What Explains Ireland's Fragile Recovery from the Crisis? The Politics of Comparative Institutional Advantage

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Introduction

The conventional wisdom among policymakers in Europe is that Ireland is recovering from the eurozone crisis because it successfully implemented the EMU adjustment program (or the Memorandum of Understanding, MOU). This is broadly true, if one accepts the performance indicators used by the Troika (the European Central Bank (ECB), the International Monetary Fund (IMF) and the Directorate General (DG) for Finance in the European Commission). According to these actors, the fact that Ireland has regained access to international finance markets, in-itself, illustrates that their prescribed fiscal adjustment strategy has worked. The Irish government, they argue, have reduced their budget deficit, recapitalized failed banks and improved labor cost competitiveness. This has led to an improvement in the external current account imbalance, with the implication that the Irish are now in a position to pay-off their long-term debt. The seeds of an export-led recovery have been sown. Other counties should now follow the Euro-Irish strategy and impose similar austerity measures.

This article challenges the conventional wisdom. It is perhaps true that a *proximate* cause of Irelands export recovery can be traced to a reduced budget deficit and an improvement in labor cost competitiveness. In this sense, Ireland has successfully internalized the adjustment constraints of being a member of the Economic and Monetary Union (EMU) in Europe. But I suggest that the *ultimate* cause of Ireland's fragile recovery can be traced to a path dependent effect of an export-led growth regime based on US investment that has nothing to do with the fiscal adjustment. More precisely, Ireland's capacity to improve its export competitiveness (in the context of unprecedented cuts in public expenditure) can be traced to an embedded state-led industrial strategy aimed at attracting US firms into the Irish economy. These firms are institutionally located in capital-intensive industries, and have shaped the Irish government's response to the crisis. It is the comparative advantage of these firms that provide the conditions for an export-led recovery not the Maastricht criteria.

The real impact of the troika adjustment in Ireland has been to increase the growing asymmetry between the *domestic* and *export* economy, whilst ignoring the need for debt restructuring. The budgetary adjustment has amounted to approximately 16 billion euros or 20 percent of GNP. Most of this has occurred *via* cuts in current expenditure and in-direct tax increases. Given the scale of the adjustment, it is hardly controversial to suggest that there has been a negative impact on economic and employment growth. The public sector has taken, on average, a 15 percent pay cut (Hardiman and Regan 2013; Regan 2013). Those reliant on social services have had their resources reduced by a similar margin. Real household disposable incomes have declined because of direct and indirect tax increases. Private sector debt is the highest in the EU, whilst the overall national debt-GDP ratio is set to peak at 122 percent in 2014. Furthermore, unemployment and under-employment remains above 13 percent. This is the real impact of internal devaluation, and it is weakly correlated with an improvement in competitiveness.

The remainder of the paper is as follows. First, I outline a framework on the political factors that shape Ireland's specific variety of capitalism. Second, I trace the domestic impact of austerity over time. Third, I argue that the seeds of Ireland's fragile recovery are context-specific to its political economy, and cannot be replicated by other countries in the eurozone. The final section concludes.

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The politics of comparative advantage

The institutional design of the EMU, which underpins the troika adjustment, operates from the rational expectations assumption that economic convergence is possible across diverse member-states of the eurozone. According to the troika, if all member-states follow a 'supply-side' adjustment strategy, in addition to the Maastricht criteria on deficit reduction, they will generate the conditions for export led growth, which will resolve their debt problems. This functionalist assumption of market convergence, to be achieved through a one-size-fits-all adjustment, is not accepted nor assumed in comparative political economy research (Hall 2012). In this tradition it is argued that different varieties of capitalism co-exist within the EU. National political economies are constructed around distinct growth regimes. This can be empirically observed in the cross-national variation in financial, corporate governance, education, training, social protection, industrial relations and labor market policies of member-states. The outcome of this institutional variation is that there are multiple paths (or equillibria) to economic and employment success.

In this research tradition it is broadly accepted that it is not possible to isolate the independent effect of a single variable, such as low public debt = higher growth, or flexible labor markets = higher employment, to explain successful strategies of adjustment. Rather the economy is modeled such that political and institutional factors interact in complex ways to provide MNC firms with different types of comparative advantage, and whose business interests are subsequently internalized by national governments. In the eurozone, MNCs in northern European countries: Germany, Austria, Netherlands and Finland benefit from their 'coordinated market' economies (CMEs). In terms of export performance, these firms benefit from centralized employer and trade union associations because the latter have the strategic capacity to coordinate wage restraint. Vocational training schemes interact with industrial production strategies to facilitate long-term investment in skills and product specialization. The outcome is that national governments in CME's generally have a preference for counter-cyclical fiscal policies and coordinated wage restraint as a means to defend external competitiveness (Johnson *et al.* 2014).

