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Table of contents

Executive summary 8

Assessment and recommendations 11

Chapter 1. **Key challenges** 17
Short-term economic adjustment 19
Sustaining robust long-term growth 21
Policies to underpin growth 26
Setting policies to underpin stability and sustainability 34
Notes 38
Bibliography 39

Chapter 2. **The housing market cycle has turned** 41
The housing market slowdown 42
The sharp fall in residential construction 44
The macroeconomic impact of the housing market cycle 45
More efficient policies towards housing 47
Bibliography 50

Chapter 3. **Financial stability: Banking on prudence** 51
Containing risks to the financial system 53
Policy issues and responses 55
Conclusion 56
Notes 57
Bibliography 58

Chapter 4. **Adapting government spending to lower revenue growth** 59
Tax revenues are less robust 60
Government spending is likely to slow 63
Fiscal performance has remained sound but is weakening 65
Additional resources should be used effectively 68
Improving public sector management 71
Public-Private Partnerships 74
Conclusion: Fiscal policy must adapt to a more challenging environment 75
Notes 76
Bibliography 76

Chapter 5. **Setting the pension system on the right track** 79
The basic state pension is the foundation of the system 81
Public sector pensions will become increasingly costly 86
Private pension saving needs to increase 86

Options for pension reform 93
Notes 95
Bibliography 96

Chapter 6. **Integrating migrants: Learning from OECD experience** 99
Migration trends 100
The policy approach and recent reforms 106
The economic impacts of migration 108
Policy challenges 115
Notes 125
Bibliography 127
Annex 6.A1. Do fast-growing economies attract more migrants? 129

Glossary 131

Boxes

2.1. Reforming taxation of housing 48
2.2. Summary of recommendations on the housing market 50
3.1. Summary of recommendations on financial stability 57
4.1. Uncertainty around the fiscal balance as the economy slows 66
4.2. OECD principles for private sector participation in infrastructure 75
4.3. Summary of recommendations on fiscal policy 75
5.1. Green Paper on Pensions 93
5.2. Summary of recommendations on pension reform 95
6.1. Recurring themes: migration issues in other countries 118
6.2. Summary of recommendations on migration 125

Tables

1.1 Short-term outlook 21
1.2. Decomposition of GDP growth 22
1.3. Ireland's international investment position 23
1.4. Foreign direct investment 24
1.5. Progress in structural reform: Competition policy 27
1.6. Progress in structural reform: Upgrading infrastructure 30
1.7. Progress in structural reform: Research and innovation 30
1.8. Progress in structural reform: Education 31
1.9. Progress in structural reform: Female participation 32
2.1. Housing market indicators show a slowdown 42
2.2. Progress in structural reform: Housing 48
4.1. General government fiscal position 60
4.2. The composition of tax revenues has changed 61
4.3. Spending on economic infrastructure under the National Development Plan 74
6.1. Labour force status of those aged 15 and over 103
6.2. The main migration channels 106
6.3. Employment performance by education level 109
6.4. Change in employment by nationality 110
6.5. Age of immigrants compared with the native-born population 111
6.6. Possible macroeconomic impacts of immigration from new member states . . . 112
6.A1.1. Regression results 129

Figures

1.1. Real GDP per capita . . . 18
1.2. The 2000s so far . . . 20
1.3. House prices have begun to fall . . . 21
1.4. Productivity levels relative to EU15 . . . 22
1.5. Employment in development agency assisted companies . . . 24
1.6. Indicators of competitiveness . . . 25
1.7. Ireland's share of world export markets . . . 25
1.8. Relative price of items covered by Groceries Order . . . 28
1.9. Indicators of infrastructure . . . 29
1.10. Female participation has risen a lot but is still low . . . 33
1.11. Fiscal performance has weakened . . . 36
1.12. Old-age dependency ratio . . . 37
2.1. House prices in relation to income and rents . . . 43
2.2. Actual and fundamental house prices . . . 44
2.3. Residential investment per capita . . . 45
2.4. Housing investment and net exports . . . 46
2.5. House price volatility and the tax treatment of housing . . . 47
3.1. Banking sector share prices and government bond yield . . . 52
3.2. Credit default swap rates . . . 56
4.1. Corporation tax and stamp duty revenues . . . 62
4.2. Real expenditure has expanded rapidly . . . 63
4.3. Main components of higher public spending . . . 64
4.4. The government balance sheet has been strengthened . . . 65
4.5. A larger fiscal deficit is a risk . . . 66
4.6. Spending is heavily committed to priorities . . . 67
4.7. Indicators of healthcare efficiency . . . 70
5.1. Old-age dependency will eventually match other countries . . . 80
5.2. State pension . . . 81
5.3. Gross replacement rates . . . 82
5.4. Public expenditure on pensions . . . 83
5.5. Employment rates by age . . . 85
5.6. Gross replacement rate from state pension . . . 87
5.7. Occupational pension schemes . . . 88
5.8. Sources of retirement income by quintile . . . 89
5.9. Projected net fiscal revenues from tax-favoured retirement savings plans . . . 91
6.1. Foreign-born population . . . 101
6.2. Immigrants by nationality and birthplace . . . 101
6.3. Migration over time . . . 102
6.4. Percentage of jobs in each sector held by immigrants . . . 103
6.5. Share of immigrants with a tertiary-level qualification . . . 104
6.6. Over-qualification rates . . . 105
6.7. Ratio of unskilled wages to the average wage . . . 109
6.8. Earnings growth and immigrant share . . . 110
6.9. Link between net migration and economic growth . . . 113
6.10. Distribution of migrants across the country . . . 117
6.11. Net inward migration rates . . . 123

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The economic situation and policies of Ireland were reviewed by the Committee on 20 February 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 5 March 2008.

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes and David Rae under the supervision of Peter Hoeller. Research assistance was provided by Isabelle Duong.

The previous Survey of Ireland was issued in March 2006.

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BASIC STATISTICS OF IRELAND (2006)

THE LAND

Area (1 000 km²)		Major cities (thousand inhabitants)	
Total	70	Dublin (borough)	1 187
Agricultural	43	Cork	119
		Galway	72

THE PEOPLE

In thousands		Total labour force (thousands)	2 132
Population	4 240	Civilian employment (% of total)	
Natural increase (2005)	34	Agriculture, forestry and fishing	5.8
Net migration	70	Industry and construction	27.7
Number of inhabitants per km²	61	Services	67.5

PRODUCTION

Gross national income (GNI)		Gross fixed capital investment	
In billion €	149	In % of GNI	30.9
Per head (€)	35 174	Per head (€)	10 881

THE GOVERNMENT

Public consumption (% of GNI)	18.8	Composition of Parliament (seats)	
General government (% of GNI)		Fianna Fail	78
Current and capital expenditure	38.7	Fine Gael	51
Current revenue	42.2	Labour	20
Net debt	2.0	Other	17
Last general elections: May 2007		Total	166

FOREIGN TRADE

Exports of goods and services (% of GNI)	93.8	Imports of goods and services (% of GNI)	81.2
Main merchandise exports (% of total)		Main commodity imports (% of total)	
Office and electrical machinery	22.4	Manufactured goods and articles	27.4
Organic chemicals	19.8	Office and electrical machinery	24.5
Manufactured goods and articles	17.8	Other machinery and transport equipment	19.3
Medical and pharmaceutical products	16.6	Chemicals and related products	13.7

THE CURRENCY

Monetary unit: Euro		Currency unit per $, average of daily figures	
		Year 2007	0.730
		February 2008	0.679

Executive summary

The Irish economy has performed remarkably well over the past decade, propelling per capita income to above the EU average. Though the period of rapid catch-up has ended and productivity growth has slowed in recent years, the economic fundamentals remain strong. Economic activity has been fuelled by strong domestic demand but is now easing. In the short run, wage restraint and labour market flexibility will be important to continue to attract foreign direct investment and to crowd in foreign demand to offset slowing domestic activity. In the longer run, stronger productivity growth and continued increases in participation rates will be needed to sustain a fast pace of real income growth. The easing of activity has led to a slowdown in government revenues and a sharp drop in the fiscal surplus. At the same time, the government is committed to a large infrastructure investment programme, and there is strong demand for better public services. Over the long term, the public finances face serious pressures from the ageing of the population.

Maintaining strong growth. *Productivity has faltered, partly due to the buoyancy of the lower-productivity construction sector in recent years. Better performance will hinge on boosting competition in sheltered sectors and the network industries, on improving the innovation framework and raising education standards further. Moreover female participation, while rising quickly, could be assisted by further increasing the supply of childcare places. The design of child benefits does little to encourage women to join the workforce.*

Reforming the taxation of housing. *Much of the past large rise in house prices was justified by economic fundamentals and rates of home ownership are high. But the unusually favourable tax treatment increases the role of housing in the economy and adds to volatility in the housing market. There should be a gradual move towards a more neutral system of housing taxation.*

Containing risks to the financial system. *The risks associated with the sharp run-up in domestic indebtedness have so far been contained. Irish banks are well-capitalised and profitable, so they should have considerable shock-absorption capacity. However, turmoil in the international markets continues to impact on the Irish financial system. Transparency in financial markets world-wide needs to be improved to restore confidence. It is important to prepare for downside risks and, in conjunction with international efforts, Ireland should consider its own arrangements.*

Public spending needs to slow. *Fiscal performance has been strong in recent years but revenue growth has moderated as the economy, particularly the housing market, has weakened. Public expenditure is set to slow but it is important to avoid locking-in expensive commitments, particularly on public sector pay. As spending rises more slowly, improving public services will have to rely more on undertaking further reforms to public sector management and getting better value for money.*

Ageing will put pressure on government spending in the long term. *Ireland faces the same, although more distant, pressures from ageing as other countries. A long-term framework needs to be put in place now to ensure decent incomes in retirement and fiscal sustainability. The recent Green Paper on Pensions sets out a comprehensive range of options for reform. A future*

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package of measures should include linking the standard retirement age to longevity and ensuring that private pension savings are adequate. The current system of tax incentives for pension saving is very generous but needs to be better targeted.

Improving the integration of immigrants. *The scale of inward migration has been remarkable in recent years. Most migrants are young, well educated and work, but are often in basic jobs. Integration policy should continue to focus on language training of adults as well as children, and the recognition of professional qualifications. The uncertainties about future migration flows pose a challenge to planning public services and infrastructure investment. Flexibility needs to be built into the planning of major projects.*

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Assessment and recommendations

Growth has slowed, testing the resilience of the economy

The Irish economy expanded rapidly in recent years, driven by domestic demand, but activity is now easing. In particular, the housing market has cooled: house prices are falling and fewer houses are being built. Despite the slowdown, growth could remain above the euro area average, although downside risks prevail in the short run. Economic fundamentals remain strong, however, with a skilled workforce, a flexible labour market, moderate taxation, a business-friendly regulatory environment and a still sound fiscal position. Following many years of a booming economy, slowing economic activity will test the resilience of the drivers of economic growth, and the fiscal, financial and macroeconomic frameworks. At the same time, the physical infrastructure and public services need to be improved further. Ireland should also ensure that social progress is sustainable in the long term, particularly as the population ages.

Raising productivity growth is the key long-term challenge

Labour productivity levels are high in international comparison in the manufacturing sector but the previously rapid productivity growth has slowed. Performance is less impressive in the services sector. The buoyancy in construction and in lower-productivity services sectors has weighed on overall productivity growth in recent years. Ireland remains a favoured destination for foreign direct investment (FDI) and is successful in attracting investment in higher valued-added activities such as pharmaceuticals, biotechnology, finance and software. But the real exchange rate has appreciated and competiveness has been eroded. There has been some loss of export market share, although strong performance in financial and business services has partly mitigated these effects. Wage and price moderation are needed to avoid a more serious weakening of export performance. Indeed, gaining competiveness would crowd in foreign demand, offsetting slowing domestic demand. Stronger competition would help to raise productivity and reduce costs. The abolition of the Groceries Order has lowered prices and shows what can be achieved from increasing competitive pressures. Some progress has been made to increase competition in other areas but more remains to be done, especially in network industries and sheltered professions. Innovation capacity in the Irish-owned sector is weak. Spending on research and development (R&D) is relatively low, despite rapid increases, and public resources in this area should be allocated more effectively.

Greater female participation would boost labour supply

Growth has been boosted by rising employment of women and net inward migration. The female participation rate is rising rapidly and will increase further with additional childcare places coming through investment in the National Childcare Strategy. Another area to be addressed is increased out-of-school-hours care. More should be done to help lone parents participate in the labour market. Incentives for second earners to work full time should be sharpened further. Moreover, child support should be tied to the actual use of childcare. Effective implementation of recent plans to move to a mutual obligations approach for single parents would raise employment and reduce child poverty.

The housing market cycle has turned

The buoyant housing market helped to sustain strong economic growth in recent years as housing investment reached almost 16% of gross national income (GNI), the highest in the OECD. But the market has turned since 2006. Much of the exceptionally large increase in house prices can be justified by Ireland's strong income growth, population expansion and the rising share of younger households. However, house prices appeared to have overshot their long-run equilibrium level and a rebalancing of demand and supply in the housing market was necessary. Some further easing in house prices is possible and there is a risk that prices could fall below their long-run level before recovering. Housing investment has fallen sharply and indicators of future activity, such as building permits, are much weaker than in recent years. In line with international experience of housing construction cycles, it is anticipated that this downswing in activity could soon be over and that house-building would fairly quickly return to the rate needed to meet the growing demand for housing. On this basis, GNI growth is projected to decline from 5% in 2007 to 3% in 2008, before recovering again in 2009, while unemployment could rise to 5½ per cent. Downside risks to growth prevail. The slowdown in the housing market could be sharper and more protracted, with greater implications for employment and the wider economy. Risks of lower growth also stem from economic weakness in the United States and the United Kingdom, and the strength of the euro against the dollar. Ireland is particularly sensitive to such developments due to the direction of its trade flows and the important role played by US firms in FDI.

The Irish housing tax system is among the most favourable in the OECD. This generosity has generally contributed to the volatility of the housing market, although the recent reforms to stamp duty were well-timed to support the housing market during the current slowdown. Such instability is particularly costly as Ireland is a small member of a much larger monetary union. It can no longer use monetary policy to slow house price growth or cushion the broader effects of a sharp slowdown in the housing market. Tax breaks favouring owner-occupation also contribute to making housing expensive. These effects should be reduced either by limiting mortgage-interest tax relief with the aim of phasing it out over time, or by introducing a property or capital gains tax. While this makes economic sense, in the Irish context where over 80% of households own their home, a profound tax reform of the housing sector is unlikely to be implemented any time soon. However, the experience of other countries shows that these reforms can be made and that a gradual approach is likely to be successful.

Financial system risks have been contained

Lending has been strong, not only for residential mortgages but also for commercial property and the construction industry. Property-related lending now accounts for more than half of the stock of bank lending. Deposit growth was much weaker than lending growth, leading to a widening funding gap, which is proportionally the largest in the European Union. This gap is mainly covered by the issuance of securities as well as by borrowing from other financial institutions. The Central Bank and Financial Services Authority of Ireland (CBFSAI) had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. To reduce such vulnerabilities, the CBFSAI implemented a new Consumer Protection Code, which limits the scope for predatory lending practices, and introduced a forward-looking liquidity regime just before the international financial market turmoil struck. It also took regulatory action to reduce risks by increasing the risk-weighting for high loan-to-value mortgages for owner-occupiers and speculative commercial real estate lending.

The international financial market turmoil has so far raised funding costs for Irish banks to some extent, while lending standards have tightened. Both are likely to reduce banks' willingness to supply loans and bank lending has decelerated sharply, though weaker demand has clearly also played a role. The global financial market turmoil has brought new policy issues to the forefront. The liquidity squeeze is partly due to a lack of transparency internationally. The CBFSAI has moved quickly in this respect. A survey of the major banks in Ireland shows that they have little exposure to the sub-prime market, hedge funds and the private equity sector. This publication initiative is welcome and should be made a regular feature. The Irish banks are highly profitable and well-capitalised, so they should have considerable shock-absorption capacity. But it would also seem important to be prepared to deal with downside risks. In this context, the EU Deposit Guarantee Schemes Directive is being reviewed and Ireland should consider the efficacy of its own arrangements in the light of this.

Public expenditure growth needs to slow and efficiency must be increased

Ireland enjoyed spectacular growth in tax revenues over the past five years. This allowed real public spending to increase faster than in any other OECD country except Korea, while the government also paid down public debt and started to build a fund to pay for future pension liabilities. This left the public finances in a healthy position. Revenue growth has, however, decelerated sharply as the economy has slowed and the government surplus shrank from 3½ per cent of GNI in 2006 to ½ per cent in 2007. Over the coming years the growth in tax revenues will be lower than that seen in recent years, partly due to lower property-related receipts. Current expenditure needs to increase more slowly than in the past. The budgeted slowdown of spending over the coming years is welcome and maintains infrastructure investment as a priority. However, the budget still plans to raise current expenditure by 7.7% in 2008 and the budget is likely to show a deficit of close to 1% of GNI in 2008. It will be important that current spending growth slows further in subsequent years as planned. In particular, it will be crucial to avoid expensive commitments. The recent public service pay benchmarking exercise showed that public and private sector wages are broadly in line and pay restraint will be necessary in the

upcoming national pay negotiation under the "*Towards 2016*" social partnership agreement.

Expectations for improvements in public services will remain high even as government spending slows. Achieving value for money will become increasingly important if higher standards of service are to be delivered. A wide range of improvements has been made to the management of public spending: a unified budget has been introduced; a multi-year framework for capital expenditure has been implemented; Value for Money reviews are being undertaken in all government departments; the Management Information Framework (MIF) has been rolled out across government; and a new Efficiency Review of public expenditure has been launched. However, the framework needs to be consolidated: the budget constraint on spending departments needs to be tighter, in line with the more top-down approach to expenditure management introduced by the new unified budget framework, to focus efforts on delivering services more efficiently and directing resources to where they are most effective. The multiannual budget framework for current spending should be strengthened along the lines of the models introduced in other countries, to avoid sharp changes from year-to-year and excessive spending growth at times of buoyant revenues. The focus of expenditure management should continue to shift from control of inputs to specification of outputs, and the link between analysis and decision-making should be tightened.

The pension system should be put on the right track

Ireland faces similar long-term fiscal sustainability pressures from ageing as other OECD countries; although its relatively young population today means that the problem is more distant, there is no room for complacency and it is important to act early so as to be able to deal with later pressures in a gradual way. It is well-placed to tackle these issues as taxation and government debt are low, some pre-funding of public pensions is being undertaken, and the sizeable investment programme will be scaled back well before ageing pressures peak. Yet, public spending on pensions is set to rise by more than 6 percentage points of gross domestic product (GDP) by 2050, more than in most other EU countries, while health and elderly care spending is also likely to rise rapidly. It is important to develop a long-term framework now to ensure the sustainability of public finances and adequate retirement incomes. Substantial increases in the effectively flat-rate state pension have reduced pensioner poverty. The current system will become unsustainable as the population ages, even with the resources in the National Pension Reserve Fund. This will eventually require substantial changes in the overall composition of public spending, in taxation or in the pension system. The standard retirement age should be indexed to longevity and an explicit target for the value of the state pension adopted. The current approach to up-rating public service pensions in payment should be reconsidered. Action should be taken to ensure that disability is not used as a route into effective early retirement and that those with some work capacity remain in the labour market. The recent Green Paper on Pensions has outlined options for reform. This should be used as an opportunity to implement a coherent package of measures that would put the system on the right track for the long term.

