Does the European Social Model Have a Future?

Challenges and Responses 70 years after the Beveridge Report

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Economic Challenges

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1. Introduction

The Irish economy is facing extremely challenging times as a result of the global economic recession which began in 2008. The effects of this recession in Ireland have been greatly exacerbated because of past policy mistakes that allowed a major property market bubble to develop and also permitted the banking system to become overexposed to the property sector. The consequences have been a severe contraction in output, a major financial crisis and the rapid emergence of high rates of unemployment. Due to the collapse in economic activity in Ireland over the period 2008 to 2010 and the associated rise in unemployment, economic output per head had fallen back to its 2000 level by the end of 2011[2].

In this talk I want to concentrate on the twin challenges of very high debt levels and a very high unemployment rate that form the core of the lasting legacy of the economic crisis. Because of a growing dependence of the public finances on transaction taxes in the property sector in recent years, the severe economic shock had a catastrophic impact on the

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1 Economic and Social Research Institute, Dublin, Ireland. This p*aper was prepared for the Social Justice Ireland Conference* 2012, **July 3rd, 2012. The material included in this paper draws on work contained in Fitz Gerald and Kearney (2011)** *Irish Government Debt and Implied Debt Dynamics: 2011-2015*, ESRI**,** Bergin, A., FitzGerald, J., Kearney, I. and C. O'Sullivan, 2011, "The Irish Fiscal Crisis", *National Institute Economic Review*, No. 217, July 2011, p. R47-R59, **and a presentation I made on October 13th 2011 to an OECD LEED conference.**

2 Using real GNP per head as a measure.

public finances. Government borrowing shot up to 14 per cent of GDP in 2009, having averaged a small surplus on the public finances over most of the period 2000-7, and was 13 per cent of GDP in 2011[3]. Cumulative government direct intervention in the banking system was equivalent to 37 per cent of GDP in 2011, while contingent liabilities related to the banking system are currently estimated at over 110 per cent of GDP. The explosion in government debt has led to domestic and international concerns as to the sustainability of Irish government debt over the medium-term.

Along with this debt crisis, the Irish labour market has deteriorated rapidly during the recession. The unemployment rate has increased from below 5 per cent to almost 15 per cent, with a strong growth in long-term unemployment and a steady fall in active participation in the labour market.

The policy challenges facing the authorities in tackling the debt and unemployment crises are considerable. During the previous unemployment of the 1980s, the authorities were forced to implement a severe programme of fiscal consolidation despite a mounting unemployment problem. Unfortunately we find ourselves facing the same policy dilemma today, despite high unemployment the authorities are forced to implement pro-cyclical policies which serve to deepen the recession.

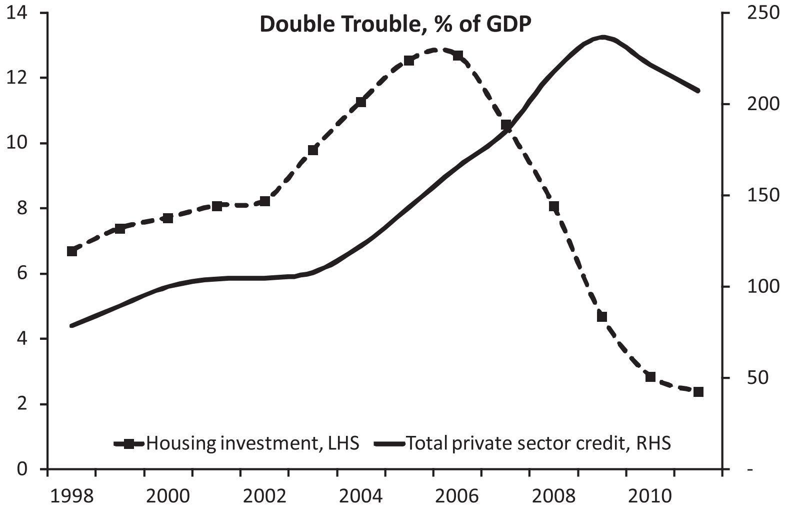
2. Double Trouble: Twin Housing and Credit Bubbles