Ireland is not a CME but it is an export-led economy. The government achieves this through attracting US investment, and the comparative advantage provided to business firms by its liberal market economy (LME), or shareholder model of capitalism. Since the early 1990's it has been one of the most open economies in the world, with 85 percent of all production sold on international markets. Unlike the German *Mittelstand* the companies who export are predominately foreign owned. The Irish business cycle is closer to Britain than continental Europe, with the implication that companies are more dependent on financial markets for capital investment. The labor market is the second most flexible in the EU after Britain, and there is no legal right to collective bargaining. According to IBM (2010), the level of job creation associated with US FDI is the highest in the world. In this sense Ireland's small open economy is closer to the adjustment requirements of EMU, which assumes that wages and prices adjust flexibly and automatically to exogenous shocks. The export economy been nurtured by government-agencies and built around a long-standing historical relationship between Ireland and the United States (O'Riain 2013). Furthermore it is a specific variety of capitalism that cannot be easily replicated and long preceded the Maastricht criteria, the EMU and the Troika intervention.

Virtual exports and competitiveness

US companies are responsible, remarkably, for almost 90 percent of Ireland's exports. Investment into Ireland by these companies is substantial. According to the US Bureau for Economic Statistics (BEA), US investment stock was valued at 122 billion US dollars in 2009 (54 percent of total FDI), with over 500 US subsidiary firms operating in Ireland (Walsh 2014; Barry and Bergin 2012). According to the US Chamber of Commerce, a powerful lobby group with significant influence over Irish public policy, the number of US affiliated firms is closer to 650 (many of whom are based in Ireland on paper for tax purposes). The Irish Industrial Development Authority (IDA), a government agency tasked with attracting FDI, provides data on the sectoral distribution of US investment. Most firms are located in the financial services, chemical-pharmaceuticals and information & communication technology (IT) sectors. The pharmaceutical sector, alone, accounts for approximately *one fifth* (38.7 billion euros) of Ireland's entire GDP, but employ less than 4 percent of the workforce (Finfacts 2013).

The CEO's of large MNCs such as Microsoft, Google and Facebook regularly cite three main reasons for

why US companies invest in Ireland: flexible English speaking workforce, direct access to the European single market and low-corporate taxes (in addition to the wider business-friendly regulatory environment). Ireland's external competitiveness is hugely dependent on these firms. They are capital-intensive industries and therefore, unlike German MNCs, individual employers are less concerned with coordinated wage restraint. Their profit and productivity is one of the core factors in explaining why Ireland is alone among the euro periphery to record a balance of payment surplus (see Figure 1 on the current account). The policy preference of these export-firms, much like in Germany, shapes the Irish governments position on economic policy, particularly in international organizations such as the EU. This can be observed during the fiscal adjustment period. The Irish governments bargaining position was entirely premised on defending the competitive advantage of its low corporate tax regime.

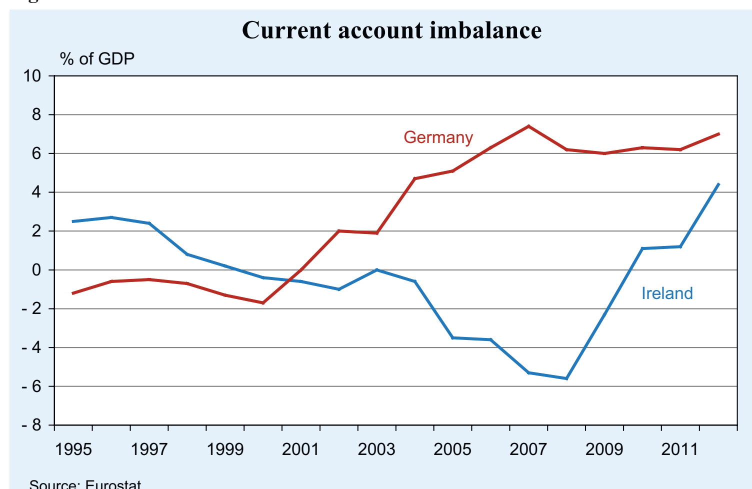
Attracting multinational investment *via* low corporate taxes has been the lynchpin of Irish industrial and economic policy for over fifty years (Barry and Bergin 2012; Hardiman and MacCarthaigh 2010). The sustainability of this strategy, however, is questionable. In 2012 service related exports associated with large MNCs such as Google and Facebook equated to 91 billion euros. But almost 40 billion euros of this was directly associated with tax-related transfer pricing (Finfacts 2013). This means that almost half of the income associated with service-exports (which now dominate overall exports) was completely unrelated to anything that is happening in the Irish economy. Transfer pricing and other corporate strategies such as the 'Dutch Sandwich' are mechanisms whereby US companies relocate profits into Ireland *via* the Netherlands and the Bermuda Islands to take advantage of low taxes. The headline corporate tax rate in Ireland is 12.5 percent, whilst the Irish government maintains that the effective rate is 11.9 percent. But research carried out by Finfacts (2013) and Stewart (2013) suggests that the actual effective tax rate is closer to 2.5 percent.