Despite increases in the pension level, there is still a large gap for most people between the state pension and an adequate replacement income in retirement. Private pension

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provision is therefore very important. Many people have good private coverage, particularly through employer defined-benefit (DB) schemes, but there is a substantial group without adequate private coverage. The current tax incentives to encourage private pensions are very costly and poorly targeted. These incentives should be reduced and better targeted. A system of capped matching payments, for instance, would be more effective. Alternatively, some degree of compulsion could be considered to raise pension saving, for instance by moving from "opt in" to "opt out" private pensions. If this approach does not succeed in raising pension saving, a fully compulsory scheme may become necessary. The private pension system should be made more efficient. Improvements to the funding standard for DB company pension schemes should be considered. The current emphasis on a "wind-up" test, that requires schemes to be able to buy annuities if the scheme were to close immediately, does not adequately reflect the future funding needs of pension funds and may encourage investment in low-yielding assets.

Migration has helped the economy grow rapidly but more should be done to integrate migrants

Ireland turned from being a traditional emigration country to an immigration country in the mid-1990s. The economic boom has spurred immigration, which got another massive boost after 2004 when Ireland opened its door to the new members of the European Union. Currently, around 15% of people living in Ireland were born outside the country and this share has doubled in just ten years. Immigration has boosted growth, alleviated labour market bottlenecks and kept Ireland attractive for multinational companies. As the majority of migrants are young and employed, they have not put major demands on public services or the welfare system. On the other hand, the rapid population growth has added to infrastructure bottlenecks and fuelled housing demand. With the free movement of people across Europe, the focus should be on better integration.

Immigrants tend to have a higher education level than the native Irish. Yet, they often work in basic jobs and their wages are considerably below average. This suggests that Ireland may not be getting the most out of its immigrant workforce. Language training for adult immigrants should be stepped up as weaker linguistic skills are probably important in explaining the wage gap and international experience suggests that language training on arrival significantly improves future employability. Language support for migrant children is also important to avoid social disadvantages being perpetuated into the future. The number of special language training teachers is rising rapidly. Apart from language issues, job matching can be difficult, if immigrants have trouble getting their foreign qualifications recognised. Despite efforts at harmonisation at the EU level, to which the National Qualifications Authority of Ireland is contributing, certain regulated professions still have licensing requirements, which can be onerous, and the introduction of an on-the-job skill assessment programme for cases where qualifications are difficult to assess should be considered.

The infrastructure programme needs to cope with large uncertainties about future migration flows

In recent years, inward migration was well above the rates assumed in the official population projections. If high levels of inward migration are sustained, they will add to

existing pressures on the physical and social infrastructure. On the other hand, lower inward migration or even a net outflow cannot be ruled out. Uncertainties about population growth pose a challenge for prioritising public spending and infrastructure planning: this relates to the extent and type of demand, as well as its geographic location. In this context, it will be important to extend user charges for infrastructure services. This would restrain demand, result in a more efficient use of infrastructure and help to signal where new investment is warranted. Project evaluation should include an analysis of the optimal timing of projects and choose projects that have the appropriate life span and flexibility. Planning should also seek to take other margins of adjustment into account. For instance, more electricity could be imported from other countries.

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Chapter 1

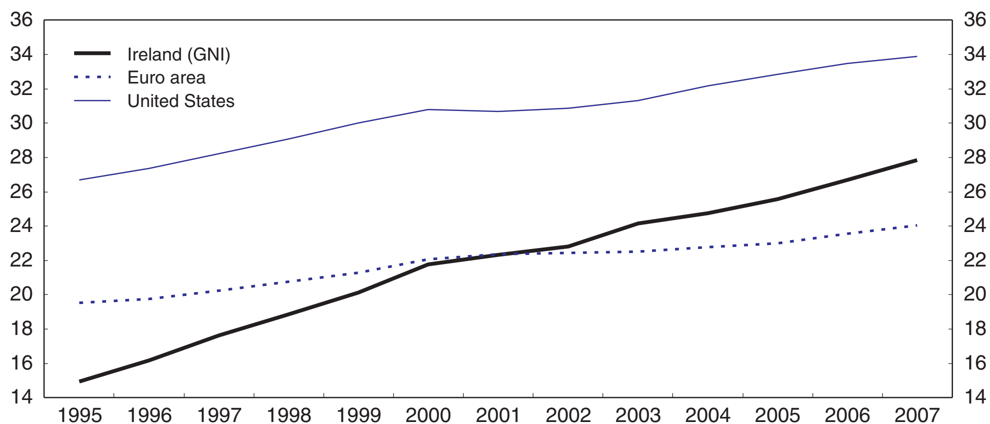
Key challenges

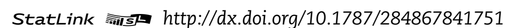
Strong economic activity has been maintained and economic fundamentals remain sound. The end of the long housing expansion will, however, slow growth and presents more difficult challenges than in recent years. In the short run, the economy must adjust to lower housing activity and the risks the slowdown creates. In the long term, maintaining high rates of productivity growth is the key challenge. It is important that Ireland remains internationally competitive. Policy can support productivity growth through achieving stronger competition, improved infrastructure, more innovation, increased human capital and higher labour market participation. Ireland should ensure the stability and sustainability of its economic and social gains. A more efficient housing market would contribute to greater stability and recent international financial market turmoil highlights the need to continue to prepare for financial shocks. Maintaining a prudent fiscal policy as revenue growth slows will help to promote stability, although this will require more efforts to improve efficiency if services are to be improved. Ageing will eventually pose significant challenges that can be reduced if action is taken now to prepare the pensions system. Successful long-term integration will help to ensure that immigration is a success.

Ireland has maintained a very strong economic performance in recent years (Figure 1.1). Growth in income per capita has been among the highest in the OECD, unemployment is low and the country remains an attractive place to do business. It is receiving more than its fair share of foreign investment in high value added sectors and, by opening its borders and having a flexible labour market, it has been a magnet for an astonishingly large number of migrants from Eastern Europe.

Figure 1.1. **Real GDP per capita**

Thousand euros, at 2000 purchasing power parities





Source: OECD (2007), *Economic Outlook 82 database*; IMF(2007), *World Economic Outlook*, October.

The economy is beginning to adjust to the end of the long housing expansion that saw construction and house prices appear to overshoot their long-run sustainable levels. Residential investment has declined and a substantial number of construction workers needs to find jobs elsewhere. Dealing with the short-term adjustment will require labour market flexibility, wage restraint and a prudent fiscal policy.

Over the longer term, the government has ambitious objectives for economic growth and social progress over the next five years, as set out in the 2007 Agreed Programme for Government, and beyond. Sustaining economic growth requires efforts to boost productivity and labour market participation. Further action is needed to remove bottlenecks of physical and human capital as well as to strengthen competition to ensure that Ireland does not price itself out of the global market. In a number of areas, there is the opportunity to set policies on the right path to limit instability and ensure long-term sustainability. This includes housing policy, financial stability issues, fiscal policy, pension reform and the integration of immigrants. This chapter provides an overview of these challenges.

Short-term economic adjustment

The economy is slowing sharply as house-building falls

Growth picked up and the economy grew strongly in the most recent years (Figure 1.2). Activity was largely driven by domestic demand rather than by exports as in the Celtic Tiger era of the late 1990s. Demand was supported by strong consumption, large increases in government spending and a buoyant housing market.

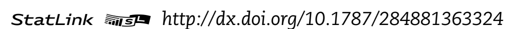
The rapid increase in output during recent years was facilitated by rising employment due to higher rates of labour force participation and strong inward migration, particularly from the new member states of the European Union. Despite these favourable improvements in supply capacity, the buoyant housing market and strong domestic demand led to annual HICP inflation that was above the euro area as a whole throughout 2006 and 2007: the annual rate of inflation on the harmonised measure, which excludes mortgage interest payments, was almost a percentage point higher in 2007 and the national consumer price index (CPI) measure of inflation peaked at above 5% as rising interest payments added to domestic cost pressures. Despite this, the impact on relative unit labour costs of manufactured goods and Ireland's share of world trade has been relatively modest so far.

The strong activity in the housing market that sustained strong economic growth is over (Chapter 2). House prices are falling (Figure 1.3), housing market activity has dropped and loan approvals are down by one fifth on a year ago. In the short run, higher interest rates did much to cool demand but this slowdown was needed to bring down house price inflation and housing activity to more affordable and sustainable levels. It remains likely that the housing market as a whole will not make a hard landing but there is a risk of a larger and more sustained correction.

The pace of economic growth slowed in the second half of 2007 and is likely to remain well below potential in 2008 (Table 1.1). Residential investment, which accounted for more than a sixth of gross national income (GNI) in 2006, is falling very sharply. This will continue to have a substantial impact on the growth of output and employment in 2008. Unemployment is forecast to reach around 5½ per cent. Although growth will be low by Irish standards, it will still be stronger than in many other OECD countries. With the decline in housing projected to bottom out during 2008, growth could strengthen again in 2009.

There is a risk that the fall in housing construction will be greater or more sustained than anticipated. Larger falls in house prices or tighter credit conditions could also slow growth. There is a further downside risk to activity from economic weakness in the United States and the United Kingdom, and the strength of the euro against the dollar and the pound. Ireland is particularly sensitive to these factors due to the direction of its trade flows and the very important role played by foreign investment by US firms.

Figure 1.2. **The 2000s so far**

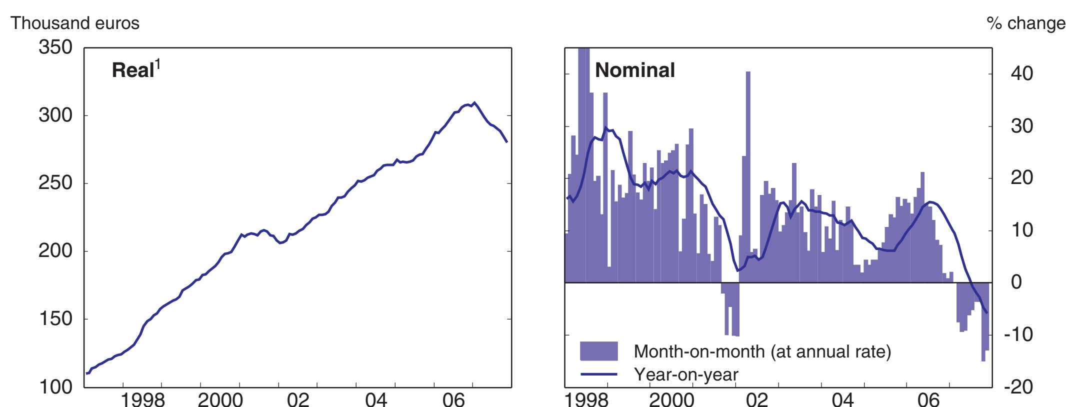
StatLink  http://dx.doi.org/10.1787/284881363324

1. Unemployment in per cent of labour force, employment in per cent of working-age population.
2. Harmonised Index of Consumer Prices, per cent growth over the same quarter of previous year.
3. Public administration and defence, education, health and other services.
4. Estimates from the Central Statistics Office.

Source: OECD (2007), *Economic Outlook 82 database* and Central Statistics Office.

Figure 1.3. **House prices have begun to fall**

permanent tsb/ESRI house price index



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1. In 2006 prices, deflated using the harmonised consumer price index.

Source: Permanent tsb, *www.permanenttsb.ie/house-price-index/*.

Table 1.1. **Short-term outlook**[1]

Percentage change

	Outcomes				Projections	
	2004	2005	2006	2007[2]	2008	2009
Real gross domestic product (GDP)	**4.3**	**5.9**	**5.7**	**5.2**	**2.9**	**4.2**
Private consumption	4.0	7.4	5.3	6.4	4.7	3.8
Government consumption	2.3	4.1	6.4	6.3	5.2	4.5
Gross fixed investment	6.9	12.0	3.0	3.5	–1.8	4.2
Total domestic demand	3.8	7.9	5.7	3.4	2.7	4.1
Net exports[3]	0.4	–0.9	0.6	2.2	0.8	0.6
Real gross national income (GNI)	**3.7**	**4.9**	**6.4**	**5.0**	**3.0**	**4.6**
Memorandum items						
Inflation: Harmonised CPI	2.3	2.2	2.7	2.8	2.5	2.0
Inflation: Harmonised underlying[4]	2.1	1.8	2.5	2.3	2.1	2.0
Employment	3.0	4.7	4.4	3.3	1.5	2.3
Unemployment rate (% of labour force)	4.4	4.4	4.4	4.8	5.6	5.4
Current account balance (% of GNI)	–0.7	–4.2	–5.0	–5.0	–3.8	–3.6
Government net lending (% of GNI)	1.6	1.4	3.4	0.6	–1.2	–1.3

1. Projections are those published in *Economic Outlook* No. 82. Government net lending projections were updated to include later information on the fiscal position.
2. Estimate.
3. Contribution to GDP growth.
4. Excluding energy, food, alcohol and tobacco.

Source: OECD (2007), *Economic Outlook 82 database*, and OECD calculations.

Sustaining robust long-term growth

Long-term growth potential remains high relative to the OECD average. Although gross domestic product (GDP) growth is well below the rates of the Celtic Tiger era of the second half of the 1990s, it has nevertheless averaged over 5% per year since 2001 (Table 1.2). In recent years, activity was fuelled by a substantial rise in the working-age population, reflecting both domestic demographic factors and inward migration, while labour productivity growth has slowed.

It is, however, difficult to disentangle the underlying productivity trend from special factors such as the contribution from the "modern" sector and structural shifts in activity.

Table 1.2. **Decomposition of GDP growth**

Average annual growth rates, per cent

	1989-95	1995-2001	2001-07
GDP	5.3	9.1	5.3
Total hours worked	1.3	3.6	2.4
Of which:			
Working-age population	1.3	1.9	2.4
Employment rate	1.1	3.3	0.8
Average hours	–1.1	–1.5	–0.7
Labour productivity	3.9	5.3	2.9
Of which:			
Capital intensity[1]	0.0	1.5	0.9
Multi-factor productivity	3.9	3.8	2.0

1. Capital intensity defined residually as labour productivity less multi-factor productivity growth.

Source: OECD (2007), *Economic Outlook 82 database*, and OECD calculations.

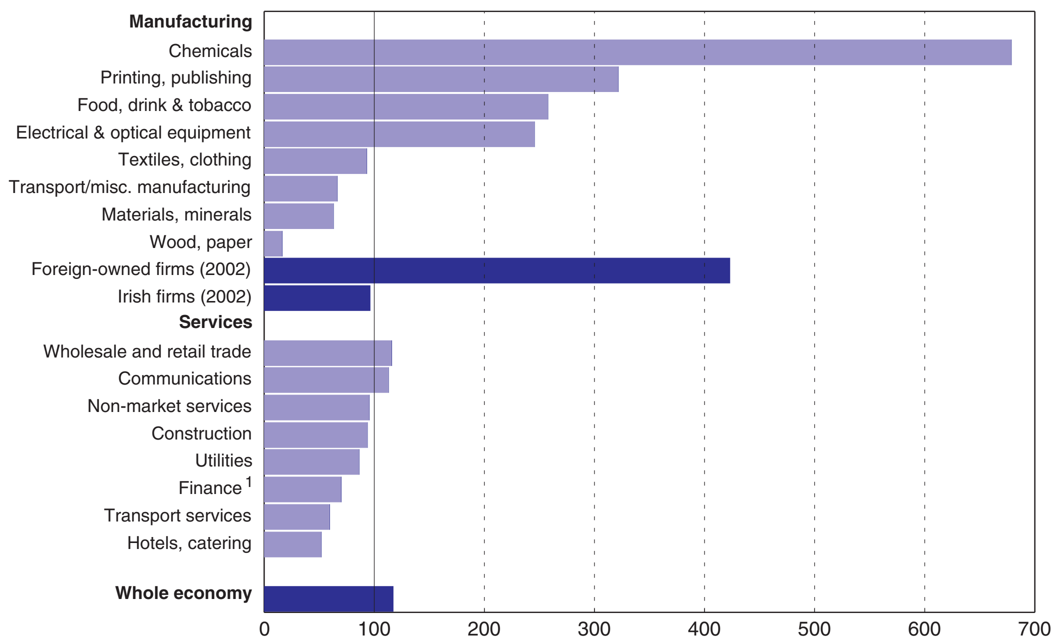
For instance, between 2000 and 2006, the shift in employment away from high-tech manufacturing and towards the relatively low-productivity construction and non-market service sectors has reduced measured productivity growth by nearly 1 percentage point per annum. Some of this will unwind as employment in the building industry falls.

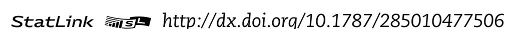
Maintaining productivity growth is the key longer-term challenge

Labour productivity levels in manufacturing are high by international standards. Output per worker is close to or above the EU15 average in most manufacturing industries (Figure 1.4). Foreign multinationals have much higher (measured) productivity than local

Figure 1.4. **Productivity levels relative to EU15**

Gross value added per hour in 2003, EU15 = 100

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1. Finance sector covers financial intermediation, insurance and pension funding (except compulsory social security), and related auxiliary activities. These correspond to ISIC Revision 3 industries 65, 66 and 67.

Source: Cassidy, M. and D. O'Brien (2007), "Ireland's Competitiveness Performance", *Quarterly Bulletin*, No. 2, Central Bank and Financial Services Authority of Ireland, Dublin (based on *Groningen 60-industry database*).

firms and have generated the lion's share of growth over the past decade, but it would be misleading to regard the Irish success story as exclusively driven by the multinational sector as labour productivity in Irish-owned manufacturing firms is respectable in its own right: in level terms, it is close to the European average and has grown relatively quickly over the past decade (OECD, 2006).

In contrast, productivity in several service sectors appears to be less impressive (bearing in mind the difficulties in measuring and comparing service sector productivity across countries). Productivity is below the EU15 average in most service sectors, the exceptions being communications and distributive trades.

Ireland remains highly dependent on foreign trade and investment

As a financial and production intermediary, Ireland has one of the OECD's most open economies. While this has contributed to its impressive economic performance, it has also left it exposed to shocks originating abroad not just because of the scale of its financial and trade linkages but also because these links are concentrated on a small number of partner countries. Total foreign assets and liabilities amount to more than 1 300% of GNI each (Table 1.3). Much of this is portfolio investment through the International Financial Services Centre (IFSC), but even non-IFSC assets and liabilities are large relative to GNI. Approximately half of all liabilities are owed to the United States.[1] On the trade side, exports amounted to around 93% of GNI in 2007 while imports were 80%. Two industries – chemicals, and information and communication technology (ICT) – account for three-quarters of goods exports. These industries are almost entirely US-owned and they sell mainly to Europe.