The Irish economy enjoyed an exceptional period of sustained growth from 1994 through to the early years of the last decade. This was largely driven by the expansion in world trade and a rapid increase in world market share for Irish exports. The rapid rise in employment and incomes together with the increased availability of low cost finance as a

[3] Excluding the once-off costs of the banking crisis, the respective deficits are 11½ per cent in 2009 and 9½ per cent in 2011.

consequence of EMU membership and the globalisation of the financial sector resulted in a boom in the building and construction sector in the last decade, in particular a rapid expansion in house building. As shown in Figure 1, housing investment peaked at 13 per cent of GNP in 2006, more than double the EU-15 average. This housing boom drove economic growth over the "bubble" years from 2003 onwards so that the level of actual output rose well above the potential of the economy to deliver.

Figure 1: The housing bubble and credit bubble.

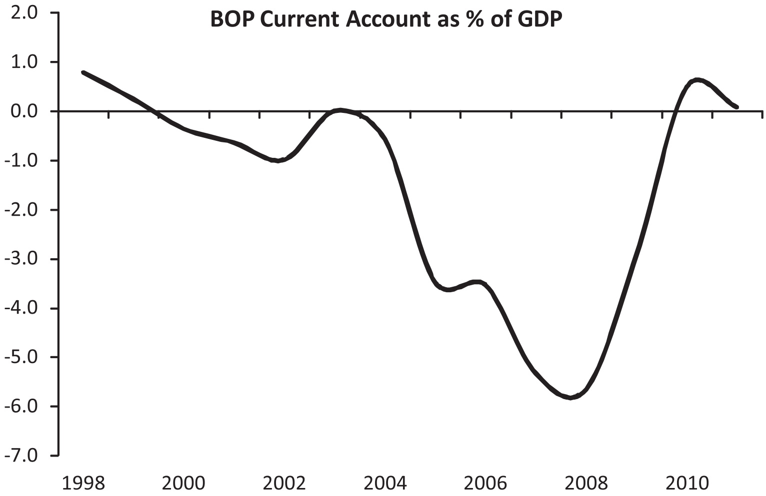


Source: CSO National Accounts and Central Bank Quarterly Bulletins, own calculations.

The second strand of the emerging bubble can be seen in the explosion in private sector credit which increased from 100 per cent of GDP in 2002-2003 to well over 230 per cent of GDP by 2009 (Figure 1). This dramatic increase in bank lending was financed abroad. While domestic savings were sufficient to fund the housing boom up to around 2003, thereafter they proved increasingly inadequate. Instead, the banking sector financed the boom by borrowing increasing sums abroad and relending these funds domestically to the property sector.

The first "conventional" early warning indicator of this growing domestic imbalance was the balance of payments, where the big increase in investment in housing was reflected in a growing deficit on the current account of the balance of payments, matched by a growing surplus on the financial account which reflected the foreign borrowing by the banking sector (Figure 2). The deficit on the current account began to deteriorate from 2003 onwards, a much earlier indicator of looming danger than output, employment or public finance indicators.

Figure 2: Early warning indicator



Source: CSO Balance on International Payments, own calculations.

The bursting of these bubbles has caused significant damage to the economy both in terms of measured economic activity and in employment. Whether measured by GDP or GNP, the latest quarterly data suggest that measured output in 2011 is at levels last seen in 2003 or 2004[4] (Figure 3) while the unemployment rate has soared from below 5 per cent of the active labour force in 2007 to almost 15 per cent by early 2012 (Figure 4).

[4] As mentioned earlier, real GNP per capita is currently at 2000 levels, the fall is even larger since the population has increased over the period.