Virtual exports do not equate to an improvement in external competitiveness. The post crisis export-led recovery should, therefore, be viewed with caution. Irish exports fell in 2013 by 5.2 percent because the product patent associated with a selection of pharmaceutical companies came to an end (locally referred to as the patent cliff). As a consequence Ireland's trade surplus subsequently declined from 42 billion to 37 billion euros, and is set to decline again in 2014. This is a concern for the Irish government because they have become so fiscally dependent on the revenues generated by US corporations, who currently contribute 1.8 billion euros in corporate taxes. In 2008 total revenue associated with US companies was 4.8 billion euros (Walsh 2014). Total Irish revenue in the same year was only 41 billion euros. Hence, whilst it is true that Ireland is in the process of generating an export-led recovery, and this is the primary mechanism through which the country will improve external competitiveness, it is almost entirely dependent upon the interests of international markets and foreign owned US MNCs.

The eurozone crisis and debt restructuring

But if Ireland had the LME conditions to generate an export-led growth regime both before and after the eurozone crisis, how did the country manage to price itself out of international sovereign bond markets in 2008? This was the direct outcome of a decision by the Irish government to give a blanket guarantee to the bad debts of its failed *domestic banks,* which have, to date, cost the Irish taxpayer 60 billion euros (Whelan 2013b). In the aftermath of this decision, and under pressure from the ECB, the public debt-to-GDP ratio increased from less than 40 to almost 100 percent; it is due to hit 122 percent at the end of 2014. It was this decision to take on all the private liabilities of the banking sector that ultimately forced the Irish government into the hands of the Troika.

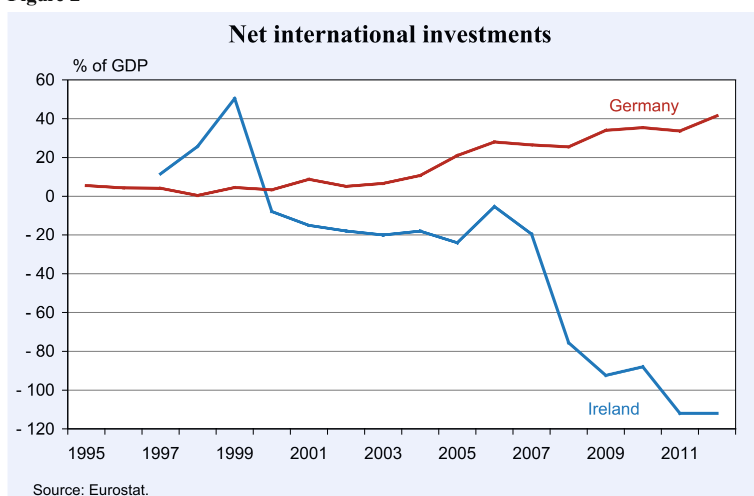
Figure 1



The brief background to this is that upon entry to the EMU, and particularly in the period from 2002-2008, Irish banks borrowed recklessly on the European inter-bank money market (reflected in the scale of capital inflows into Ireland, see Figure 2 on net international investment as a proxy indicator). In 2002, Irish bank lending was 60 percent of GDP but by 2007 this had increased to over 240 percent. In a context of negative real-interest rates and light touch financial regulation this explosion in bank borrowing is unsurprising, and well documented (Whelan 2013b; Kelly 2010). The impact, however, was that it shifted the Irish growth regime away from exports to domestic demand, most of which was accounted for by an increase in household mortgages (and hence private debt, see Figure 3).