Table 1.3. **Ireland's international investment position**

Per cent of GNI

	In 2002			In 2006		
	Total	IFSC[1]	Non-[2]IFSC	Total	IFSC[1]	Non-IFSC
Assets						
Direct investment abroad	53	13	39	63	15	48
Portfolio investment	514	438	76	812	693	111
Total[2]	871	680	191	1 345	1 089	256
Liabilities						
Direct investment in Ireland	164	71	92	80	37	43
Portfolio investment	420	351	69	822	698	123
Total[2]	893	635	257	1 352	1 049	303
Net position						
Direct investment	–111	–58	–53	–17	–22	5
Portfolio investment	94	87	7	–9	–6	–4
Total[2]	–22	44	–66	–7	40	–47

1. International Financial Services Centre.
2. Total does not equal the sum of the preceding rows because it includes other investments not shown in the table.
Source: Central Statistics Office.

While swings in foreign direct investment (FDI) have been large, this mainly represents financial transactions rather than tangible projects (Table 1.4).[2] A better gauge of Ireland's attractiveness to foreign investors undertaking physical investment is the number of people employed by overseas firms supported by the Industrial Development Agency and other development agencies. While there have been some high-profile closures of plants by

Table 1.4. **Foreign direct investment**

Per cent of GNI

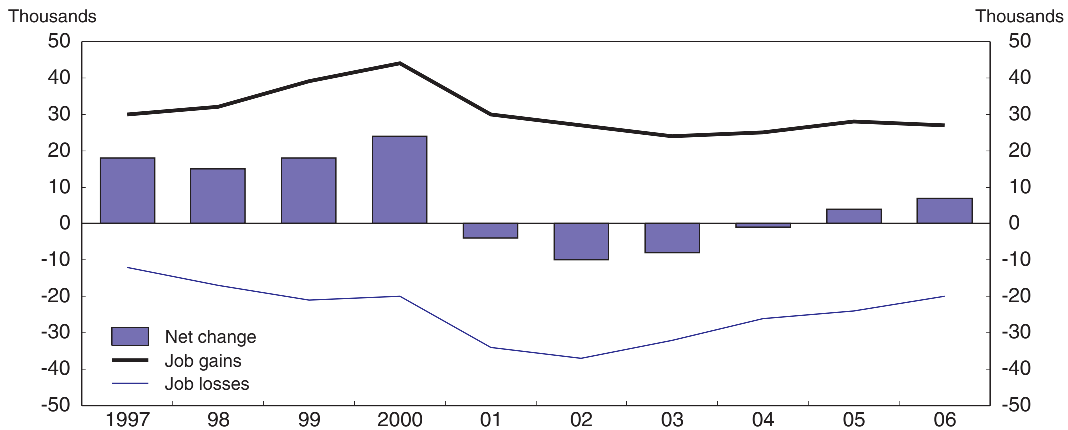
	1998	1999	2000	2001	2002	2003	2004	2005	2006
Investment in Ireland	11.6	22.4	31.4	11.0	29.4	17.2	–6.9	–18.8	–0.5
Investment abroad	5.1	7.5	5.6	4.6	11.0	4.2	11.7	8.5	7.8
Net investment	6.5	14.9	25.8	6.4	18.3	13.0	–18.6	–27.2	–8.3

Source: Central Statistics Office.

foreign multinationals, the rate of job losses has declined since 2002 and the entry of new firms means that net job creation returned to positive territory in 2005-06 (Figure 1.5). The type of FDI projects that Ireland attracts continues to change with a larger share of financial services and ICT activity. FDI in the life sciences, including pharmaceuticals, healthcare and biotechnology, has been strong: Ireland received a quarter of all the FDI into Europe in the life sciences area in the year to June 2007.

Figure 1.5. **Employment in development agency assisted companies**

Full-time employment in manufacturing and internationally traded financial services



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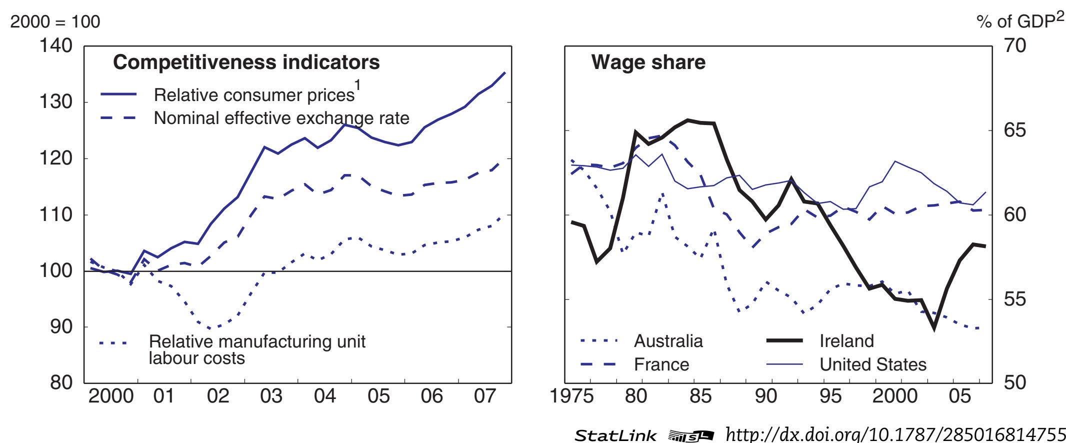
Source: Forfás, *Annual Employment Survey*.

Competitiveness needs to improve to boost exports

Long-run growth prospects depend heavily on export performance as the Irish economy is particularly open. More immediately, higher net exports would boost demand and ease the adjustment process following the downturn in housing construction. Ireland has been losing competitiveness since the year 2000 as measured by relative consumer prices (Figure 1.6). The nominal exchange rate has appreciated, and wages and consumer prices have been growing faster than in its trading partners. But unit labour costs in the more export-orientated manufacturing sector have risen less sharply since 2000, initially falling, as wages in that sector have kept more in line with productivity growth. As a result of the developments in competitiveness, the improvement in Ireland's share of world exports has stalled and even fallen back modestly since 2002. The contribution of net exports to growth has been small or negative in recent years (Figure 1.7). But even more or less maintaining market share is a reasonable performance given the growing weight of emerging economies in world trade. Since the late 1990s, Ireland has gained market share

Figure 1.6. **Indicators of competitiveness**



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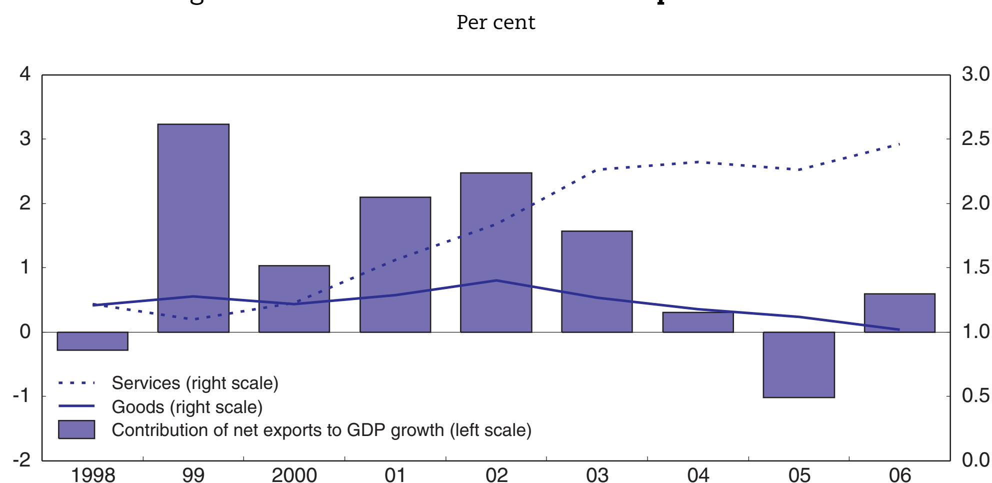
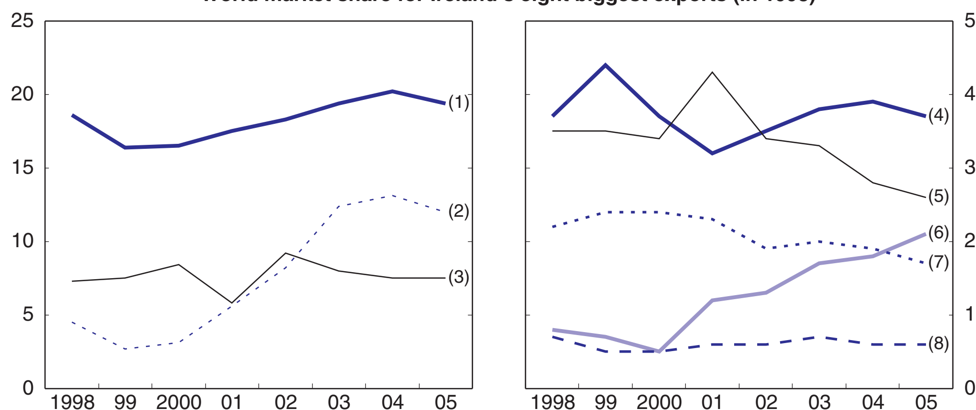
1. Relative consumer prices in terms of consumer price indices.
2. GDP at factor cost. GNI for Ireland. Wage share excludes self-employment income.

Source: OECD (2007), *Economic Outlook 82 database*.

Figure 1.7. **Ireland's share of world export markets**

Per cent





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(1) Computer services; (2) Financial services (including insurance); (3) Chemicals and pharmaceuticals; (4) Meat products; (5) ICT manufactures; (6) Business services (other); (7) Recorded media; (8) Transport and travel services.

Source: UN, *Comtrade database* and OECD calculations.

in financial and business services and has more or less maintained the share in most other categories except ICT manufactures and recorded media.

The dilemma now facing Ireland is that improved competitiveness would help macroeconomic adjustment in the short run, but there are signs that exports are becoming *less* competitive: relative manufacturing unit labour costs have risen by 7% over the past two years and the share of national income going to wages has been rising sharply since 2003 (Figure 1.6, right-hand panel). The rise in the wage share is even more striking considering that it goes against the international trend. These indicators suggest that the loss of competitiveness may be starting to become a serious problem. Although it is natural that wages in Ireland should rise in line with productivity growth, these natural or equilibrium forces may have been overtaken by disequilibrium effects. Wage growth does not appear to have responded quickly enough to the slowdown in productivity growth; strong construction activity has put additional pressures on demand; and there are concerns about whether the increase in public expenditure and wages has been fully justified in terms of efficiency (Chapter 2). Unless wage and price inflation are reined in, the export sector will not be able to contribute either to short-term adjustment or the long-run improvement in living standards. Real wage growth needs to be limited to increase in line with productivity or by even less in the short term. Competitiveness problems are exacerbated by rapid increases in non-wage costs as diverse as electricity prices, insurance premiums, office rents and local authority charges.

Policies to underpin growth

Ireland faces policy challenges to maintain strong growth. These include boosting competition, upgrading infrastructure, generating more innovation, raising human capital and increasing labour market participation. These issues were covered extensively in the previous *Survey* and are the policy priorities identified in the OECD's *Going for Growth* study (OECD, 2007). There remains scope for progress in these areas. This section provides an update on policy actions and highlights outstanding weaknesses that need to be addressed.

Stronger competition would boost productivity and reduce costs

Ireland compares well with other OECD countries when it comes to the regulatory environment. Overall regulation of the business sector is relatively light-handed and competition-friendly. Nonetheless, there are still too many sheltered sectors where competition is restricted and where the interests of producers and suppliers are favoured over the interests of consumers (Table 1.5). Boosting competition in these sectors would help to reduce prices, make Irish firms more competitive and raise productivity.

The need to increase competitive pressures remains in some of the network industries:

- In the *electricity sector*, the main problem continues to be the market power of the state-owned Electricity Supply Board (ESB). It currently owns the transmission network and has a large share of the generation capacity. Its dominance contributes to higher prices: one study estimates that 30% of the gap in electricity prices between Ireland and the average EU country can be explained by inefficiencies in the Irish market.[3] The previous *Survey* and the *Review of Energy Policy* conducted by the International Energy Agency (IEA, 2007) recommended a range of measures to reduce ESB's dominance.

Table 1.5. **Progress in structural reform: Competition policy**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Consider giving the Competition Authority power to impose sanctions. Review the Authority's staffing. Reduce the costs and delays of court proceedings.	No progress, but the Competition Act 2002 is under review.
Abolish the Groceries Order. Revise the retail planning guide to allow bigger stores.	The Groceries Order was abolished in 2006 leading to a noticeable drop in (relative) prices.
For pharmacies, replace the 50% retail mark-up with a flat dispensing fee, auction the right to run a pharmacy and abolish the "three year" rule for pharmacists who were not trained in Ireland.	The pharmacies sector was reformed in 2007. The government intends to abolish the three-year rule at an unspecified future date once other regulatory reforms are bedded in.
Remove the ceiling on the number of pub licenses.	No progress but the alcohol legislation is up for review in 2008.
Remove unnecessary restrictions in the legal profession including abolishing the bar council's monopoly on legal training. Speed up the registration process for foreign professionals.	There have been some minor reforms regarding barristers but other competition restrictions remain in place. The government has not responded to the Competition Authority's recommendation for an independent regulator.
Integrate the electricity market with Northern Ireland and the rest of the United Kingdom. Split up ESB by separating the transmission grid from the generation capacity. Consider splitting generation into competing firms.	An all-island wholesale electricity and gas market took effect in November 2007. By the end of 2008, ownership of the transmission network will be transferred from ESB to EirGrid. The regulator has ordered ESB to sell some generation plants to reduce its market share to 40% by 2010.
Liberalise the bus market. Appoint an independent regulator and remove restrictions on the number of bus routes that can be operated by private firms.	In the Programme for Government, the government has committed to improving bus services by reforming the bus licensing legislation. The European Commission is investigating whether state aid to bus companies is legal.
Reduce state ownership.	No progress.

- In the *telecoms sector*, the main issue is the slow rollout of broadband. Eircom, the telephone incumbent, dominates the market and the regulator (ComReg) has persistently criticised Eircom for dragging its feet over local loop unbundling.[4]
- The *bus market* is also relatively sheltered as private companies are restricted from competing with the state-owned bus firm on certain routes, and the regulator is not independent.

Unnecessary restrictions crop up in other sectors including the *licensed trades* such as the legal, medical, dental and veterinary professions. These rules are sometimes put in place to protect the public but they can be out of all proportion to their objectives. All EU countries are currently doing a stock-take of restrictions in the service sector as part of implementing the services directive. This provides a good opportunity for Ireland to clear away these barriers to competition and trade.

A reduction in *state ownership* could also improve economic efficiency. Today, government-owned firms have a monopoly or dominant position in the postal, energy, transport, health insurance, television and forestry industries. The government also has a minority shareholding in the national flag-carrier airline. Even if there are no explicit rules that favour them, state-owned enterprises can enjoy a competitive advantage through more gentle regulatory oversight, a lower cost of capital due to implicit guarantees, implicit subsidies or cross-subsidies and the dominant position they may have inherited from their days as protected monopolies.

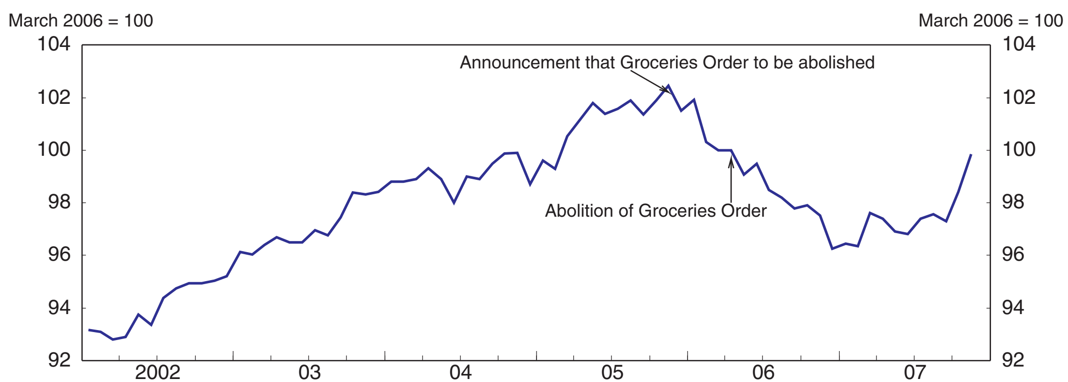
A general problem with the *competition framework* is that enforcement can be difficult because it has to use criminal law processes and meet criminal law standards of proof. However, progress has been made recently with the Irish Competition Agency securing 18 criminal convictions in a cartel case and this is encouraging for the strategy of using the criminal law: the Irish competition authorities are the first in Europe to get a custodial

sentence for a breach of competition law. The Competition Act is under review. It may be useful to include clearer guidance regarding fines since the penalties handed down so far have typically been light.

Despite these weaknesses, there has been solid progress in several areas since the previous *Survey*. First, the Groceries Order, which prevented price competition for basic foodstuffs, was abolished. This has been a notable success for competition policy: since the Order was abolished, the relative price of those items has fallen sharply (Figure 1.8). Second, restrictions on foreign-trained pharmacists, which were a major barrier to competition in the sector, will shortly be removed. Third, the powers of the telecoms regulator were greatly strengthened in April 2007. Just one month later, it reached agreement with Eircom to resolve all substantial matters holding back the local loop unbundling process. Fourth, the electricity regulator ordered ESB to sell some of its generation plants to reduce its market share. In addition, an all-island wholesale electricity and gas market was implemented in November 2007. It will have an independent market operator and ESB will no longer own the grid.

Figure 1.8. **Relative price of items covered by Groceries Order**

Relative to similar items not covered by the Order[1]



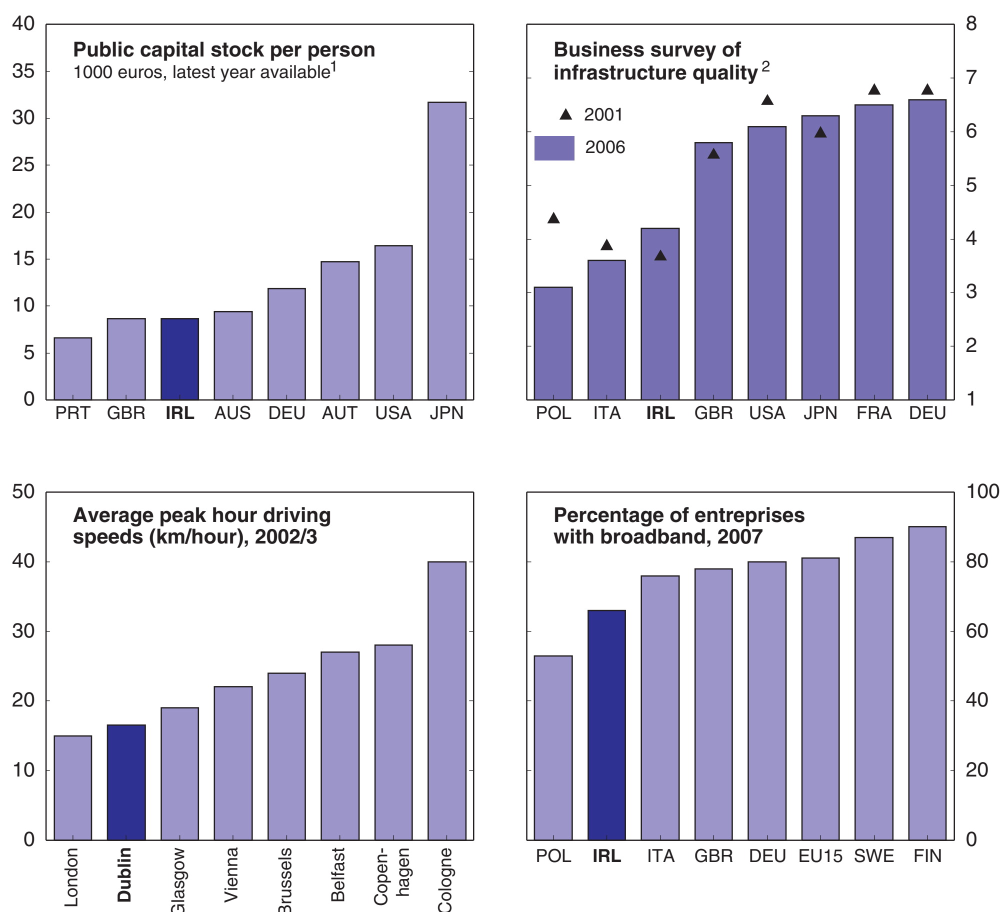
1. Groceries Order items included elements of food and non-alcoholic beverages, off-licence alcohol and household non-durable goods. Non-Groceries Order items included elements of foods and non-alcoholic beverages and household non-durable goods.