Figure 3: Collapse in output and incomes and labour market

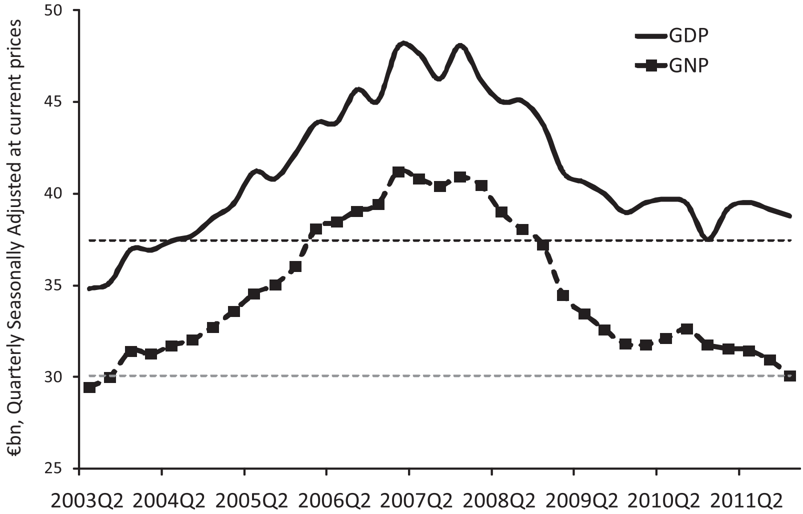
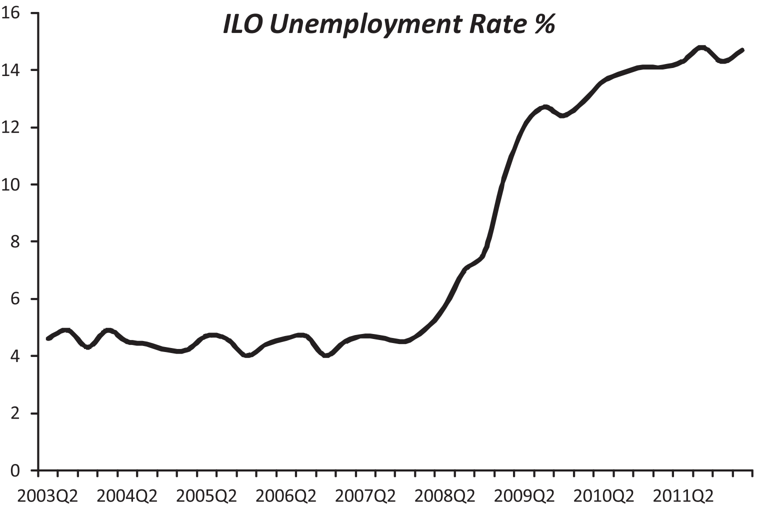


Figure 4: Collapse in labour market

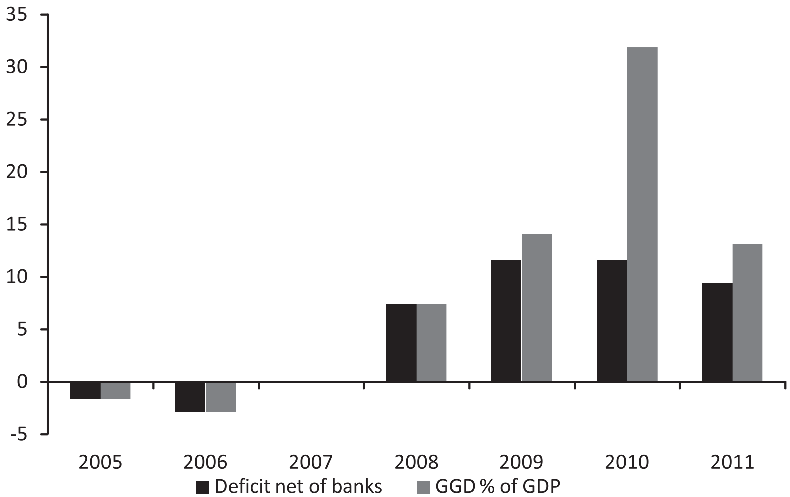


Source: CSO Quarterly National Account and CSO Quarterly National Household Survey.