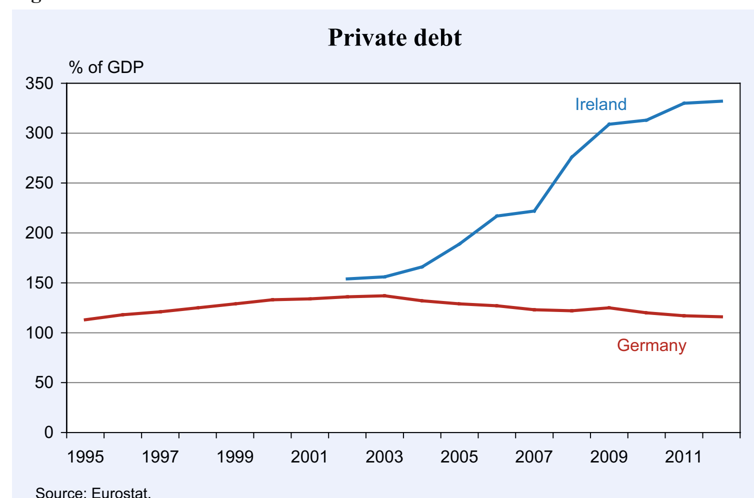
In response to house-price inflation, unit labor costs rose faster than any other eurozone country, with the implication that Ireland lost external competitiveness (see Figure 4). However, this increase in ULCs was mostly accounted for by wage increases in the *non-traded* sectors (particularly the public sector). US companies in the traded sectors of the economy (who account for 90 percent of exports) did *not* lose competitiveness *vis-à-vis* Germany (Wood 2014). Hence the overall increase in ULCs in Ireland cannot be equated with an overall loss of export competitiveness. The export-economy was autonomous to the boom in domestic demand (which was responsible for creating full employment). Price increases in the midst of a debt-led boom in domestic demand do *not* move in tandem with ULCs, as might be assumed in manufacturing dominated CMEs such as Germany. In this regard, it is misleading to use ULCs as an indicator of improved competitiveness in a finance driven economy such as Ireland. If one uses a broader export-price based indicator of competitiveness, the traded sectors of the Irish economy (mainly US owned) remained competitive relative to Germany throughout the boom-bust period.

Figure 2



Source: Eurostat.

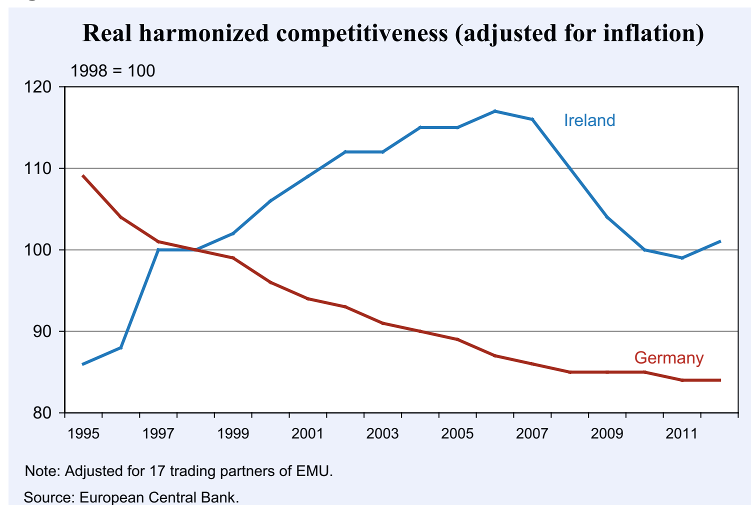
Figure 3



Source: Eurostat.

The decline in Irish ULCs by 22 percent, relative to the eurozone core, is primarily because of cuts to public sector wages and restructuring by Irish firms in the domestic economy. Despite this successful adjustment by Irish firms and the public sector, according to the Central Statistics Office (2013), Ireland remains overpriced by 20 percent. Ireland continues to be the fifth most expensive country in the European Union. Hence, whilst labor costs have fallen; land, energy, rental accommodation, property, legal fees, health insurance and capital all remain significantly more expensive in Ireland *vis-à-vis* Germany. The troika 'structural adjustment program' is narrowly focused on wage competitiveness and labor market flexibility but this is not where Ireland is over priced. There has been minimal attempt to negotiate a specific national structural adjustment poli-

Figure 4



Note: Adjusted for 17 trading partners of EMU.

Source: European Central Bank.

cy aimed at improving the broader cost base of the domestic economy.

But perhaps the greatest legacy of the troika adjustment has been the inability of the Irish government to renegotiate the bank debt. Irish banks are now, according to the ECB (2013), sufficiently re-capitalized. But they are not lending money into the real economy. The Irish taxpayer continues to carry the debt burden of these failed banks. To put the Irish banking *cum* sovereign debt crisis into a comparative perspective; Ireland has a population of less than 1 percent of the EU and accounts for less than 2 percent of eurozone GDP, but has paid over 41 percent of the losses associated with the Euro-banking crisis. It is highly aspirational to think US-based exports will generate the necessary economic growth to reduce a debt GDP-ratio of 122 percent.