Source: Central Statistics Office, *CPI release*, *www.cso.ie/releasespublications/documents/prices/current/pic.pdf*.

Infrastructure bottlenecks may be holding back growth

Soaring activity and rapid population growth have created a number of infrastructure bottlenecks. Major pressures are evident in roads, airports, electricity transmission, landfill, waste water treatment and broadband internet (Figure 1.9). In 2007 a global business survey ranked Ireland 25th in the OECD for the quality of its infrastructure, one place better than its 2002 ranking. These bottlenecks can have direct economic consequences, especially since foreign investors put a high weight on the quality of infrastructure when deciding where to locate. They can also have environmental and social consequences, such as pollution and long commuting times. While Ireland has one of the lowest levels of public capital in the OECD, it has one of the highest rates of public investment – higher even than some transition economies such as Hungary and Poland. So far this decade, public investment has averaged around 4½ per cent of GNI.[5] The latest National Development Plan (NDP) envisages average investments (including PPPs) of about 6% of GNP over the lifetime of the plan running

Figure 1.9. **Indicators of infrastructure**



StatLink http://dx.doi.org/10.1787/285085883828

1. At 1995 prices, using 2000 purchasing power parities. Data cover 2004 for Ireland, 2000 for other countries.
2. A high score indicates a high quality of infrastructure.

Source: OECD (2006), *OECD Economic Surveys: Ireland*; World Economic Forum (2002, 2007), *The Global Competitiveness Report* 2001-2002 (resp. 2006-2007); National Competitiveness Council (2007), *Annual Competitiveness Report* 2006, Vol. 1; Eurostat (2008), *Information Society Statistics*, online database (January).

to 2013.[6] This includes the ten-year *Transport 21* plan that covers some large-scale public transport and road projects. But even with this amount of spending, it will take until 2020 before the level of public capital per person reaches the OECD average and policy action is needed to speed up infrastructure projects, improve infrastructure planning and to allow for a better use of infrastructure services (Table 1.6).[7]

The innovation system should be enhanced

Maintaining strong rates of productivity growth will require a greater focus on research and innovation. A key challenge is to increase innovation capacity in Irish-owned firms. Having a stronger domestic research base would make it easier to deliver home-grown innovation and to capitalise on advances made abroad. While business expenditure on research and development (R&D) has increased in recent years, it remains low by OECD standards. Most of the research in the private sector is undertaken by foreign multinationals, but even then they do most of their research at home. Ireland needs to improve its

Table 1.6. **Progress in structural reform: Upgrading infrastructure**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Reduce the length and uncertainty of challenges during the planning process. To guarantee a balance between giving due regard to the concerns of people affected by projects and the need to ensure that public goods be delivered timely and efficiently:	53 major infrastructural projects have been submitted directly to the Planning Board for fast-track planning permission.
• Restrict the possibility of challenging planning decisions to persons whose financial interests would be affected by the project.	No change.
• Introduce a "silence is consent" rule to give the planning board greater incentive to comply with its statutory deadlines.	No change.
Ensure that projects deliver benefits greater than costs. To this end:	
• Suppress the possibility of avoiding a cost-benefit analysis.	Full cost-benefit analysis is now required for all projects worth more than € 30 million and measures have been taken to ensure compliance.
• Create an independent central unit responsible for the oversight and quality control of cost-benefit analyses.	A unit has been set up in the Department of Finance to promote best practice.
Avoid over-investment in infrastructure and ensure its efficient use by generalising user charges. For example:	
• Charge the full cost of providing drinking water and collecting and treating sewage.	Meters for most non-domestic users are in place by end 2007. Households continue to receive free water.
• Introduce a congestion charge in central Dublin when public transport alternatives improve.	Action will not be required until more of the Transport 21 plan has been completed.

framework conditions and ensure a ready supply of skilled researchers in order to capture a greater share of this research. At the government level, Ireland has been a late starter in investing in research. Funding for R&D has more than doubled since the late 1990s, but when measured as a share of GNI it remains on the low side compared with other countries. Staffing bottlenecks are among the factors that have limited the growth of R&D expenditure until now. The number of people graduating with a PhD each year is below the OECD average, however the Strategy for Science Technology and Innovation (SSTI) launched in June 2006 aims for a doubling in the number of PhD graduates. The implementation of the Strategy forms a central plank of the NDP and will involve expenditure of € 8.2 billion over the period of the Plan, € 3.2 billion of which will be accounted for by the higher education sector. There has been an increase in the number of high-level science researchers in Ireland as a result of additional funding through Science Foundation Ireland (SFI).

The previous *Survey* put forward some suggestions for refining the science framework in order to get the most out of the relatively limited innovation budget (Table 1.7). For

Table 1.7. **Progress in structural reform: Research and innovation**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Improve economy-wide framework conditions as they are the most important determinant of R&D.	Ongoing.
Consider rebalancing the science budget by making more use of market-led measures and scaling back direct grants. Evaluate the new tax incentive, and if successful channel more funding through it.	A new Science, Technology and Innovation (STI) strategy puts more emphasis on industry led initiatives. The tax credit was made more generous in both 2006 and 2007.
Consider whether public funding is being spread too thinly and whether Ireland would be better off concentrating its resources in a small number of world-class centres of excellence.	The Strategic Research Clusters (SRCs) programme aims to bring together internationally-competitive researchers from academia and industry in key areas such as biotechnology.
Improve co-ordination among the different players. In particular, infrastructure spending needs to be better aligned with programme funding and with the investment being made in human capital. Review the structure of the innovation system to see whether combining some of the agencies would be the best way to improve coherence. There may be a need for fewer but more specialised business incubators.	Ongoing through various bodies and committees.

example, there are many funding streams that overlap to some extent, and a tidy-up may be helpful. As in many countries, universities could make greater efforts to commercialise their research and build links with industry. Finally, funding may be spread too thinly. It might be better to focus on a small number of centres of excellence rather than promoting research centres in regions that may not be able to attain critical mass. Greater amalgamation and specialisation among institutions may therefore be useful.

Education policy should aim to match the best countries

The sharp increase in educational attainment of the adult population has been an important factor behind Ireland's success. Even so, Ireland is well below the OECD's best performers in terms of the quantity and quality of education. Its economic structure and its ambitious target for R&D both require a more skilled workforce than the average country.[8] There is room for improvement at all levels of the education system (Table 1.8). For example:

- Pre-school attendance remains low while classes are large and of short duration. Other areas of the education system have been given greater priority. The recent expansion of childcare places, however, gives a good opportunity to move towards an integrated childcare system that combines pre-primary education with crèche-based day-care at the same location. International experience has shown that this is best for children and provides greater parental satisfaction.
- In secondary schools, the OECD's PISA study shows that Irish 15-year olds do well at reading while their performance in mathematics and science is average. One issue is insufficient help for pupils who are struggling. Targeting special assistance programmes on children who have learning difficulties is more efficient than focussing help on children who come from disadvantaged backgrounds. As a result of the "mainstreaming approach", there are few remedial or catch-up programmes for children who fall behind while a number of special programmes are targeted at those from difficult backgrounds. Spending on special education has doubled since 2004, which has in part allowed more teachers and Special Needs Assistants to work solely with children in need of additional help. More intensive and better targeted catch-up programmes will become increasingly important as the children of migrants, many of whom do not speak English at home, start to enter the school system.

Table 1.8. **Progress in structural reform: Education**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Invest more in pre-primary schooling by:	
• Generalising pre-primary education from the age of three.	No progress.
• Avoiding infant classes of more than 30 children.	Average class sizes at *primary* level have fallen and the staffing schedule currently provides for an average 27 children per class, but class sizes remain determined locally.
• Expanding the duration of daily classes.	No progress.
Improve outcomes in primary and secondary education by targeting efforts on children with learning difficulties rather than on those from disadvantaged backgrounds.	Funding and resources for special needs education are substantially higher.
Give universities the means to increase their resources and the incentive to be more responsive to students' needs by levying fees that students (including part-time students) repay from their subsequent earnings. Public funding should not be cut back as fees increase.	No progress.

- Funding per student in tertiary education is around the OECD average, following recent increases in funding, but substantially below the best performers. Higher education institutions are constrained in their ability to expand and attract high quality staff from abroad. The funding situation is partly because undergraduate tuition fees were abolished in 1995.[9] This was done to improve equality of access but while significant improvements have been made in this regard, the goal has not been achieved. The economic and equity arguments for students paying a greater share towards the cost of their tertiary education are strong. Ireland should consider the system in Australia, New Zealand and the United Kingdom with upfront tuition fees that can be covered by a loan, repaid later when the individual begins to earn above a certain threshold. Aside from bringing more funding into the system, this type of scheme can make education institutions more innovative and more geared to the needs of students. It can also raise efficiency by encouraging students to choose more useful courses and not waste time in their studies. Some structural re-organisation may also help to obtain better quality and value for money at the tertiary level. The OECD's *Review of Higher Education in Ireland* in 2005 made several suggestions, such as greater management autonomy and more specialisation and amalgamation among the smaller institutions in order to reach critical mass. Greater flexibility, such as evening and weekend courses, will become more important to help working adults up-skill without dropping out of the workforce.

Participation can be raised further

While immigration has been a main source of labour supply growth in recent years, there are areas where indigenous labour supply can be raised substantially such as the participation of women. To some extent this will happen naturally as cohort effects and changing cultural attitudes work their way through, but the increase could be stronger with some help from policy reforms (Table 1.9).

Table 1.9. **Progress in structural reform: Female participation**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Encourage more out-of-school-hours care where school facilities are suitable.	Recent budgets have allocated funding in this area, and school boards are becoming more willing to offer their facilities.
Implement plans to increase the supply of training places for childminders.	No progress yet, but there is a target of 17 000 new training places by 2010.
Over time, link childcare support such as the Early Childcare Supplement to employment status or to the use of formal childcare.	The government moved in the opposite direction by raising the universal Child Benefit by up to 7% in the budget for 2007 without making it more targeted. It also changed the subsidy system for childcare support so that recipients of social welfare get substantially more than working parents.
Phase out the Home Carer's Tax Credit.	No progress.
Give priority access to community childcare to working parents, especially lone parents.	Priority is given to disadvantaged parents, especially those on welfare.
In order to reduce child poverty, provide job-search assistance and childcare support to lone parents. In return, boost job search requirements for lone parents on income support whose children are of school age. Consider allowing lone parents to keep some of their benefit for a limited time after going back to work. Raise the threshold from which the One Parent Family Payment starts being withdrawn and reduce its phase-out rate.	A substantial reform of lone parent support is under consideration. It proposes a mutual obligations approach, including some job search requirements. The upper income threshold for entitlement to the one parent benefit was raised in the budget for 2007.
Continue reducing average and marginal effective tax rates on second earners. Consider moving to individual taxation.	The top rate of income tax has been reduced to 41% and average rates reduced through higher thresholds and allowances.
Introduce fines for employers found in breach of Equal Pay legislation.	No progress.

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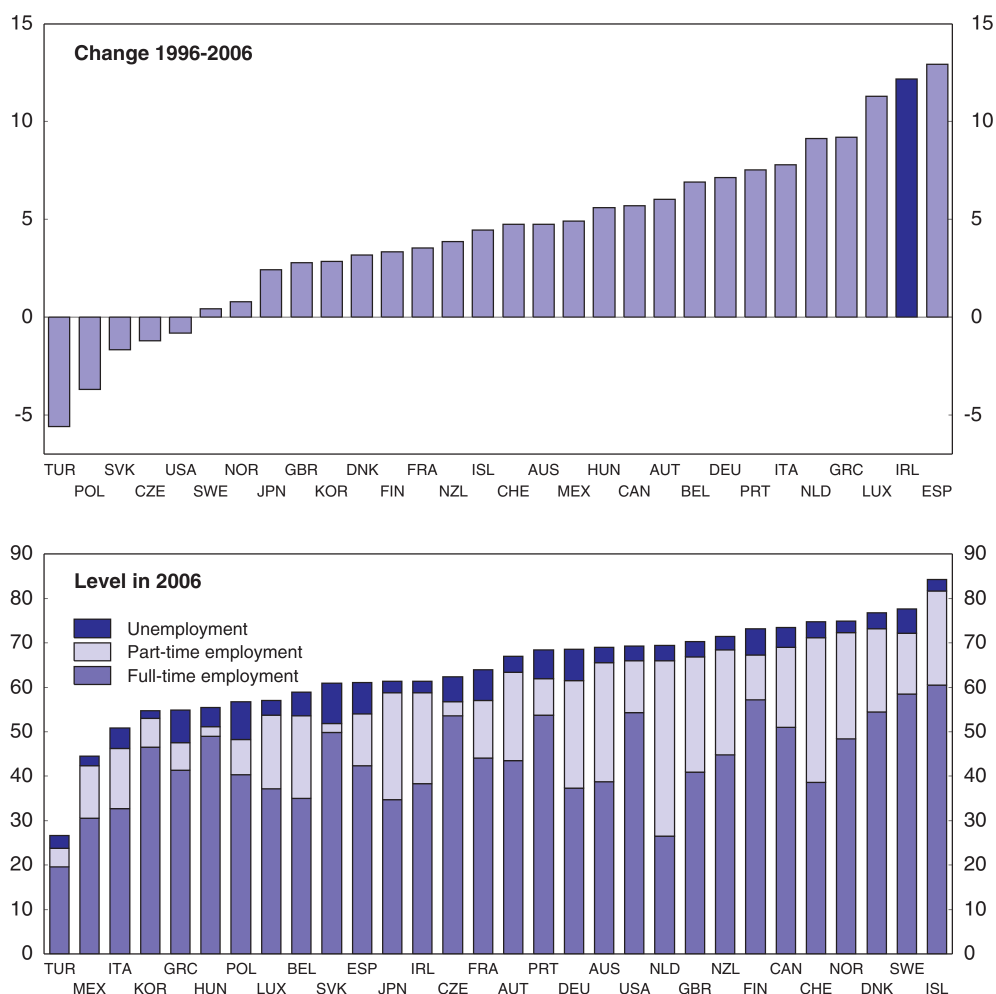
While the female participation rate has increased enormously over the past decade, it started from such a low base that it is still below the OECD average (Figure 1.10). Part-time employment is more common in Ireland than elsewhere, so the effective female labour supply is well below average. Women with children have a very low participation rate by OECD standards. As argued in *Going for Growth* (OECD, 2007), raising pre-school attendance by children is also important for developing Ireland's human capital.

Figure 1.10. **Female participation has risen a lot but is still low**

Percentage of women aged 15-64 in the labour force



StatLink http://dx.doi.org/10.1787/285107263173

Source: OECD (2007), *Labour Force Statistics – online database*, September.

Part of the problem is that there are not currently enough childcare places, though the National Childcare Strategy is helping to fix that. It includes the construction of childcare facilities and aims for 50 000 extra places by 2010. When fully up and running, it will bring the coverage rate of formal childcare close to the current OECD average. Rather than concentrating on expanding supply, a more balanced policy would put greater focus on the demand side by providing income support to make childcare more affordable. There are limits to how quickly this could be done because if demand grows more quickly than

supply, it is likely to simply raise costs in the sector. The government already spends a considerable amount on child benefits and child benefits have been raised by 85% since 2004.[10] But this expenditure is poorly targeted as the Child Benefit and the Early Childcare Supplement are cash transfers that are paid whether parents are working or not and regardless of whether they are actually using childcare services. Ireland could get significantly greater value for money if support was linked to employment, job search or the use of formal childcare services (OECD, 2003). It has chosen not to go down this route because of a perception that it would discriminate against mothers at home. However, it is important to convince the public that the tax-benefit system is already biased against mothers at work, so a more targeted approach would not only deliver better value for money but would make the system fairer as well.

There is also a scarcity of out-of-school-hours care. In the past, school boards have been reluctant to open up their facilities for after-school programmes, but a few trail-blazers have succeeded in changing the attitude of some of the more hesitant boards. There is a target of 5 000 new out-of-school-hours places by 2010 and, while this seems achievable, it would cover less than 1½ per cent of the population aged 6-12. The government should ensure that public investment in school buildings also benefits communities after school hours, which would help to raise after-school provision of childcare, improve value for money and avoid the need to ferry children from one location to another.

The country also suffers from having a large number of single parents whose employment rate is low by OECD standards. This has clear economic costs, but the social costs associated with child poverty are far more important. The best way to reduce child poverty is to help parents return to work. The problem in the past has been a hands-off welfare system that does not encourage lone parents to work even part-time combined with a high effective marginal tax rate if they shift from a part-time to a full-time job. This is changing for the better. The Community Childcare Subvention Scheme (CCSS) helps provide childcare to disadvantaged families through grants to community providers enabling them to charge reduced fees to parents based on their ability to pay. The government also plans to move towards a mutual obligations approach for single parents. The details have not yet been worked out, but the proposal is to provide greater support for training, job search and childcare combined with a work requirement after the youngest child reaches a certain age. It is essential for these activation initiatives to be successful that the public employment service (FÁS) has sufficient resources to activate people effectively and meet additional demands as more people are covered.[11]

The income tax system also contributes to reducing the incentives for second-earners to work full time, though the problem is less severe in Ireland than in some other European countries. Ireland has a hybrid income tax system that is somewhere between individual and joint taxation of household members, with the consequence that second earners can pay the highest marginal tax rate (48%, including social contributions) at a relatively low income level.[12]

Setting policies to underpin stability and sustainability

In the short run, the major challenge is to keep the economy on a stable path; in the long run, the sustainability of economic and social progress needs to be ensured. This *Survey* discusses these issues in depth. The functioning of the housing market should be

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improved and gradual change needs to start soon, before the next upturn begins. The downturn in the housing market and international financial market turmoil has highlighted the need to be prepared for shocks to the financial system. Slower revenue growth will put a premium on maintaining fiscal prudence and progressing in the on-going efforts to improve value for money from government spending. Ageing will pose fiscal challenges in the long term. The special chapter focuses on how to ensure that the recent boom in migration results in the successful longer-term integration of migrants.