3. An Explosive Debt Crisis

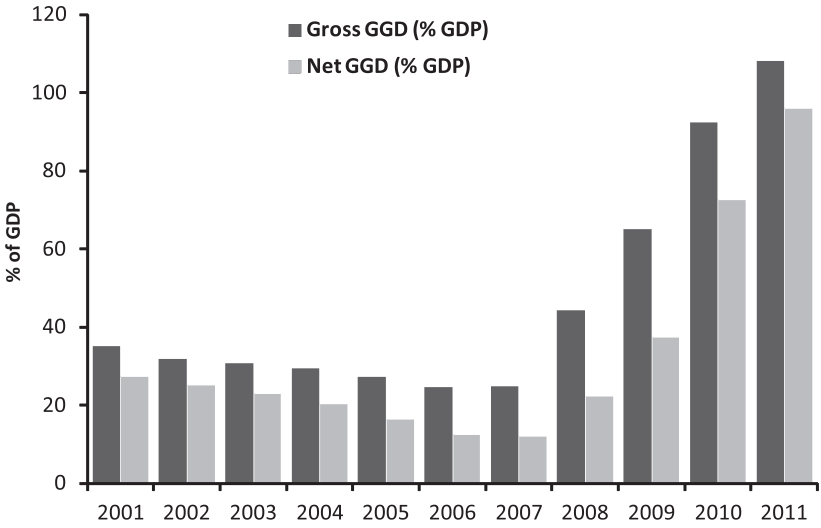
The collapse in the property market bubble, the resulting implosion of the domestic banking system and the associated huge fall in domestic output led to a dramatic growth in government indebtedness over the last four years. Having been one of the EU economies with the lowest government debt burden in 2007, Ireland has moved to being one of the more heavily indebted economies with gross government debt estimated at 108 per cent of GDP in 2011.

Figure 5: Deficit



The very rapid deterioration in the fiscal position from 2007 onwards (Figure 5), together with significant transfers of funds to the banking system and injections of capital into the banks meant that by the end of 2011 gross and net government debt amounted to 108 per cent of GDP and 96 per cent respectively. Figure 5 shows the General Government Deficit (GGDP) as a % of GDP. These deficit figures in 2009-2011 include funding of the banking system. While it is necessary to exclude "once-off" effects of banking internventions to arrive at the "underlying" deficit, these banking interventions have had a significant effect on the measured deficit in every year since 2009, this annual recurrences raises issues about them being treated as once-off.

Figure 6: Gross and Net Debt



Over the period 2000 to 2007 Irish government debt was low and falling (see Figure 6). In 2001 the government set up the National Pension Reserve Fund (NPRF) and 1 per cent of GNP was invested each year in that fund to provide for future pension requirements. The value of the fund grew rapidly to €21 billion in 2007. Along with cash balances and surpluses on a number of other managed funds, these investments meant that the gap between gross and net government debt grew steadily between 2001 and 2007, from 8 percentage points of GDP in 2001 to 13 percentage points of GDP in 2007. In 2008 the Irish authorities pre-funded future deficits by borrowing significant additional sums so that liquid assets – in the form of both cash holdings and the NPRF – amounted to almost half of total gross government debt (Figure 5).

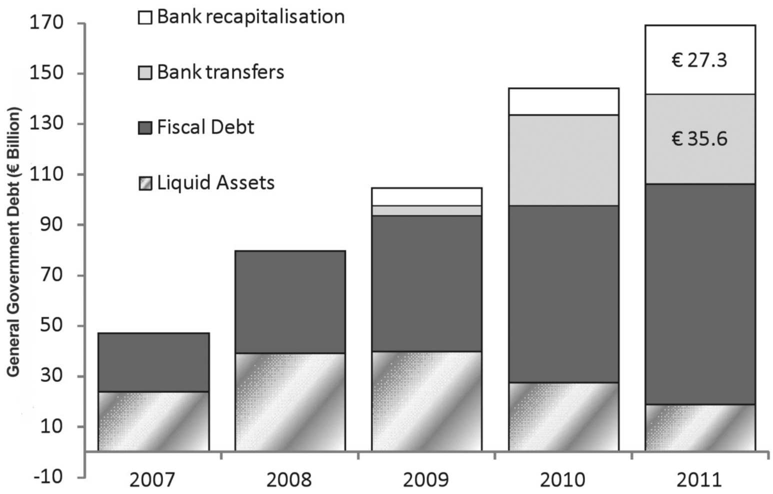
In 2009 the government decided that some of the assets of the National Pension Reserve Fund (NPRF) could be used to recapitalise troubled banks. These are referred to as “directed investments”. Effectively these NPRF assets were made available to the exchequer to help fund the government deficit and bank recapitalisations. The total value of the NPRF at the end of 2011 was €14.5 billion, of which €5.4 billion was available as liquid financial assets[5].

