housing and community, and less markedly, social protection (Graph 9). The compression of capital expenditure was much more significant than in the EA. Following a peak of 5.2% of GDP in 2008, public investment fell to a low of 1.8% of GDP in 2013 before recovering marginally (to 2% of GDP) in 2014, but still below the EA average of 2.7% of GDP.

Social protection also contributed to expenditure consolidation, declining from 16.8% of GDP in 2009 to 15.3% in 2013. However, because of the very strong increase in the preceding years the share of social protection expenditure on total primary expenditure continued to increase from around 35.6% in 2009 to around 38.6% in 2013. The reduction in social protection expenditure relative to GDP mainly reflected decreasing family/children and unemployment benefit rates, partly offset by an increase in pension expenditure due to a rising number of pensioners. Old age benefit rates remained largely unchanged as early proposals to reduce them were reversed in the face of vocal protests of vested interests.

The decline in health spending mostly reflected lower purchases of goods and services and lower wages. Yet, the share of financial resources allocated to the Department of Health has grown constantly over the period. The latest revised budget for 2015 allocated more than one fourth of government expenditure to health, while it absorbed around one fifth earlier in 2000. The reduction in education spending is mostly attributable to wage bill cuts and capital expenditure contraction (Graph 10), while the increased benefits for tertiary education – aimed at incentivising further education by the unemployed – partially offset the spending reductions on primary and secondary education.

The choice of keeping the impact of fiscal adjustment on social protection expenditure low was consistent with one of the key government objectives under its 2010 National Recovery Plan, which, later on, became a key reference for the EU-

IMF financial assistance programme, namely to achieve sustainable public finances in a way that is socially fair and protects the most vulnerable.[10]

Table 1 Ireland: fiscal consolidation episodes and income inequality

years	CAPB (overall change)	GINI_post (overall change)	GINI_pre (overall change)
1981-1984	6.92	-1.05	4.34
1986-1989	4.70	-0.18	0.15
2010-2014	10.19	-0.01	0.82

Note: The Cyclical Adjusted Primary Balance (CAPB) excludes one-off expenditure-increasing financial sector measures. GINI_post refers to household disposable (post-tax, post-transfer) income. GINI_pre refers to household market (pre-tax, pre-transfer) income..
Source: European Commission. Data for the GINI-coefficient comes from the Standardized World Income Inequality Database v5.0 (Solt 2014).

The effectiveness of this strategy is evidenced by the fact that the distribution of disposable income did not deteriorate in Ireland during the recent fiscal adjustment (2010-2014) (see Table 1). According to the latest Eurostat income and living condition statistics, monetary poverty and income inequality after taxes and social transfers in Ireland are today below pre-crisis levels and the EA average.

One important consequence of protecting the social welfare was a considerable compression of investment expenditure, a budgetary item that generally supports the growth potential of the economy. As indicated above, government investment expenditure was also compressed in the EU as a whole although by much less.

Conclusions

In the run-up to the Irish economic and financial crisis, the size of the Irish government increased (as measured by the expenditure-to-GDP ratio) from a comparatively low level. Large revenue windfalls from the property bubble were used to finance an expansion of social protection; both eligibility criteria for social benefits were relaxed and benefits per head increased.

Once hit by the crisis, most EA economies, including Ireland, tried to accommodate the economic shock by maintaining existing discretionary expenditure levels and by relying on automatic stabilisers including unemployment benefits. Coupled with a sharp drop in revenues, this led to large government deficits and a sharp increase in government debt.

The correction of fiscal deficits started in earnest in 2010 for most EA countries, including Ireland. While in the EA as a whole the adjustment relied on a rather balanced policy mix, with a slightly larger role for revenue increases, expenditure cuts constituted the bulk of the Irish adjustment strategy.

As the government also aimed at protecting the most vulnerable, the brunt of the expenditure adjustment was borne by capital expenditure and public wages. The contribution from social protection to fiscal adjustment was comparatively mild and benefits per head remain high compared to other EU countries.

The choice of containing the adjustment of social protection expenditure was deliberate and agreed with the international lenders under the EU-IMF financial assistance programme. It was also conducive to maintaining the necessary social cohesion during the adjustment programme.

One crucial question for the Irish government at this stage is how to capitalise on the successful completion of the EU-IMF financial assistance programme in the coming years so as to safeguard strong economic growth going forward. As a percentage of total primary expenditure, social protection is now close to the EU average of around 40%, while the overall size of government as measured by the share of total primary expenditure in GDP is well below the EU average. At the same time, government investment expenditure, again as a share of GDP, is among the lowest in the EU while continuous health spending overruns point to increases in demand.