Support for housing should be more efficient and promote stability

Over the past decade, Ireland has enjoyed the largest increase in house prices in the OECD, though prices started at a low level. The increase was propelled by the large rise in disposable income and low real interest rates. Demographic changes also spurred the market, with strong growth of the population at the age where people tend to buy a house, while the average number of people per dwelling has fallen. And there has been significant immigration. However, house prices have overshot and are now declining. The most likely scenario is a rapid adjustment in house-building to a more sustainable level and some further decline in house prices. To help avoid volatility in the housing market, which is difficult to cope with in a monetary union, the newly-created Commission on Taxation should review the taxation of housing (Chapter 2).

Ireland has a high rate of owner occupation of housing partly reflecting Ireland's social and cultural preferences. Although this may have some benefits, it is partly the result of costly and inefficient policies that distort the housing market and increase the role of housing in the economy as a whole. The tax treatment of housing is very favourable and the ceiling on mortgage interest tax relief for first-time buyers has been increased. Support should be reduced and better targeted. This would lead to a better use of resources and could help to dampen future housing cycles. Phasing out mortgage interest relief, or introducing a well-designed property or capital gains tax would be desirable. The abolition of stamp duty on housing transactions for first-time buyers and rationalisation of the regime for others, leading to lower payments for most buyers, will help to make the housing market more efficient and flexible. Housing support for those with low incomes is focussed on building new houses. This approach is costly and only provides immediate help to a small number of people. It would be more effective to provide means-tested housing benefits or vouchers that could be used to pay either a mortgage or rent.

Lending growth and international financial market turmoil have raised issues for the financial system

As well as the buoyant housing market, the commercial property market and the construction industry have also expanded very rapidly. Bank lending rose substantially in the context of very low real interest rates and more relaxed lending conditions. The private sector debt-to-income ratio now exceeds 200%, up from 100% in the late 1990s, and is high by international comparison, with a heavy concentration of lending in the property and construction sector. The Central Bank and Financial Services Authority of Ireland (CBFSAI) clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. In addition, Irish banks are funded to a considerable extent by issuing securities and borrowing in the interbank market, which has also raised concerns.

The CBFSAI has taken action to reduce risks, including higher risk weightings on some assets, an improved regime to monitor liquidity and the implementation of a new

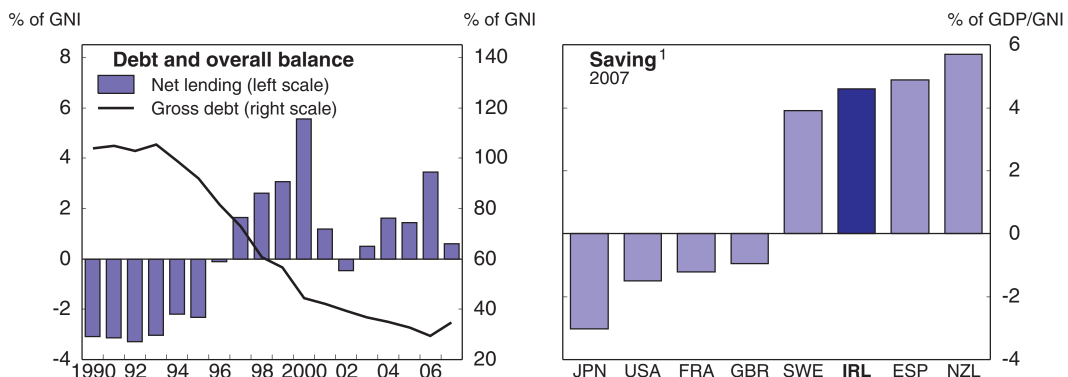
Consumer Protection Code to avoid predatory lending practices. The slowing in house prices and subsequent decline since mid-2007 has eased a key concern, as it brings house prices closer to fundamentals, improves housing affordability and helps to stabilise repayment burdens for new borrowers. Internationally, the ongoing financial market turmoil has led to a liquidity squeeze, higher funding costs for banks and a tightening in lending standards. It has also raised transparency issues about banks' exposures and credit lines to structured investment vehicles, hedge funds and private equity. A survey undertaken by the CBFSAI indicated that exposure of mainstream Irish banks to the sub-prime market was low, with Irish credit institutions reporting very limited exposures to the US sub-prime market, while banks' investment in residential mortgage-backed securities is small. Irish banks are profitable and well-capitalised, so that they should have considerable shock-absorption capacity. But the financial system should also be prepared to deal with downside risks. The EU Deposit Guarantee Schemes Directive is under review and Ireland should consider the design of its own scheme when the European framework is settled (Chapter 3).

Fiscal policy should adapt to lower revenue growth

The fiscal position was strong in the years up to 2006, despite one of the largest increases in public spending in the OECD, owing to the rapid expansion in revenues (Chapter 4). The general government account has been close to balance or in surplus since 1995 and public debt has become very small (Figure 1.11). The level of public savings (current revenue minus current expenditure) was one of the highest in the OECD and this has left ample room to fund longer-term capital investment. Around 4½ per cent of GNI has been spent on public investment so far this decade.[13] By law, 1% of Irish GNP is put into a pension reserve fund in order partly to pre-fund future pension liabilities.

Figure 1.11. **Fiscal performance has weakened**

General government sector



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1. OECD estimates; current revenue less current expenditure. Ireland in per cent of GNI. *Outlook* projections for Ireland updated to include later information on the fiscal position.

Source: OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Revenue growth, however, slowed sharply in 2007 and the fiscal balance fell to around 0.6% of GNI from 3.4% the previous year. Stamp duty and corporation tax receipts were lower in 2007 than the previous year, although the latter was partly anticipated due to negative cash flow effects from bringing forward the payment date for preliminary

corporation tax. Stamp duty receipts are expected to decelerate further in 2008. This weakness in revenues, alongside the planned slowdown in expenditure growth, is anticipated to lead to a deficit of around 1¼ per cent of GNI for 2008 and 2009. Recent developments highlight some fragility in elements of tax revenue (Chapter 4). In the longer term, distortionary and costly tax expenditure should be eliminated where these cannot be shown to be effective. A Commission on Taxation has been established to consider these issues, as well as others such as the financing of local government and a carbon tax.

Spending growth is planned to slow in the coming years but will continue to be fairly rapid in 2008. Implementation of the NDP and infrastructure investment has been given priority and fiscal plans remain prudent overall. However, it is important to avoid locking in generous long-term social expenditure and public sector wage commitments at this point of the revenue cycle.

With revenue growth likely to be constrained over the next few years, the public sector will need to give more emphasis to boosting efficiency and effectiveness. Steps have already been taken in this direction but more needs to be done. A review of the Irish Public Service by the OECD, which has been commissioned by the Irish government, is currently underway.

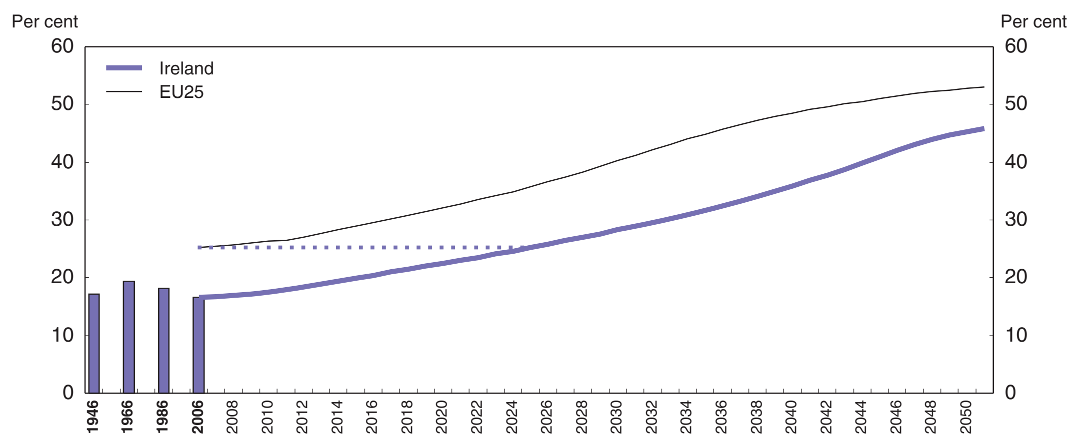
In the future, it is important that additional expenditure leads to an increased volume and quality of public services rather than being absorbed in wages and prices. The second Public Sector Benchmarking Body report has shown that wages in the public sector compare well with those in private firms, in part due to more generous pension entitlements, and that no substantial increase in public sector wages is necessary.

Population ageing will put substantial pressure on public finances in the long term

Looking to the longer term, Ireland faces one of the sharpest increases in age-related public spending in Europe, largely because its young population means that it is starting from a low base. Currently it has one of the youngest populations in Europe. It has some time on its hands: it will not be before 2025 that the old-age dependency ratio rises to the level that the EU25 faces today (Figure 1.12). But this should not be seen as an excuse to put

Figure 1.12. **Old-age dependency ratio**

Population aged over 65 relative to working-age population



StatLink http://dx.doi.org/10.1787/285131038583

Source: Eurostat and Central Statistics Office.

off some needed expenditure reforms such as a redesign of the pension system (Chapter 5). Many other European countries have left it too late, while Ireland has the luxury of being able to start early and therefore spread the adjustment over a longer time period. As the population ages, it will become increasingly difficult to provide an adequate retirement income for older people and maintain a fiscally sustainable pension system. Increases in benefits have reduced old-age poverty but there is a gap for most households between the state pension and a reasonable replacement income in old age. Ireland relies heavily on private savings to close this gap but many people are not saving enough. The challenge is to provide a long-term framework that achieves an adequate level of private saving.

The effective retirement age is now 65 and it is not uncommon to work beyond this age, but there remain obstacles to the participation of older workers. The phasing out of the Pre-Retirement Allowance (PRETA) and extension of the preventive process of unemployment assistance have removed incentives for those aged above 55 to leave the workforce. It is, however, important to ensure that other effective early retirement pathways do not open up through disability benefits.

Better integration is needed to get the most out of immigrants

The surge in immigration over the past decade, and especially since the European Union was enlarged in 2004, means that around 15% of the workforce was born in another country. Immigrants who arrived in the 1990s were predominantly British, American or had Irish nationality through their parents. This cohort has integrated easily into society and the job market. Since 2004, the inflow has been dominated by Eastern European migrants, mainly from Poland and Lithuania. They are well educated on average and have a very high employment rate, but they tend to work in jobs well below their skill level. In this sense, they are not fully integrated into the workforce and their talents are not being put to their best use. There is a third group of immigrants, from outside Europe. This covers a diverse range of people, some of whom face significant integration problems. Apart from the economic and labour market issues, the public sector will face new challenges over the next few years as more migrants settle permanently and bring over their spouses and children. Integration policy is only just getting off the ground. Policies for better integrating migrants are discussed in depth in Chapter 6 as well as the challenges that uncertainty about future migration flows poses for infrastructure planning.

Notes

1. This figure applies to 2001-03 and is based on ultimate beneficial ownership (if a US company channels funds through another jurisdiction, the statistics look through this and attribute it to the US rather than the intermediary). The estimates are based on CSO statistics reported in Lane and Ruane (2006).
2. For example, the cumulative net FDI outflow of 35% of GNI in 2005 and 2006 was mainly due to loans from IFSC companies to their affiliates abroad.
3. The rest is due to a different fuel mix. See Deloitte and Touche (2005).
4. See the regular *Status Reports on Local Loop Unbundling*, published by ComReg.
5. The definition of public investment in the OECD National Accounts differs from that used in Ireland, which show that public investment has been around 6% of GNI over the same period.
6. . This figure excludes public non-exchequer capital investment, such as in the electricity and gas sectors, of about € 18 billion over the same period.
7. See Chapter 5 of OECD (2006).

8. For a discussion of future skills needs, see Expert Group on Future Skills Needs (2007).
9. The Exchequer has in effect been paying fees on behalf of the students since their abolition.
10. This figure is for the child benefit payment rate in respect of the first and second child and includes the Early Childcare Supplement that was introduced in the budget for 2006.
11. € 50 million has been allocated under the National Development Plan (NDP) for the Department of Social and Family Affairs to provide an activation programme that engages with all social welfare recipients, but this covers a wide range of people including lone parents, people with a disability and the unemployed.
12. Using a model based on micro-economic data for Ireland, Callan *et al.* (2007) show that changing the tax treatment of couples would have a substantially greater impact on participation by married women than would a general tax cut that costs the Exchequer the same amount.
13. The definition of public investment in the OECD National Accounts differs from that used in Ireland, which show that public investment has been around 6% of GNI over the same period.

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Chapter 2

The housing market cycle has turned

After many years of sustained growth, the housing market has slowed: house prices are falling and there has been a sharp reduction in the number of new homes being built. The exceptional rise in property values in recent years was largely driven by higher income and demographics, but did appear to overshoot the sustainable level. House prices may ease further and could even fall below their long-run value. Residential investment is experiencing a sharp slowdown. This will have some effect on wider economic activity. If a more severe slowdown occurs, the housing market could pose risks for economic growth and the financial system. Phasing out policies that distort the housing market could help to dampen future housing cycles and maintain the competitiveness of the economy.

Although housing markets boomed in most OECD countries over the past decade, the increase in real house prices in Ireland has been exceptional: house prices are more than 2.5 times higher in real terms than 10 years ago. This partly reflects the same factors that have driven housing markets elsewhere, such as a period of relatively low nominal interest rates, but also the "catch-up" in Ireland following the Celtic Tiger years, strong inward migration and the starting position of relatively cheap housing. The housing market has now turned. Indeed, house prices have begun to fall while they are still rising in many other countries, even if at a slowing rate. The main consequence for wider economic activity so far has come from the sharp slowdown in housing construction, although there are risks of a stronger impact and effects on the financial system (Chapter 3). This housing cycle, the first since Ireland joined Economic and Monetary Union (EMU), raises a number of structural policy issues that should be addressed before the next cycle begins.

The housing market slowdown

House prices are falling as measured by the mix-adjusted permanent tsb/ESRI House Price Index and the price for second-hand houses recorded by the Department of the Environment (Table 2.1). This follows a sustained deceleration in prices since the second half of 2006. Some further easing of house prices is possible. The weakness in house prices has been matched by a sharp fall in the number of transactions. As demand slows and prices fall, owner-occupiers are less likely to trade-up or down and fewer new households try to get onto the housing ladder. Although houses are becoming more affordable, potential buyers are likely to be cautious until prices appear to have stabilised.

Table 2.1. **Housing market indicators show a slowdown**

Year-on-year growth rate

	2006				2007		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
House prices							
Permanent tsb/ESRI series	11.1	14.3	15.3	13.0	9.2	2.9	–1.8
New houses	11.4	11.9	12.1	9.0	9.0	7.7	3.2
Second-hand houses	14.4	14.1	18.9	6.8	9.0	2.1	–4.0
Loan approvals (number, all agencies)	28.6	7.8	–23.3	–24.5	–21.9	–28.4	–18.3
Planning permissions	–4.5	–16.8	–6.9	–11.8	–3.1	0.7	–2.6
Construction volume	16.8	–2.6	–12.3	5.5	–19.8	–6.2	
Quarterly house completions	24.3[1]	n.a.	18.3	1.5	–8.6	–13.8	–22.8
New house registrations	15.0	12.5	13.6	–14.0	–28.0	–40.7	–52.2

1. Data for 2006 Q1 and Q2 were not published separately.

Source: Central Statistics Office; Department of the Environment, Heritage and Local Government; permanent tsb.

A housing market slowdown had been widely anticipated, although the timing was difficult to predict, and activity in the early part of 2007 was depressed in the short term by expectations in the run up to the general election that changes to stamp duty would occur.

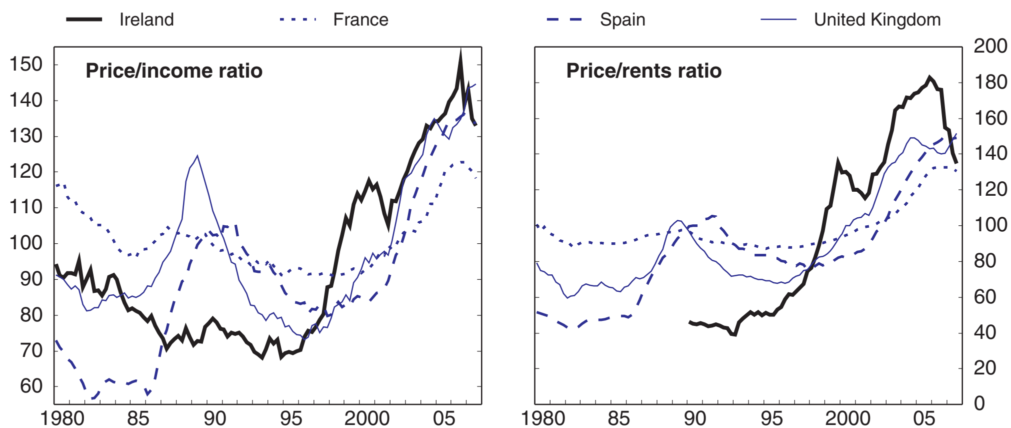
In 2005, probit analysis by the OECD suggested that the likelihood of being at a peak in real house prices in Ireland was then around the mid-point of the countries considered (van den Noord, 2006). The subsequent increase in the real value of houses, however, made it more likely that the market would soon reach a peak given past experience of how housing cycles evolve. The doubling of ECB's policy rate from 2% to 4% since December 2005 had a strong cooling effect on the housing market, even if the rate rises did not bite immediately. Econometric analysis suggests that house prices in Ireland are more sensitive to short-term interest rates than in many other countries, consistent with the popularity of variable-rate mortgages (Rae and van den Noord, 2006).

The outlook for house prices is highly uncertain but the falls to date have been relatively small compared with the massive rise over recent years. The dynamics of house prices are hard to predict. Housing cycle corrections often occur through small falls in prices followed by long periods of flat prices as homeowners are reluctant to sell at a nominal loss, waiting until the equilibrium level of prices catches up to actual prices. However, past experience cannot rule out that prices fall more sharply and overshoot the sustainable level on the downside. The long-run sustainable level of house prices, however, is likely to be much higher than in the past and prices may not be far from their fundamental level; the exceptional increase in house prices in Ireland relative to other OECD countries partly reflects the very strong economic performance of Ireland, rapid inward migration and its unusual demographic position. The sharp rise in employment and incomes, together with a rising population and a high rate of formation of new households, is likely to have increased the sustainable level of house prices considerably. The number of housing units relative to the population has caught up from a low level by European standards to 417 per thousand inhabitants, close to the EU average but still below the stock in France and Germany.