Figure 7 shows the dramatic impact that direct government intervention in the banking system since the beginning of 2009 has had on the government debt figures. By the end of 2011 total gross government debt stood at €169 billion. Just over half of that, €87 billion, is due to the “fiscal debt”, that is the effect of the cumulation of fiscal deficits on the original total stock of debt. A further €19 billion of it is due to the strategy of holding significant liquid financial assets, in the form of cash and discretionary funds held at the NPRF. A staggering 37 per cent of total government debt relates to the government’s direct intervention in the banking system. This is equivalent to €63 billion, of which €35.6 billion was a direct transfer or in other words a direct loss to the exchequer.

In late summer 2010 the government still expected to be able to fund itself on financial markets. However as the full magnitude of the potential losses in in the banking system began to be apparent in the autumn of 2010, the government had to seek aid from the IMF/EU towards the end of 2010. One of the key factors driving nervousness in the markets at that time was the scale of contingent liabilities related to the banking system that are not included in the official debt figures.

[5] At the end of 2011 €9.1 billion was in the “Directed Portfolio” of investments in Allied Irish Bank and Bank of Ireland and it is, therefore, excluded from liquid financial assets.

Figure 7: Fiscal and Bank Debt



There are three main sets of government liabilities in relation to the banking system: liabilities that are included in the Government debt relating to direct intervention by the government in the banking system as shown in Figure 7; contingent liabilities arising from NAMA bonds backed by property assets; residual contingent liabilities arising from the government guarantee of the bulk of covered banks' liabilities. Table 1 shows the most recent estimate of the total value of these contingent liabilities at 112 per cent of GDP.While there is a degree of clarity about these contingent liabilities of the State there is considerable uncertainty about the future value of the offsetting financial assets held by the covered institutions. The scale of the State's contingent liabilities in the banking system relative to the actual size of the Irish economy is very large. In this sense the State is highly geared.

Table 1: Contingent Liabilities

	% of 2011 GDP
Senior NAMA bonds	19%
Gurantees for Emergency Liquidity Assistance	10%
Deposits covered by Deposit Protection Scheme	52%
Bank Liabilities covered by ELG	32%
Total Contingent Liabilites end March 2012	112%

Source: IMF Country Report March 2012

4. Unemployment Crisis

The unemployment rate has grown with alarming speed since 2008, and most recent estimates suggest it is close to 15 per cent of the labour force. More worrying is that the persistence of unemployment, which can lead to the emergence of structural unemployment, is rising. Figure 8 shows the long-tem unemployment rate, that is those out of work for more than one year, has been rising steadily since 2009 and now accounts for roughly 60% of the total unemployed. Furthermore it is much higher among men, particularly young men. The legacy effects of this are the sector specific nature of unemployment, with very large falls in employment in the construction sector.

In addition to the fall in employment, there has also been a huge fall in participation in the labour market. Figure 9 shows what the measured unemployment rate would be using wider definitions of labour force participation, to include those who are more "marginally attached" to the labour market, underemployed part-time workers and those who are not in education who want work. Using the widest definition the measured unemployment rate in 2012 Q1 is 24 per cent. Figure 10 helps to clarify this issue. It shows total employment and the total labour force from peak to today. At its peak, in 2008 Q3 the total labour force included 2.267 million people. That had fallen by 172,000 to 2.095 million by 2012 Q1. This very sharp fall in labour force participation means that headline unemployment numbers are lower, however it is likely that this is capturing pent-up labour supply were labour market conditions to improve.