Ireland successfully re-entered the international bond markets in late 2013. This was most likely made possible by the announcement of the ECB that it was willing, if necessary, to buy the bonds of distressed eurozone states on the secondary markets. In the absence of this decision it is highly questionable whether the markets would have continued to view the Irish debt-GDP ratio favorably. This is not because markets perceive Ireland as incapable of reducing the deficit, restructuring the labor market, generating a stable parliamentary majority or cutting the welfare state – all of which are necessary conditions to receive financial assistance from the troika. The Irish taxpayer have shown themselves more than capable of accepting this, and the government more than capable of implementing it. Financial markets reacted negatively to Ireland in 2011 because the state socialized private bank debt in the absence of a European central bank capable of acting as a lender of last resort (De Grauwe 2013).

The implication is that the prospect for a sustained economic recovery in Ireland is conditional upon the sustainability of its banking *cum* public debt crisis. This cannot occur without a retrospective recapitalization of Irish banks from European Union (EU) funds, or the equivalent of a European wide bank resolution system (Whelan 2013a and 2013b). To achieve this type of coordination requires a problem-solving approach that is currently non-existent at European level. This can be traced back to the politics of comparative institutional advantage. The German federal government is unwilling to accept a fully fledge banking union, or the issuance of Eurobonds, because it would undermine their national variety of capitalism, and competitive interest rate. Simultaneously, the Irish government is unwilling to accept the need for a coordinated financial transaction tax to fund a European wide banking recapitalization scheme, because it would risk undermining the comparative advantage of its low corporate tax regime. Hence, the factors that explain Irelands fragile recovery (foreign owned export sector built on low taxes), also reduces the governments ability to support a coordinated eurozone response to the financial crisis.

Conclusion

Ireland has the capacity to generate an export-led recovery and improve its competitive position *vis-à-vis* Germany. The causal factor behind this can be traced to US foreign direct investment and a longstanding institutional relationship between Ireland and the United States, which has been nurtured by governmental state agencies. Although it is rarely described as such, this is the path dependent effect of an industrial policy built around low corporate taxes and the comparative advantage of a liberal market economy. This capacity existed before and after Ireland's entry to the EMU. But although Ireland has a strong export base, and therefore the long-term capacity to reduce the debt-GDP ratio, these sectors are relatively autonomous from the domestic economy, which has

been most affected by the fiscal adjustment. The outcome of the troika deficit-reduction strategy has been to increase the asymmetry between the foreign owned and domestically owned sectors of the economy.

Most Irish owned firms have rationalized and adapted to the fiscal adjustment (and a collapse in consumer demand) in two ways: job shedding and/or complete collapse. Domestic companies do not have access to an equivalent of a German *Kurzarbeit* scheme, whereby the adjustment is distributed *via* a reduction in working hours rather than employment. In an economic context where domestic consumer demand has collapsed, banks hoarding rather than lending credit, and households swamped in the private debt associated with underperforming mortgage loans – small and medium sized firms will struggle to recover. Hence the aggregate figures on external competitiveness, and an improvement in Irelands current account imbalance, mask a deeper structural and employment crisis in domestic sectors of the economy.

The broader question underpinning Ireland's export-led industrial strategy, however, is whether it is replicable to other eurozone countries, particularly those in southern Europe. The research findings in comparative and international political economy would suggest no. Ireland's specific variety of capitalism is built around a set of historical institutional relationships within various sub-spheres of the economy that produce political coalitions that are relatively unique to small open liberal market economies. In this sense the adjustment lessons of the Irish model can be no more imposed on southern European countries, than the German model can be imposed on Britain.

Southern European countries have macroeconomic growth regimes built around domestic demand. This previously lent itself to an accommodating fiscal and monetary policy that is no longer available in the EMU. To put these differences in a comparative perspective; the value of Irish exports of goods and services in 2012 was 192 percent of GDP (ESRI 2013), the highest in the eurozone. In Greece it was 24.4 percent, Spain 30.2 percent and Portugal 35.5 percent. Imposing a one-size-fits-all fiscal adjustment on these countries, in the assumption that they have the domestic institutional and political capacity to generate an Irish-style export-led growth recovery will only exacerbate the imbalance of capitalisms at the heart of the eurozone.

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