There are a number of ways of assessing the balance between demand and supply in the housing market and hence the sustainable level of house prices. The ratio of house prices to incomes has fallen sharply, as nominal house price inflation has eased and incomes have continued to increase rapidly (Figure 2.1). The ratio of house prices to rents

Figure 2.1. **House prices in relation to income and rents**

Average 1990 Q1-2007 Q2 = 100



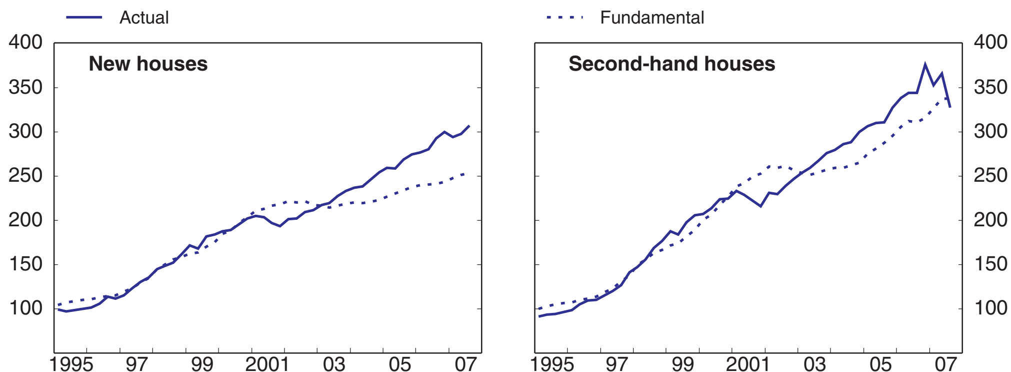
Source: OECD (2005), *OECD Economic Outlook*, No. 78, updated data.

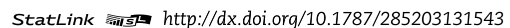
has also fallen. By bringing the cost of buying and renting more into line, this is likely to stimulate demand for owner-occupation. Furthermore, rents have accelerated and rose by 12% over the past year. The strong current demand for rental accommodation partly reflects first-time buyers being unable to afford to buy a house and thus renting for longer. Migration is likely to have increased demand for rental property too. As rents rise and house prices fall, some first-time buyer households will return to purchase housing although the impact is likely to be initially concentrated on the lower end of the housing market. Despite the rebalancing of the housing market, the value of houses in Ireland remains high compared with historical experience on these measures.

Evidence from an economic model suggests that house prices were below their long-run sustainable level in the early part of the decade but then overshot (Figure 2.2). The sustainable level of both new and second-hand house prices has continued to rise at a relatively fast rate of 5-10% annually, which would be high in international comparison but is well below the rate of increase in the late 1990s. This continued rise has been driven in large part by higher incomes and demographic factors. The model may overstate the effect on prices of demographic effects given that the large number of migrants who arrived in the past two years are more likely to have modest housing demands initially. For second-hand houses, the fall in house prices appears to have eliminated the gap with the fundamental level, although such estimates are highly uncertain. For prices of new houses, a large gap has opened up with the long-run level of house prices and there has been little adjustment to date.

Figure 2.2. **Actual and fundamental house prices**

In thousand euros, real prices[1]




StatLink http://dx.doi.org/10.1787/285203131543

1. Nominal prices deflated using the harmonised consumer price index.

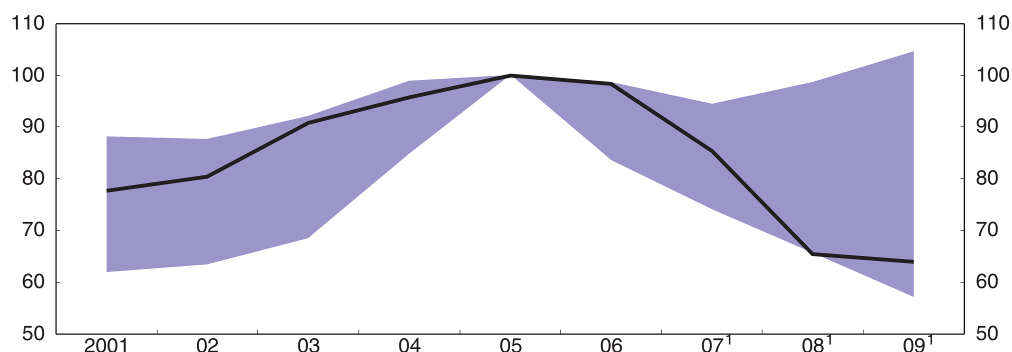
Source: Rae, D. and P. van den Noord (2006), "Ireland's Housing Boom: What Has Driven It and Have Prices Overshot?", *OECD Economics Department Working Papers*, No. 492, June, updated data.

The sharp fall in residential construction

Housing investment was 12% lower in the first half of 2007 than a year earlier. This ends the expansion in house-building that began in 1993. Over this period, housing investment more than doubled as a share of GNI to reach a peak of 16%, the highest share in the OECD. Residential investment is characterised by pronounced boom-bust cycles. Compared with the experience of 46 house-building booms in 23 countries between 1960 and 2004, the recent expansion in Ireland was big and the current slowdown is consequently likely to be relatively severe (Figure 2.3). The OECD projects a fall in

Figure 2.3. **Residential investment per capita**

Index, peak = 100



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Note: The shaded area indicates the 10th to 90th percentiles of the distribution of residential investment per capita in 46 booms in 23 countries between 1960 and 2004, where the peak is normalised at 100 and set at 2005.

1. OECD forecasts.

Source: OECD (2007), *Economic Outlook 82 database*.

completions from around 90 000 in 2006 to 50 000-60 000 in 2008, which is close to the level regarded as sustainable given rising incomes and demographic effects. But the cutback in investment could be even sharper. International experience suggests that the correction in house-building is usually relatively short-lived with sharp falls in the first two years, followed by a couple of years of stagnation. Some slumps, however, last longer and this remains a risk, especially if immigration were to recede.

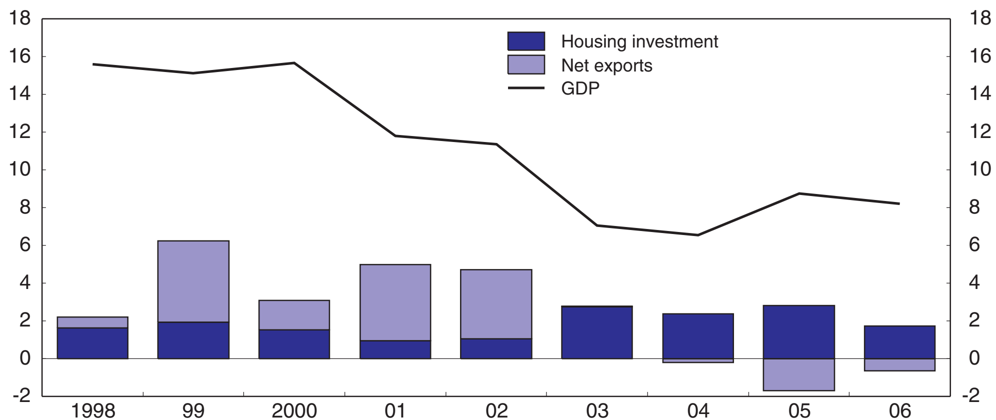
Given the large share of economic activity, the fall in housing construction will have a substantial impact on overall economic activity. Construction, including commercial and civil engineering, accounts for 12% of employment but the housing component is relatively labour intensive. Furthermore, construction accounted for one quarter of the increase in employment over the past five years. Some of this increased supply of labour has been provided by migrants (Chapter 6).

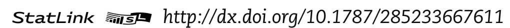
The macroeconomic impact of the housing market cycle

Housing demand has had a major impact on the economy in recent years. Residential investment has constituted around a sixth of GNI. Moreover, as the strong contribution of net exports to the growth of demand in the late 1990s receded, house-building made a major contribution to nominal growth (Figure 2.4). The strength of consumption growth is also likely to have been supported by rising house prices. People tend to purchase big-ticket durable goods when they move. There may also be more general wealth and confidence effects. These could fade as house prices fall. Many studies have failed to find a strong effect of housing wealth on consumption in Ireland: the strong growth of consumption in recent years could be explained by rising incomes and employment rather than housing. Evidence from a cross-country study, however, suggests that consumption in Ireland is relatively sensitive to the housing market as there is a high rate of home ownership, loan-to-value ratios on new mortgages are high and short-term interest rate loans are popular (Catte *et al.*, 2004). Consumer confidence has already fallen to its lowest level since 2003.

The slowdown will have a wide range of effects including putting pressure on the financial system (Chapter 3) and lowering tax revenues (Chapter 4). Simulations of the OECD's macroeconomic model for the previous *Survey* suggested that a one-third decline in

Figure 2.4. **Housing investment and net exports**
Contribution to nominal GDP growth, per cent





Source: OECD (2007), *Economic Outlook 82 database.*

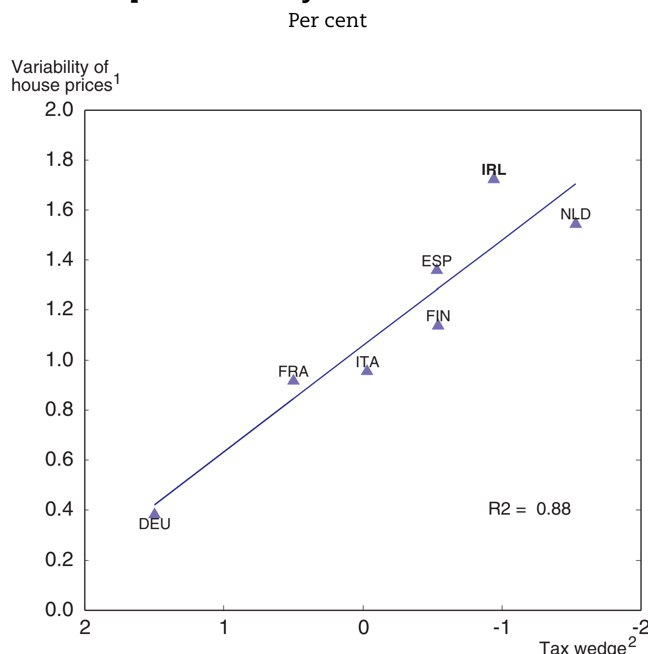
housing investment from the level at that time would reduce GNI by 2% and raise unemployment by as much as 2 percentage points. Although the current *Economic Outlook* projections paint a less severe picture, the housing market nevertheless weighs heavily on growth in 2008. The effect on overall construction activity of lower house-building is partly offset by government infrastructure construction and more spending on home improvements facilitated by the greater availability of builders. There will also be effects on the supply capacity of the economy. The reduced demand for workers in the construction industry is likely to reduce the number of migrant workers, but average productivity will increase as resources are redirected towards more productive sectors of the economy.

This is the first housing cycle in Ireland since EMU. In the past, many of the effects of the housing market slowdown on aggregate demand could have been offset in the short run by an accommodative monetary policy. This mechanism is unlikely to come into play this time, particularly because Ireland appears to be leading other economies in this episode. It has been fortunate for Ireland that the European Central Bank did not raise short-term interest rates in the autumn of 2007 as expected prior to the global financial market turmoil. The size and structure of the housing market makes Ireland particularly sensitive to changes in interest rates. Furthermore, the initial rise in house prices was related to low real interest rates in Ireland, brought about by low nominal interest rates reflecting sluggish euro area growth, while Irish inflation was relatively high. House price growth has been more rapid on average in those euro area countries with low real interest rates. This emphasises the role of other policies and the importance of Ireland maintaining external competiveness so that net exports can contribute to rebalancing the economy (Hoeller and Rae, 2007).

Housing market policies should not contribute to housing market instability, particularly as the monetary policy instrument is not available. The variability of real house prices tends to be higher where the tax wedge between after- and pre-tax real interest rates on mortgages loans is most negative (van den Noord, 2004, Figure 2.5). This is because the impact of rising house prices on the cost of purchasing a house are partly offset by the tax break so there are weaker forces in the system to slow down rising house prices. Higher house prices tend to increase the value of loans that people take out but this

Figure 2.5. **House price volatility and the tax treatment of housing**

Per cent



StatLink http://dx.doi.org/10.1787/285240733821

1. Root mean square deviation of real house price from trend, 1970-2006.
2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

Source: van den Noord, P. (2004), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale* and OECD calculations.

is partly countered by the government through the higher value of tax relief on mortgage interest payment. In addition, there is no property or capital gains tax that might curb housing demand as prices increase, although relatively high stamp duty payments have some slowing effect on housing market turnover.

More efficient policies towards housing

There would be long-run gains from more efficient policies towards housing, in addition to mitigating the cyclical volatility of the housing market. Table 2.2 summarises the recommendations of the previous *Survey* and subsequent policy action. Ireland remains the only country in the OECD that allows households some tax deduction for mortgage interest payments at the same time as not taxing property values, capital gains or imputed rent. Income invested in owner-occupied housing may therefore effectively never be fully taxed during a person's lifetime.

Other countries that previously had similar arrangements have moved towards a more efficient framework for taxing housing (Box 2.1). By contrast, the Budget for 2008 moved modestly in the other direction by raising the ceilings for mortgage-interest tax relief for first-time buyers.* Recent measures to exempt first-time buyers from stamp duty, reduce it for most others and introduce a more incremental schedule, however, will contribute

* The ceiling for rent relief was also raised to € 2 000 for a single person and € 4 000 for a couple aged under 55, which is one-fifth of the ceiling on mortgage interest tax relief. This illustrates how both housing in general and owner-occupation in particular are favoured by the tax system.

Table 2.2. **Progress in structural reform: Housing**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Phase out the bias towards housing that is embedded in the tax system. Reduce the tax incentive for speculative investment on properties.	The government moved in the opposite direction by doubling the ceiling on mortgage tax relief for first-time buyers. Reforms to the stamp duty regime will reduce the transactions costs for most buyers of residential property.
Introduce a property tax in order to fund local infrastructure and services and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.	No change.
Social housing policy should become more tenure-neutral by scaling back house-building and providing more by way of income support and/or housing vouchers.	The Rental Accommodation Scheme (RAS) pays private landlords for long-term accommodation for those who have been receiving rent supplement for more than 18 months. The latest NDP envisages large-scale investment in public housing.
Promote the supply of under-developed land.	No progress.

Box 2.1. **Reforming taxation of housing**

Many countries find it difficult to reform the taxation of housing but no other OECD country has kept such a range of favourable tax treatments of housing as Ireland. It is a complicated and sensitive policy issue in all countries, although Ireland's high rate of home ownership tends to increase such constraints. There is an understandable reluctance by policymakers to change housing taxation at a time when the market is relatively weak. However, it would be beneficial for the long run to make tax policies towards housing more efficient both to reduce the likelihood of boom-bust cycles and to make the economy more competitive. Given the current position of the housing cycle and possible impacts on prices, it would be desirable to act only gradually but to begin soon.

The least distortionary system for taxing housing, the most consistent with the way other assets are taxed, would be to tax the imputed rents on housing and treat capital gains on owner-occupied housing in the same way as for other assets,[1] preferably using a scheme that avoids the risk of accumulating a large liability to capital gains tax when the property is sold. Under such a system, mortgage and other costs relating to a house would be tax deductible. No OECD country applies this set of policies exactly, but Ireland is alone in allowing deductibility, not taxing capital gains and having no property tax.

Other countries that once had such a wide range of tax-favoured treatments of housing as Ireland have made reforms that make their tax systems less distortionary. Some countries reformed taxation of housing by removing the tax deductibility of mortgage interest: Germany (1987), France (1997/1998),[2] and the United Kingdom (2000). UK Mortgage Interest Tax Relief (MIRAS) was scrapped in a number of separate changes over a long period of time. Such a gradual approach would limit the disruptive impact on the housing market.

Ireland has also made some moves towards a more efficient system. Mortgage interest deductibility was first capped in 1974, although limits were raised in 1993 and 2003 and in 2007 for first-time buyers, and it was limited to the standard rather than the marginal rate in 1994. Further incremental steps to reform the taxation of housing could:

- Limit deductibility to first-time buyers in line with the stated objective of helping young people and families to buy their first home. The upper limit on relief to people who have owned a house for more than seven years is € 6 000 for a couple and € 3 000 for a single person. € 255 million was spent in 2007 on this relief to homeowners who had not purchased their house in the previous seven years.

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Box 2.1. **Reforming taxation of housing** *(cont.)*

- Reduce the number of years over which first-time buyers can claim relief from the first seven.
- Lower the annual ceiling on the generous relief for first-time buyers.

A useful strategy is to remove the tax deduction at a time when mortgage interest payments are set to fall, for example due to cuts in interest rates, to cushion the impact on the disposable incomes of families with mortgages. The reduction of interest deductibility could be made fiscally neutral by offsetting reductions in other taxes. For example, this could finance further reductions in stamp duty, following from those made in the Budget for 2008, that would improve the functioning of the housing market. At a minimum, a long-term commitment to freezing the ceiling for relief in nominal terms, as has been done in Spain, would slowly reduce the distortionary impact of the tax break.

An alternative approach is to maintain interest deductibility but introduce a property or capital gains tax on owner-occupied housing. Denmark, Finland and Sweden raised or introduced property taxes on homeowners, although in some cases these taxes are rather low. This attempts to approximate a tax on imputed rents. This might also be desirable in Ireland for other reasons, such as recovering some of the gains to private property owners from the benefits of public expenditure on infrastructure that raises local property values.[3]

1. Residential investment property (buy-to-let) in Ireland is essentially taxed in this way with expenses being tax deductible but rental income subject to taxation and capital gains tax applied.
2. It was re-introduced in a limited way in 2007.
3. Development contributions are currently used in Ireland by local authorities to help to pay for public infrastructure servicing new developments, such as roads and sewerage.

somewhat to making the housing market more flexible and efficient; the impact of these measures is relatively small for the average house and totally exempting first-time buyers is most valuable to the few buyers able to purchase the most expensive properties (those worth in excess of € 635 000).

Ireland has achieved very high levels of ownership relative to most other OECD countries. However, this is partly due to the tax system, which generates strong incentives towards home ownership at the expense of renting and spending money on other things. The case for a more neutral tax system was discussed in the 2006 *Survey*. The high share of the average household budget spent on housing relative to other countries is indicative of the way the current system encourages people to spend more money on it. Given that the supply of housing in desirable locations is limited, much of the extra demand pressure leads to people paying more to live in the same houses. These incentives may encourage households to invest too much of their wealth in housing and not enough in other assets such as equities or a pension. Households would face less risk if they spread their wealth more evenly across different assets. The high level of house prices could also discourage migrants, particularly where there is competition for skilled workers who can easily choose to settle in another country where housing is more affordable. High levels of stamp duty and unrecoverable costs associated with moving house may reduce the mobility of workers between different parts of the country. A deeper rental market could also ease cyclical pressures in the housing market by making it easier for households to switch at the margin between the two types of accommodation.

Spending on housing support for people with low incomes is largely directed towards capital expenditure and building new social housing. Under the National Development

Plan (NDP), € 18 billion is provided for social and affordable housing programmes and only € 3 billion for rent allowance schemes. The Affordable Housing scheme involves building homes for those with low incomes to buy at prices significantly below the actual market value. Combined with the generosity of the tenant purchase scheme for existing social housing tenants, this set of policies strongly favours home ownership. Although there may be reasons for looking favourably on owner-occupation, Ireland already has one of the highest rates of home ownership in Europe and households should be free to choose the most appropriate form of housing tenure for their circumstances, rather than facing a skewed choice. Furthermore, the current system provides support to a relatively small number of people at a very high cost as it is very expensive to build houses to sell at a discount. It can also be difficult to allocate scarce new public housing to the people who need it most. Increasing the emphasis on means-tested housing benefits or vouchers that households can use either to pay a mortgage or rent, along the lines of the Rental Accommodation Scheme (RAS), could be desirable. The low marginal tax rates facing low income households increase the scope to introduce such an element of means testing while maintaining good incentives to work.