Figure 8: Long Term UR

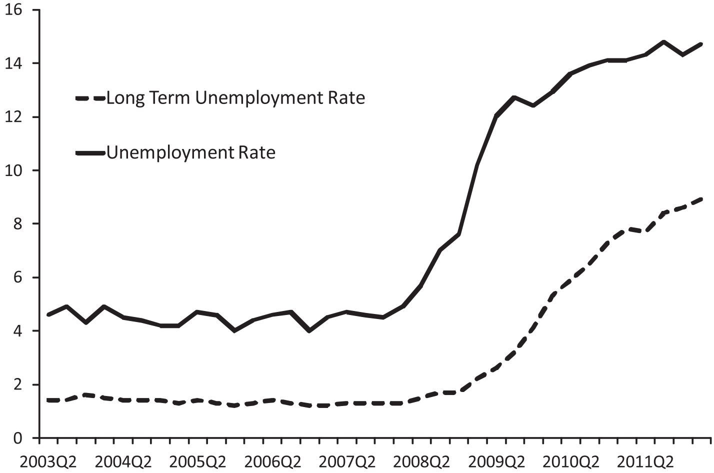


Figure 9: The labour force

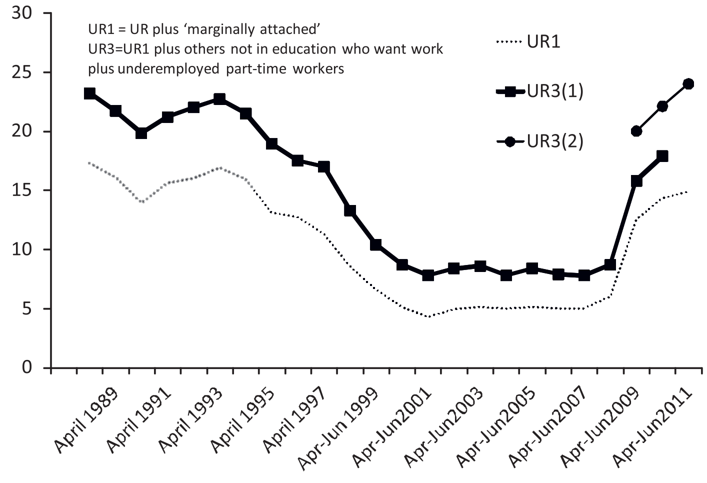


Figure 10: Loss of Jobs during Recession

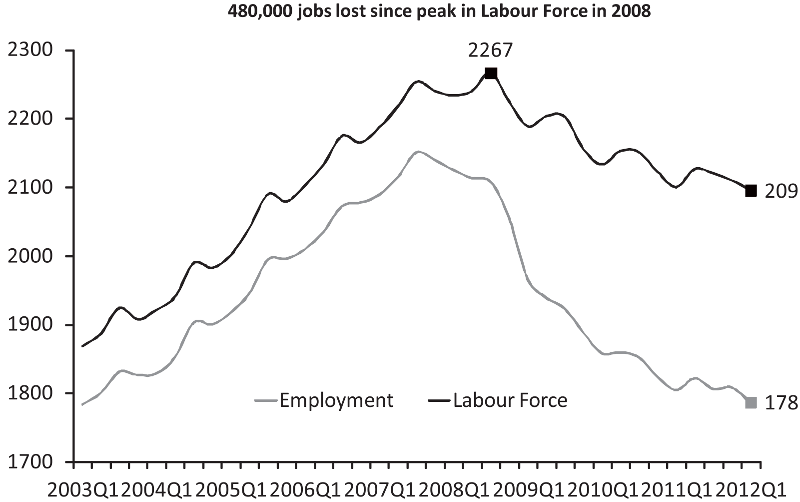
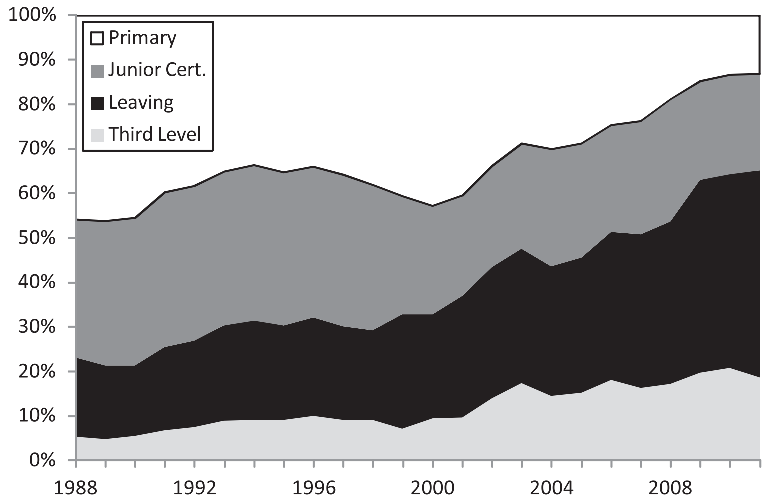


Figure 11: Educational profile of unemployed



Source: QNHS PES data for Q2 in each year, own calculations.