When designing its future fiscal strategy towards a medium-term budgetary objective that ensures long-term sustainability of public finances, Ireland will increasingly engage in discussions about the composition of government expenditure and the size and role of government. The 2015 National Economic Dialogue provided an interesting foretaste, when stakeholders raised the pertinent question of how to finance the growing need for infrastructure and health expenditure.

References

European Commission (2007), Public finances in EMU - 2007, European Economy N 3/2007.

European Commission (2013), Public finances in EMU - 2013, European Economy 4/2013.

European Commission (2015), Public finances in EMU - 2015, Institutional Paper 14/2015.

European Commission (2015), Tax reforms in EU Member States 2015 – Tax policy challenges for economic growth and fiscal sustainability, Institutional Paper 8/2015.

European Commission (2016), Post-Programme Surveillance Report, Ireland, Autumn 2015. Institutional Paper 17/2016.

IMF (2010), From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies, International Monetary Fund.

In't Veld, J, M. Larch and M. Vandeweyer (2013) Automatic Fiscal Stabilisers: What They Are and What They Do, Open Economies Review, Springer, Vol. 24(1): 147-163.

Philip R. Lane (2000), Disinflation, switching nominal anchors and twin crises; The Irish experience, The Journal of Policy Reform, Vol. 3:4, pp. 301-326.

Larch, M and A. Turrini (2011) Received wisdom and beyond: Lessons from fiscal consolidation in the EU, National Institute Economic Review, Vol. 217: R1-R18

OECD (2012), Fiscal Consolidation: How much, how fast, and by what means?, OECD Economic Policy Papers, N°1.

Solt, Frederick. (2014), The Standardized World Income Inequality Database. Working paper. SWIID Version 5.0, October 2014.

[1] Leaning against the wind' refers to the operation of automatic stabilisers including unemployment benefits and payments related to the increase of poverty during the crisis. However, the most important part of automatic stabilisation results from the inertia of the bulk of discretionary expenditure levels in the immediate wake of an economic slowdown. For a detailed discussion of automatic stabilizers see In't Veld et al. (2013).
[2] For a detailed description of Cofog statistics see:
http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Government_expenditure_by_function_%E2%80%93_COFOG
[3] A detailed account of the expenditure-based nature of fiscal adjustment can be found in European Commission (2013).
[4] https://www.welfare.ie/en/Pages/Annual-SWS-Statistical-Information-Report-2014.aspx
[5] Increases in the maximum duration and maximum payment of Maternity Benefit have resulted in a significant increase in expenditure on the scheme. In March 2006 the maximum duration of Maternity Benefit, Adoptive Benefit and Health and Safety Benefit claims was increased from 18 to 22 weeks, with subsequent extension of Maternity Benefit in March 2007 to 26 weeks.
[6] In 2006 age related pensions were replaced by State Pensions, with significant administrative alterations to several weekly payment types which had up to that point provided for people aged over 65. Recipients of Widow/er's Pension, Deserted Wife's Allowance, Blind Pension, One Parent Family Payment and Prisoner's Wife's Allowance have since 2006 transferred to State Pension (Non-Contributory) upon reaching 66 years of age, resulting in some decreases in recipients and expenditure on such schemes and concomitant increases in recipients and expenditure on State Pension (Non-Contributory). Recipients of Invalidity Pension aged 66 years or over are now automatically transferred to State Pension (Contributory) on reaching that age threshold.
[7] Data on pension beneficiaries (spr_pns_ben) are drawn up according to ESSPROS (European System of integrated Social Protection Statistics). http://ec.europa.eu/eurostat/data/database
[8] In the recent years, Ireland has indeed been active in addressing the issue of low work intensity of household by reducing inactivity traps and adjusting welfare payment.
[9] The underlying deficit excludes one-off expenditure-increasing financial sector measures.
[10] The objective was explicitly mentioned in the official programme documents which reflect the agreement with the lenders. For details see: http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp76_en.pdf

EUROPEAN ECONOMY ECONOMIC BRIEFS

European Economy Economic Briefs can be accessed and downloaded free of charge from the following address:
http://ec.europa.eu/economy_finance/publications/eeeb/index_en.htm

Titles published before July 2015 can be accessed and downloaded free of charge from:

- http://ec.europa.eu/economy_finance/publications/economic_briefs/index_en.htm
  (ECFIN Economic Briefs)
- http://ec.europa.eu/economy_finance/publications/country_focus/index_en.htm
  (ECFIN Country Focus)

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
  via EU Bookshop (http://bookshop.europa.eu);

- more than one copy or posters/maps:
  - from the European Union's representations (http://ec.europa.eu/represent_en.htm);
  - from the delegations in non-EU countries (http://eeas.europa.eu/delegations/index_en.htm);
  - by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (http://bookshop.europa.eu).

KC-BE-16-011-EN-N

ISBN 978-92-79-54475-0