Box 2.2. **Summary of recommendations on the housing market**

- Begin gradually to reduce the bias towards home ownership in the tax system following the possible approaches identified in Box 2.1, either by starting to phase out mortgage-interest tax relief or by introducing a property or capital gains tax on owner-occupied housing.
- Introduce a property tax to fund local infrastructure and services. This would broaden the tax base and redistribute some of the windfall gains from those who benefit from living close to public infrastructure projects.
- Social housing policy should become less reliant on direct provision of publicly-owned housing and provide assistance more through alternative methods such as the Rental Accommodation Scheme (RAS) which makes use of good standard private rental housing to meet long-term housing assistance needs.

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Chapter 3

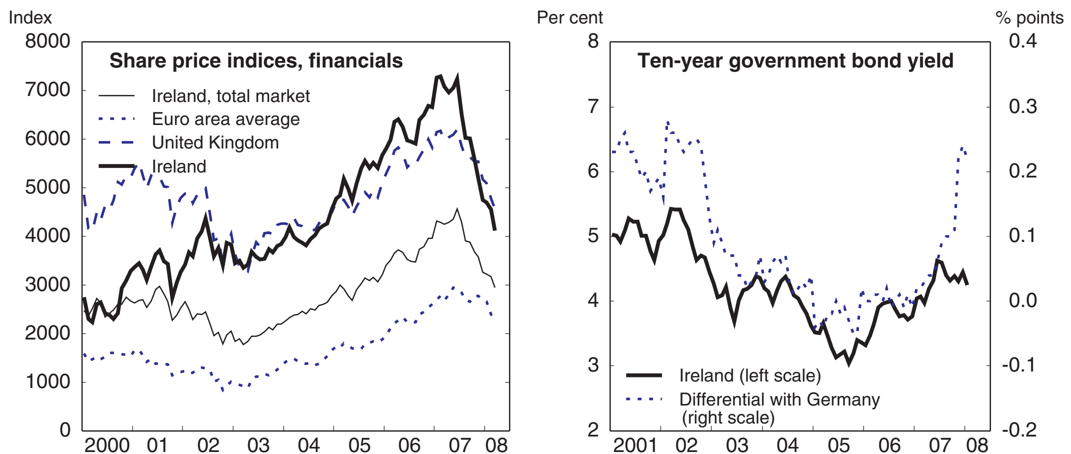
Financial stability: Banking on prudence

Lending has been strong, with debt ratios reaching very high levels. The Central Bank and Financial Services Authority of Ireland (CBFSAI) had clearly identified the major vulnerabilities and taken action to mitigate them. The Irish banks are well-capitalised and profitable, which provides a cushion to weather the more difficult times ahead. This chapter reviews financial market developments, the actions by the CBFSAI and the new policy issues that have come to the fore with the financial market turmoil.

The Irish financial markets have grown very fast since the turn of the century. Domestic bank lending has risen by about 25% annually, double the rate in the euro area as a whole. Stronger competition has reduced interest margins, to which banks reacted by cost cutting, while lending was spurred by the strong property market. Property-related lending (residential mortgages, commercial property and lending to construction companies) now accounts for more than half of the stock of bank lending. Deposit growth has not kept up with lending growth. An increasing share of lending was funded mainly by the issuance of securities as well as by borrowing from other financial institutions, with nearly half coming from UK banks. At 60% in mid-2007, Ireland is the country with the lowest deposit-to-credit ratio in the European Union.

Prior to the weakening in the Irish housing market and the recent international financial market turmoil, the Irish banks were in great financial shape: they had the highest rate of return on assets in the euro area, while non-performing loans to total loans had fallen to 0.7% in 2006 from 1% in 2000. Moreover, the agency ratings of Irish banks are among the highest in the euro area. The financial share price index on the Irish Stock Exchange more than tripled between 2000 and 2006. It then fell sharply and the decline was much larger than in the euro area on average (Figure 3.1). Even though Ireland's government net debt position is much better than that of Germany, the government bond yield differential with Germany re-emerged in late 2007. This is a reflection of the international financial turmoil.

Figure 3.1. **Banking sector share prices and government bond yield**



StatLink http://dx.doi.org/10.1787/286071408731

Source: Datastream and European Central Bank.

Containing risks to the financial system

Since May 2003, the financial industry has been supervised by the Financial Regulator (before April 2006 the Irish Financial Sector Regulatory Authority). It is placed inside the central bank as an autonomous entity, which ensures close co-operation between the two. The main tasks of the Regulator are to provide a sound regulatory environment that facilitates competition, to protect consumers and to foster a stable financial services industry (Financial Regulator, 2006). In addition, it is at the forefront of implementing EU financial market directives. It regulates banks, insurance companies, investment and retail intermediaries, stockbrokers and collective investment schemes, including those operating in the IFSC.[1] Non-deposit lenders, which have been involved in the development of Ireland's still limited market for sub-prime mortgage loans, were not regulated until recently. Sub-prime mortgages are estimated to account for about 2% of mortgage lending in Ireland, providing a new mortgage mechanism for some customers who might previously have experienced difficulty obtaining a loan because, for example, of the nature of their employment, or being new to Ireland. The CBFSAI in its *Financial Stability Report 2007* found that the mainstream Irish banking sector has a minimal level of involvement in this market and that average loan-to-value ratios were generally modest.

The CBFSAI had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities (CBFSAI, 2005 and 2006). The private sector debt-to-income ratio had reached 216% of GNI by the end of 2006, up from 100% in the late 1990s. It is among the highest in the European Union. The speed of increase was an additional concern. It noted that, notwithstanding the strength of the banking system, a correction in house and commercial property prices if it were to be combined with a significant increase in arrears, could pose significant difficulties for the health of the banking system. The CBFSAI also highlighted the over-concentration of income and loan books to property-related business,[2] falling net interest margins, a reduction in the forward-looking element in provisioning[3] and a widening funding gap as adding to the vulnerabilities. The funding gap is largely made up by the issuance of securities and borrowing in the interbank market. The widening of the gap is of concern, because wholesale funding is more expensive than retail deposit-funding, thereby reducing profitability, and it is generally more sensitive to confidence shocks than deposit-based funding. Liquidity risks are mitigated by the significant medium-term maturity element of many of these liabilities as well as the relatively wide range of funding options available to the domestic banking sector. The CBFSAI judged that risks arising from the insurance sector were very low.

Against the background of the sharp rise in lending, the CBFSAI took several actions:

- Because of the decline in general provisions and the persistently high growth rate of mortgage lending, the CBFSAI increased the risk weighting on high loan-to-value mortgages for owner-occupiers and for exposures secured by properties that are not occupied by the borrower to increase the capital cushion. It also raised the risk weight applied to speculative commercial real estate lending in Ireland.
- It introduced new liquidity requirements for credit institutions. Rather than focusing on the stock of liquid assets, the new regime is based on a forward-looking mismatch approach under which cash flows are assigned to relevant time bands.
- It implemented a new Consumer Protection Code, which came fully into effect in July 2007. It is legally binding and comprises general principles supplemented by more detailed rules, which regulated financial service providers must obey. It also published

Minimum Competency Requirements for persons who provide advice on or sell retail financial products. More recently, legislation was passed that addressed CBFSAI concerns that non-deposit-taking sub-prime market lenders and firms providing home reversion loans or personal loans were not covered by the new Consumer Protection Code and the Minimum Competency Requirements.

- The CBFSAI initiated stress testing not only for credit,[4] exchange rate, interest rate and equity-related risks, but also for liquidity risks (Kearns, 2006). Concerning the latter, the Stability Reports now include a test for a decline in deposits and in the value of certain liquid assets. On the other hand, the Reports have underlined the limits of stress testing and that behaviour could change in circumstances where uncertainty increases significantly and rapidly.

The significant slowing in house prices and subsequent decline since mid-2007 has eased a key concern as it brings house prices closer to fundamentals, while housing affordability is improving and repayment burdens on new loans are stabilising (CBFSAI, 2007). Moreover the rate of debt accumulation by the household and non-financial corporate sector has eased substantially. On the other hand, housing permits and commencements have plummeted. This is probably reinforced by the buy-to-let market. Since 2004, it has risen very rapidly, with 26% of mortgages outstanding being attributed to investors in June 2007. Investors have relied heavily on capital appreciation for their returns in past years as rents were fairly stable. New investors are facing a shortfall in terms of covering their mortgage obligations with rental income. Those who have invested in mid-2007 face an estimated shortfall of 36%. A faster increase in rents and, for new investors, lower house prices have started to lower this shortfall.

The commercial property market has also been strong. As growth in capital values has been buoyant until recently, outpacing the increase in rents, yields on commercial property investment have been compressed and are now low in international comparison (Woods, 2007). Capital value growth has eased considerably during 2007, though still rising at a brisk pace in the third quarter of 2007. Investment in the Irish property market is likely to be much weaker in 2008 than in 2007. Irish banks have also provided funding for property investment in the UK property market, which has also weakened considerably. International experience suggests that commercial property busts tend to have greater consequences for the stability of the financial system than a sharp downturn in house prices. Indeed, stress testing involving a severe shock has shown that there is likely to be a larger deterioration in asset quality for commercial property-related lending than for residential mortgages.

The high overall share of property-related lending implies a considerable vulnerability to a shock to the sector. Following a shock, banks might find that the performance of the loans is correlated and asset quality could deteriorate in many loans. An additional risk is that price changes in these markets are correlated, which has indeed been the case. Moreover, price cycles have been highly correlated across countries in recent years, so that international diversification could aggravate rather than mitigate risks going forward. While Irish banks earn a significant share of their profits in other countries, the majority of foreign earnings are made in the United Kingdom (Kearns, 2007). On the other hand, the health of the banking sector has remained robust, when measured by a range of indicators and the results of stress-testing exercises.

International financial market turmoil has raised funding costs in an environment of already low net interest margins and slower lending growth.[5] Lending standards have tightened considerably and all these factors together could reduce banks' willingness to supply loans. Since August 2007, there has been little effect of higher interbank rates on interest rates for new loans for house purchases as margins are tied to the ECB's main refinancing rate. There has been a slight increase in the average interest rate on existing mortgages (10 basis points) and a further small increase in December. Rates of new business loans have gone up by more (nearly 40 basis points). While difficult to gauge, banks are likely to ask for more documentation and collateral when providing loans.

Policy issues and responses

The international financial market turmoil has brought a number of policy issues to the forefront (Hurley, 2007 and ECB, 2007). The global liquidity squeeze is partly blamed on a lack of transparency in banks' exposure to the sub-prime market and credit lines extended to structured investment vehicles, hedge funds and private equity. A survey undertaken by the CBSFAI (CBSFAI, 2007) indicated that exposure of mainstream Irish banks to the sub-prime market was low, with the Irish sub-prime market representing only 2.3% of new mortgages issued in 2006. Irish credit institutions report very limited exposures to the US sub-prime market, while banks' investment in residential mortgage-backed securities is small. Exposure to hedge funds was also found to be small. Exposure to the private equity sector is more substantial, although it still accounts for a small percentage of total assets. The CBFSAI's initiative in enhancing transparency is clearly welcome and should be a regular feature. Updates of Irish banks on their performance did not include any large write-downs. The CBFSAI is also participating in a euro area initiative to collect information on Financial Vehicle Corporations. Unfortunately, to date such initiatives have not reassured markets sufficiently and share prices of financial institutions have not recovered.

Given the liquidity problems in the interbank market and despite establishing that liquidity risks are low in the stress-testing exercises, the CBFSAI has asked banks to report weekly on their liquidity situation and receives regular updates on liquidity contingency plans. The close monitoring of the situation also involves regular information-sharing meetings between the central bank, the Regulator and the CEOs of the main financial institutions.

In the Irish deposit insurance scheme, depositors may be compensated 90% of their deposits up to a maximum of € 20 000. This is the minimum required by the EU's Deposit Guarantee Schemes Directive, but it is in mainstream of European law and practice and should be sufficient to provide protection to the vast majority of depositors. While the same amount is guaranteed by many other EU countries, the guarantee is much higher in the United States where more than $100 000 is covered. The UK authorities have recently announced that the UK guarantee will rise considerably from an already higher level, following the bank run on Northern Rock. The Irish scheme is funded *ex ante* by a levy of 0.2% on deposits and the fund contained € 460 million at end June 2007. All insurance schemes lead to moral hazard problems so that finding the right amount of deposit insurance is difficult. The optimal coverage is that which will keep depositors whose losses create political sympathy "at home and off the streets" (Kaufman, 2007). More would reduce effective monitoring and disciplining of the banks by depositors competent to do so, though the evidence for the latter actually occurring is thin. More importantly perhaps

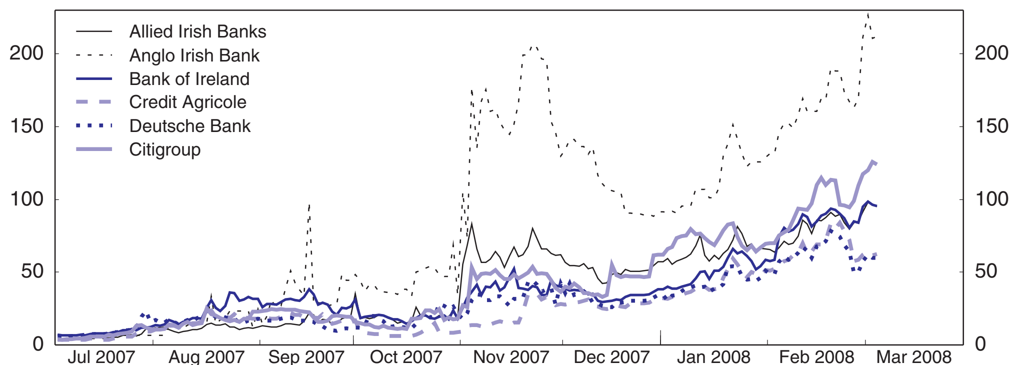
than the size of the guarantee is that arrangements are in place that give depositors near-immediate access to the par value of their insured deposits, which is the case in the United States, but not in Ireland and most other European countries. In Ireland, the scheme must be in a position to pay within three months of the central bank determining that a credit institution is unable to repay deposits or a court suspending the depositors' ability to make withdrawals. In exceptional circumstances, the scheme may have up to three extensions of three months in line with the European directive. The scheme is obliged to pay out as expeditiously as possible and is not required to wait for three months before payment. Liquidity concerns could still be an important consideration for depositors in withdrawing deposits. Moreover, the fund is small, which could be an additional consideration.[6] A review of the EU Deposit Guarantee Schemes directive is currently being undertaken in the context of the EU roadmap in response to international financial market turmoil.

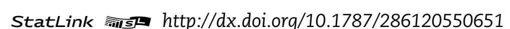
Conclusion

The CBFSAI is a highly respected institution and the Irish regulatory framework got high marks in IMF reports (IMF, 2006). It has well identified the major financial stability issues and has urged lenders and borrowers to behave in a prudent way. At the same time, it has taken regulatory action to reduce risks, has introduced a new Consumer Protection Code, which has helped to avoid predatory lending practices that have occurred elsewhere, and has taken some measures to enhance the transparency of financial markets. And with fortunate timing, it introduced a forward-looking liquidity regime just before the financial market turmoil struck. In addition, rapid growth has provided extensive earnings opportunities for Irish banks, reducing their incentives to engage to a large extent in more high-risk investment strategies, and they have remained profitable and well-capitalised. But international financial market turmoil is not over yet. Credit default swap rates are still above those in the early part of 2007 (Figure 3.2).

Figure 3.2. **Credit default swap rates**[1]

One-year senior bonds




StatLink http://dx.doi.org/10.1787/286120550651

1. The reported rate indicates the cost of insuring senior corporate bonds against default. It is measured in basis points. One-hundred basis points implies that it costs € 100 000 to insure debt of € 10 million.

Source: Datastream.

Any assessment of the situation can, of course, only be tentative. There is no generally accepted definition of financial stability, or of its converse of financial instability.

Regulators can be transparent in the sense of publishing work, assessments and decisions. But financial stability is usually perceived as a negative concept, involving the absence of something unwanted, an extreme event that has not happened yet and the likelihood of which is unknown (Goodhart, 2006). In that sense, those involved in prudential supervision can only keep the shock-absorption capacity of the financial system strong, and also be prepared to deal with specific downside risks.

The recent international financial market turmoil has tempted some to advocate a move into regulatory overdrive. This is not the way to go. The costs and benefits of regulatory steps need to be carefully weighed. Over the past two decades, financial innovation has flourished in an environment of macroeconomic stability; it has reduced liquidity constraints, new credit products suit a wider range of borrowing needs and it has helped the spreading of risks. It is important to secure these benefits, though the recent financial market turmoil has brought some new issues to the forefront. Tackling these, while remaining vigilant about financial market developments, should keep the Irish financial markets well managed.

Box 3.1. **Summary of recommendations on financial stability**

- Enhance transparency further by regularly surveying off-balance sheet exposures of banks.
- Improve stress testing further. In this respect, the CBFSAI has established a work programme that, *inter alia*, follows up on suggestions by the IMF's FSAP report.
- The EU Deposit Guarantee Schemes Directive is being reviewed. Ireland should consider the efficacy of its own arrangements following the review.

Notes

1. The total assets of IFSC banks are about as large as those of the domestic banks. But the links between the IFSC institutions and the domestic Irish financial market are limited in terms of providing credit to Irish residents or taking deposits from them. Also interbank borrowing between them is limited. However, IFSC banks could be an important counterpart for domestic banks' credit risk transfer activities, and domestic banks could hold securities issued by IFSC banks (see Box F in Central Bank & Financial Services Authority of Ireland, 2006).
2. In mid-2006, property-related lending was 60% of total lending. In the United Kingdom it was 42%.
3. General provisions are being phased out, because of new International Financial Reporting Standards. These provisions are made against inherent but unidentified losses in the loan book.
4. In October 2007, the Regulator issued revised guidance on stress testing with respect to residential mortgages. Credit institutions should stress test mortgages at 2% above the ECB's minimum bid rate plus a margin of 0.75%; interest only mortgages should be tested on the basis of repayment of interest plus principal; the outcome of the test should inform the decision to grant a loan; and stress testing should be incorporated into the credit institution's credit policy which should be approved by the board. Moreover, the liquidity stress tests have been modified to take into account the new liquidity regime.
5. Financial market turmoil is discussed in a broader context in OECD (2007) and ECB (2007).
6. In the case of a large pay-out, credit institutions can be obliged to make additional lodgements within seven days.

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Chapter 4

Adapting government spending to lower revenue growth

Softening economic growth and the slowdown in the housing market mark a turning point for fiscal policy. Strong revenue growth in earlier years financed a sustained expansion of government spending and some cuts in tax rates, while still allowing the government to run a substantial fiscal surplus. This left the public finances in a healthy state with net government debt declining to a very low level. But this benign picture is changing as growth slows and tax receipts increase more slowly. Public spending growth needs to slow. The challenge is to improve public services further without large increases in resources. In these circumstances, it will be even more important to get better value from public spending and to accelerate public management reforms.