Figure 11 shows that the educational profile of the unemployed has changed radically from the 1980s. In 1988 23% of those unemployed had the Leaving Certificate or higher, whereas now this is 65%. This changes the sort of interventions and training programmes required, and paints a slightly more optimistic picture of what the future will hold as the economy recovers as the higher the education level the better employment prospects are.

5. The policy challenge: high debt and high unemployment

The depth of the fiscal crisis, coupled with mounting costs for the government from the financial crisis, forced the Irish authorities to make very significant interventions to stabilise the deficit. To date, the total amount of ex ante cuts implemented is equivalent to almost €24 billion (15 per cent of GDP), with a further €8.5 billion in cuts planned for 2013-2015.

Since the summer of 2008 the Irish fiscal position deteriorated very rapidly. Beginning in autumn 2008, the authorities responded to this deterioration with a series of austerity budgets designed to stabilise the deficit. The speed of the widening of the deficit, even in the face of these measures, warranted a supplementary budget in the spring of 2009 and it was not until 2010 that the measures undertaken were sufficient to see the deficit stabilise. Table 2 summarises the *ex ante* measures undertaken and planned. By the end of 2010 the general government deficit had stabilised, however at a very high level of 11 ½ per cent of GDP. In November 2010 the Irish government agreed a package of loans from the EU/IMF designed to help fund Irish debt over the period 2011-2013. That agreement also mapped out a further package of austerity measures designed to bring the deficit below 3 per cent of GDP by the middle of the decade.

Roughly two-thirds of the actual and planned austerity package relates to cuts in expenditure, both current and capital. In 2009 and 2010 significant cuts in public sector pay levels were introduced, equivalent to up to 15 per cent of gross salary. There have also been very large cuts in expenditure on capital projects. On the revenue side, taxes on income have risen substantially in these years. Over the period 2011-2014 the consolidation measures total €15 billion, or 10 per cent of 2010 GDP. This means that cumulatively by 2015 the Irish authorities will have introduced ex ante austerity measures equivalent to over 20 per cent of GDP.

Table 2: The Austerity Package

	2008	2009	2010	2011	2012	2013	2014	2015	Total
Revenue	0.0	5.6	0.0	1.4	1.6	1.1	1.1		10.8
Expenditure	1.0	3.9	4.3	3.9	2.2	2.3	2.0		19.6
of which capital:	0.0	0.6	1.0	1.9	0.8	0.6	0.1		5.0
Total	1.0	9.4	4.3	5.3	3.8	3.4	3.1	2.0	32.3

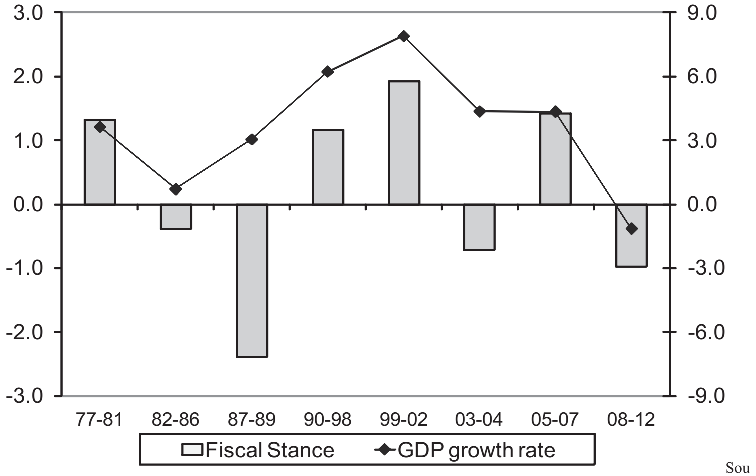
Source : Department of Finance, various. See footnote.[6]

Figure 11 shows our estimates of the fiscal stance in Ireland over recent decades. Using the ESRI HERMES model of the Irish economy, this is estimated by comparing a scenario where both government expenditure and taxes are indexed with the actual budgetary outturn for each year. The methodology is described in Kearney *et al.* (2000)[7]. A positive difference implies an expansionary budget and a negative sign indicates a contractionary budget.

6 For 2008-2010 *Report of the Review Group on State Assets and Liabilities*. [Table 2.1: Budgetary Adjustments since mid-2008 – Planned Budgetary Impact.] For 2011 and 2012 *Budget 2011, Budget 2012, Medium Term Fiscal Statement,* November 2012 Table 2.1. The figures included show the full year effects, including carryover, and exclude once-off measures. For 2013-2015 figures from *Medium Term Fiscal Statement,* November 2012 Table 2.1

7 Kearney, I., McCoy, D., Duffy, D., McMahon, M., and D Smyth, 2000. "Assessing the Stance of Irish Fiscal Policy", in A. Barrett (ed.), Budget Perspectives: Proceedings of a Conference held on 19 September 2000, ESRI.

Figure 12: Fiscal Stance (LHS) and GDP growth rate (RHS), annual averages.



Source: own calculations.

Scanning across Figure 12 we can see that the origins of the fiscal crisis of the mid 1980s can be traced to inappropriately stimulatory fiscal policy in the late 1970s and early 1980s. While tough budgets were introduced in 1983 and 1984, the process was only completed with further very tough budgets in 1988 and 1989. A consequence of this long drawn out adjustment was a lost decade in terms of growth.

It would have been much more appropriate to have run a much tighter fiscal policy over the course of the last decade, resulting in a substantial and increasing surplus up to and including 2007. Figure 12 shows our estimate of the fiscal stance from 1977 to 2012 cumulated over successive periods of expansionary or contractionary budgetary stance. The graph also shows the average annual growth rate in those periods. At first glance it is clear that fiscal policy has been broadly pro-cyclical throughout the last three and a half decades, with the exception of the years 1987-1989 when the government introduced a successful fiscal consolidation during a period of positive growth.

What is interesting about the 2005-2007 period is the similarity in the growth rate and the magnitude of the fiscal stance to the earlier 1977-1981 period of expansion. By contrast, the subsequent fiscal consolidation of 2008-2012 has been deeper than that estimated in the period 1982-1986 when very little progress was made ex post in discretionary budgetary adjustments. In both cases, the austerity measures were introduced against a backdrop of low or negative growth and rapidly rising unemployment. The fiscal consolidation in the 1980s was only successfully completed in the latter part of the decade during a reemergence of strong growth in external demand which helped to offset the very sharp fiscal contraction of the years 1987-1989.

There are few easy options in tackling the current levels of debt facing the Irish government. The current programme of austerity, with an agreed package of cuts totalling €32 billion over the period 2008-2015, should, on official assumptions, be sufficient to all but eliminate the primary deficit by 2013. However, the very high current levels of debt mean that if growth were to prove less than assumed in the Department of Finance estimates, it would not be sufficient to stabilise the debt to GDP ratio before 2015 (see FitzGerald and Kearney (2011)).

I have earlier aluded to the dangers of a lost decade: this is especially pertinent in relation to long-term unemployment, youth unemploment and male unemployment. The crisis in the labour market means that it is not sufficient to await resolution of the debt crisis before tackling the problem of long-term unemployment, as recognised in the *Pathways to Work* initiative. My colleagues at the ESRI have done a lot of work on this: key policy initiatives to tackle long term unemployment involve the use of labour market activation measures, and education and training measures[8].

8 Submission to the *Joint Committee on Jobs, Social Protection and Education* on Unemployment and Youth Unemployment, *Elish Kelly, Seamus McGuinness and Philip O'Connell,* The Economic and Social Research Institute, April, 2012

As I type these last lines I am also keeping an eye on developments in Greece, where elections are taking place today. The news stories this weekend are full of reports of further plans to accelerate fiscal integration, an emerging crisis for Italian sovereign debt and the crisis for Spanish banks. Against this backdrop of a political, economic and financial crisis in Europe, and more particularly in the Eurozone, the twin fiscal and employment crises facing Ireland are thrown into even sharper relief. There are no easy choices ahead.