Fiscal performance was strong in the years up to 2006 as strong revenue growth outpaced the sharp increase in public spending. Government receipts had risen by close to 50% in real terms in the previous five years, somewhat faster than national income, and this sustained an almost equally large increase in public spending as well as allowing debt to be repaid. But the fiscal balance deteriorated rapidly in 2007 as revenue growth weakened with the general government surplus falling to around 0.6% of GNI, down from 3.4% the previous year. After several years of unexpectedly buoyant receipts, the growth of tax revenues more than halved, mainly due to the weakening of the housing market (Table 4.1).[1] This reflects underlying changes in taxation that play an important role in determining the fiscal outlook and risks. Expenditure growth is set to slow to reflect weaker revenue growth: it is crucial that this is achieved. A small fiscal deficit is likely in the coming years but the underlying fiscal position remains sound, although the budgetary situation is more challenging than in the recent past. To meet demand for better public services, it will become increasingly important to raise efficiency as the scope to raise spending narrows.

Table 4.1. **General government fiscal position**

Percentage change on previous year

	2001	2002	2003	2004	2005	2006	2007[1]	OECD forecasts	
								2008	2009
Total receipts	4.4	7.8	10.4	9.6	9.3	13.4	6.1	3.0	5.4
Taxes	2.7	7.2	10.7	10.5	10.2	14.8	5.7	2.6	5.6
Personal	4.3	–4.0	12.7	13.2	9.3	14.9	10.5	5.2	6.1
Business	5.7	15.9	8.0	2.8	3.2	21.5	–15.8	–9.6	3.0
Indirect taxes	0.7	13.2	10.2	11.0	12.7	13.0	8.3	3.4	5.7
Social security contributions	12.2	10.1	9.3	9.6	10.2	10.8	9.1	5.2	5.8
Expenditure	16.7	12.2	7.4	7.1	9.9	8.1	13.7	7.6	5.7
Memorandum items									
General government net lending (% of GNI)	1.2	–0.5	0.6	1.6	1.4	3.4	0.6	–1.2	–1.3
Saving (% of GNI)	5.2	3.3	3.6	4.4	4.2	6.6	4.6	2.7	2.4
Gross debt (% of GNI)	44.0	42.3	39.4	38.5	37.8	34.7	34.8	36.6	38.4
Expenditure per person (thousand €, 2007 prices)	11.94	12.58	12.86	13.36	14.00	14.40	15.20	15.78	16.38

1. OECD forecasts based on *Economic Outlook 82*, but updated to include later information on the fiscal position, including the Budget for 2008. The impact of discretionary policy changes on the forecast is small.

Source: OECD (2007), *Economic Outlook 82 database*, Department of Finance, *Budget 2008*, and OECD calculations.

Tax revenues are less robust

Revenue growth slowed sharply in 2007 and is expected to be weak in 2008. This slowdown has partly been driven by a sharper than expected fall in stamp duty receipts as housing market activity has dropped. The Budget for 2007 included a number of measures to lower taxes on income by enhancing tax credits, raising standard rate bands and

reducing the higher rate of income tax by 1 percentage point to 41%. The Budget for 2008 contained few discretionary measures other than to adjust credits and allowances to keep low earners out of the tax net and average earners below the higher rate of income tax, and a reform to the stamp duty regime for houses. Further ahead, revenue growth will pick up but, as the economy expands more slowly, will remain at around half the rate of recent years.

These developments are shaped by a profound shift in the composition of tax revenues, although income, corporation and consumption taxes continue to make up the vast bulk of receipts. There has been some move away from income taxes and social security contributions and towards indirect taxes and taxes on capital (Table 4.2). For example, stamp duty revenues rose from € 0.4 billion in 1995 to € 3.2 billion in 2007 to represent around 5% of total revenues. As is evidenced by recent developments, these growing revenue streams are relatively volatile (Figure 4.1). This reflects two factors. Firstly, these tax revenues often respond very strongly to movements in the underlying tax base. For example, as in other countries, firms can offset losses against corporation tax and this can make receipts very sensitive to changes in corporate profitability. Secondly, the underlying tax bases are more volatile than GDP. In the case of stamp duty, this is levied on the value of housing transactions which is very cyclical as the number of houses being sold and house prices tend to move in the same direction. Estimates suggest that a 10% fall in house prices and 20% fall in the volume of transactions might reduce stamp duty revenues by around 0.5 percentage points of GNI. In some ways, the growing importance of these taxes weakens the relationship between tax receipts and GNI and diversifies government income, which could make it on average less cyclical. There are also times, however, when these factors can align to create a "perfect storm". In 2006, a strong economy and housing market boosted revenues but a weak economy combined with a housing correction could create an opposite large shortfall in revenues. The more volatile nature of receipts needs to be taken into account, as has been the case in recent budgets, in making judgments about the appropriate stance of fiscal policy.

Table 4.2. **The composition of tax revenues has changed**

Share of revenue

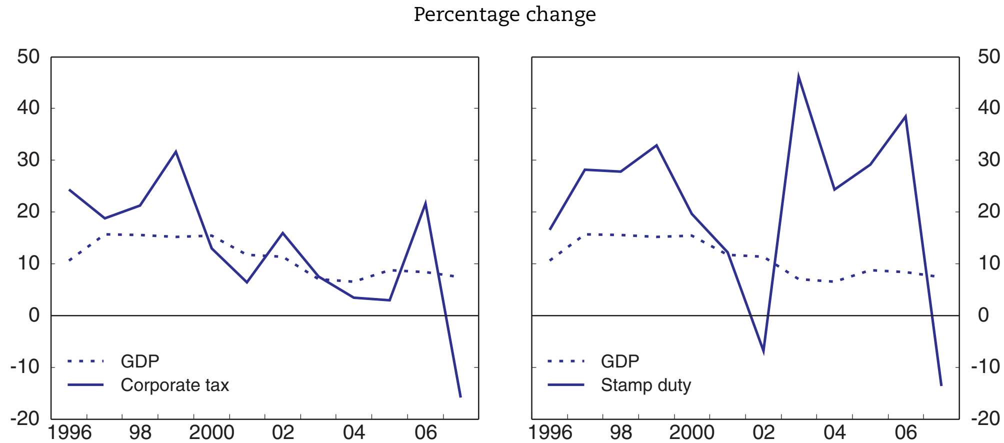
	1995	2007
Income tax and social security	44.3	37.4
Corporation tax and taxes on capital	9.1	16.4
Excise duties	15.4	9.7
VAT	19.4	24.2
Stamp duty	2.1	5.3
Other	9.7	7.1

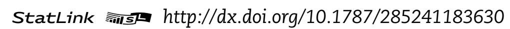
Source: Central Statistics Office, *Annual Income and Expenditure Tables;* Department of Finance, *Budget* 2008 and OECD calculations.

Over the longer term, some tax revenue items could undergo a structural decline. In particular, VAT receipts from new houses and stamp duties on housing market transactions will tend to weaken as the housing market completes the "catch-up" process of bringing the housing stock up to standard. Furthermore, around half of corporation tax receipts in 2006 were paid by firms supported by the Industrial Development Agency (IDA, 2007). This is close to 1.5% of GNI. Corporate tax bases are highly mobile across borders and

Figure 4.1. **Corporation tax and stamp duty revenues**

Percentage change





Source: Central Statistics Office, *Annual Income and Expenditure Tables;* OECD (2007), *Economic Outlook 82 database* and OECD calculations.

it would be relatively easy for these profits to move elsewhere and for tax revenues to decline. Although the authorities remain committed to keeping the current corporate tax rate, the relative benefits of locating in Ireland depend on many factors including the tax rate in other jurisdictions. The average statutory corporate tax rate has come down considerably in the European Union in recent years and several countries have announced further cuts.

The tax system continues to create substantial distortions and a large amount of revenue is foregone due to tax expenditures. Over half of the cost of credits is due to basic personal tax credits and pensions. There are also substantial tax expenditures related to housing (Chapter 2). In 2003, tax expenditures (excluding basic personal tax credits) were estimated to be worth around a sixth of current expenditure. Following a review in 2005, several property-related tax reliefs were phased out and a cap was placed on the total amount that could be claimed by individual taxpayers, but the cost of some of the remaining credits may have increased. Many tax reliefs remain. A small number of new reliefs was introduced in the Budget for 2007 and some others were expanded or renewed. As argued in the 2006 *Survey* (OECD, 2006), these tax expenditures distort economic activity and contribute to lowering the effective tax rate on the highest earners, as these reliefs are typically worth more to them. Data for 2003 showed that one-third of the 400 highest earners had an effective tax rate of less than 25%. The cap introduced in 2006 to ensure that at least 50% of a person's gross income will be subject to tax has helped to address this issue and is estimated to have brought in an additional € 70 million in revenue. The top 1½ per cent of income earners contributed over a quarter of total income tax revenues in 2007. The lowering of average stamp duties on residential properties, streamlining of the schedule and exemption of first-time buyers introduced in recent budgets are welcome and should increase mobility as well as giving a boost to housing-market activity, although the tax saving of around € 5 000 on an average property represents less than 2% of its value. A Commission on Taxation has been established with a mandate that includes examining the overall role of different types of tax, the efficacy of tax expenditures, the financing of local government and the introduction of a carbon tax. The Budget for 2008 already contained measures to reduce pollution through the tax system by linking carbon-dioxide

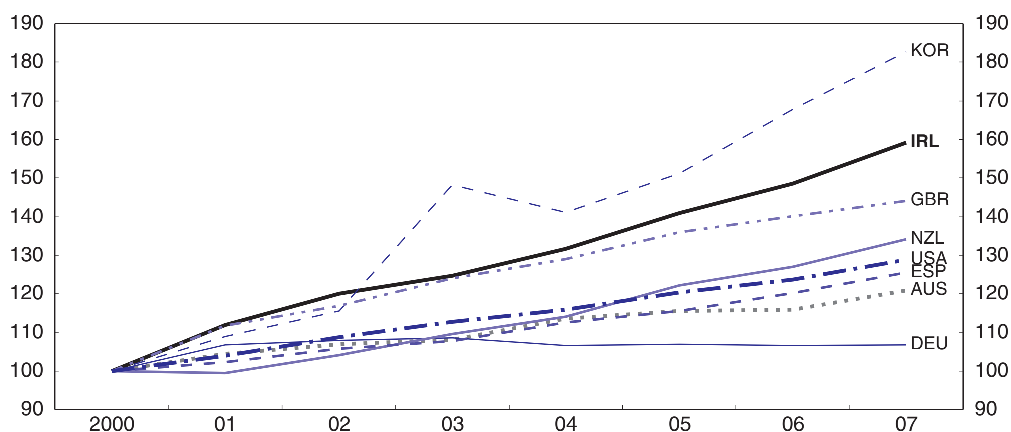
emissions to Vehicle Registration Tax and capital allowances and expenses for business cars. The Budget also makes motor tax rates depend on engine size.

Government spending is likely to slow

Public expenditure increased by around 15% in nominal terms in 2007. Spending growth is expected to moderate in 2008 as a stepping stone to annual growth of around 5-6% in later years. This requires a substantial change of pace after the rapid catch-up growth in earlier years: the increase of government expenditure from 2000 to 2006 was second only to Korea in the OECD (Figure 4.2). Such large and sustained increases in public spending have rarely been experienced in developed countries since the 1960s, even if the share of government spending in national income remains low by OECD standards. Although the pace of growth will be very much lower than in recent years, the rate of expansion will still be faster than in most other euro area countries.

Figure 4.2. **Real expenditure has expanded rapidly**

Cumulative growth since 2000



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Source: OECD (2007), *Economic Outlook 82 database.*

Investment has been given priority over current expenditure, particularly through the commitment to implement the programme for € 184 billion of government spending in the NDP 2007-13. € 56.6 billion has been allocated to capital investment in the 2008-12 Multi Annual Capital Envelope. The main priorities for spending are improving the economic infrastructure and reducing social exclusion, although substantial funding is also envisaged for enterprise and innovation, increasing human capital, and the social infrastructure. Ireland already has one of the highest rates of public investment in the OECD, on a par with Spain and only below Korea, Mexico and the Czech Republic. The Budget for 2008 brought forward investment relative to earlier plans, particularly for public transport projects and road building. Capital expenditure growth will slow sharply after 2008 but a high level of public investment will be maintained as set out in the NDP. In contrast to previous national development plans, the role of EU funding will be negligible as Ireland is no longer among the European Union's lower income states.

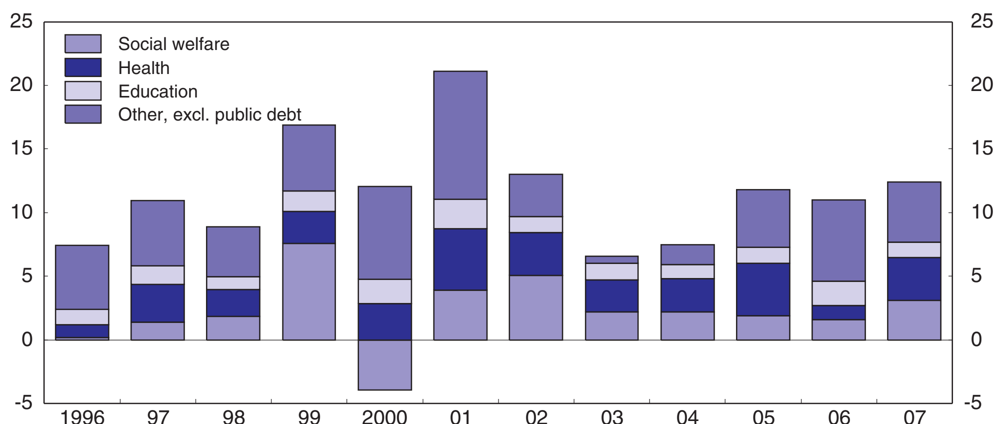
Current expenditure growth has also expanded rapidly, albeit at a slower pace than investment since 2006. This is expected to moderate over the coming years. Increases in

current government expenditure in the Budgets for 2007 and 2008 were broadly based. The main discretionary changes were to raise the level of the state pension and to provide more generous social benefits in real terms. These have raised the contributory state pension from € 193.30 to € 223.30 per week for a single person, raised child benefit from € 150.00 to € 166.00 and increased the basic rate of benefits for adults under a variety of schemes from € 165.80 to € 197.00.

This comes against the background of rising benefit levels and greater funding for healthcare that have been key factors behind the rising share of government expenditure relative to GNI in recent years (Figure 4.3). In real terms, current expenditure on social services such as health and education increased by a quarter between 2004 and 2007.[2] The government increased basic benefits (such as the unemployment benefit) by 18% in real terms between 2005 and 2007 and largely achieved its goal of raising the benefit to 30% of the average wage. In the *Social Partnership Agreement* the government commits to maintaining this level over the long term, although it is unclear whether this is in real terms or as a share of the average wage. The sustainability of long-term commitments should be scrutinised in a clearer framework for the objectives and level of social benefits (Chapter 5). As social welfare payments have become more generous, the design and administration of benefits needs to take more account of the adverse impacts on labour supply. It is striking that one-fifth of the working-age population receives some form of income support, despite the dynamism of the economy, an unemployment rate close to 5%, and a young population.[3] Funding for long-term care has been reformed. From 2008, care recipients will be entitled to the same financial assistance no matter whether they are in a public or private long-stay bed. They will continue to pay fees but will pay no more than 80% of their disposable income up front. If user charges exceed this level, the rest is charged against the value of the person's home and will be paid back when the estate is settled (up to a maximum of 15% of the value of the house).

Figure 4.3. **Main components of higher public spending**

Contributions to annual government spending growth, per cent



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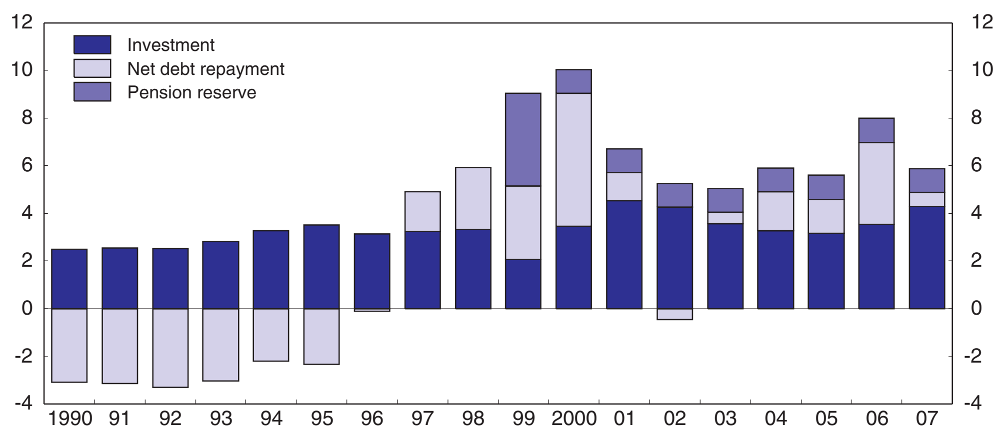
Source: Central Statistics Office, *Annual Income and Expenditure Tables*; Department of Finance, *Budget 2008* and OECD calculations.

Fiscal performance has remained sound but is weakening

In recent years and up to 2006, there was an operating surplus of receipts over current expenditure that has largely been used to improve public infrastructure (Figure 4.4), although some was paid into the National Pension Reserve Fund (NPRF) to cover future pension costs (Chapter 5) and a small part was used to pay down government debt. The fiscal surplus narrowed by around 2 percentage points of GNI in 2007, as revenue growth slowed sharply but expenditure increased at a double-digit rate. Spending growth is anticipated to moderate in 2008 but will remain well above the increase in receipts. The Budget for 2008 anticipates a deficit in coming years of around 1% of GNI. The increase in the deficit is stronger than implied by past relationships which suggest that the primary budget surplus would fall by around 0.4-0.5% of GNI for each 1 percentage point reduction in output relative to potential (Girouard and André, 2005). This shortfall is partly due to an unexpectedly sharp fall in revenues related to property. Although recent Budgets have been prepared on conservative assumptions about economic growth and have included a sizeable General Contingency Provision to deal with an unexpected deterioration in the fiscal balance, the sharp rise in expenditure in 2007 was ill-timed given developments in revenue and the targeted slowdown in expenditure for 2008 only closes part of the gap to the growth rate of receipts. It is important to ensure that spending increases in line with nominal growth of GNI. While elements of a multi-annual approach to managing current expenditure are in place, there is scope for strengthening this framework along the lines of the systems in many other countries to avoid sharp changes from year-to-year and excessive spending growth at times of buoyant revenues.

Figure 4.4. **The government balance sheet has been strengthened**

As a percentage of GNI



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Source: OECD (2007), *Economic Outlook 82 database* and OECD calculations.

The updated *Outlook* projection shows a further weakening in the fiscal balance in 2008 to a deficit of 1.2% of GNI: receipts continue to fall as a share of national income over the forecast horizon but expenditure growth does not fall below income growth until 2009. As with any fiscal projection, the scenario of a manageable deterioration of public finances is surrounded by major uncertainties. These risks underline the importance of slowing the growth of current expenditure as planned (Box 4.1).

Box 4.1. **Uncertainty around the fiscal balance as the economy slows**

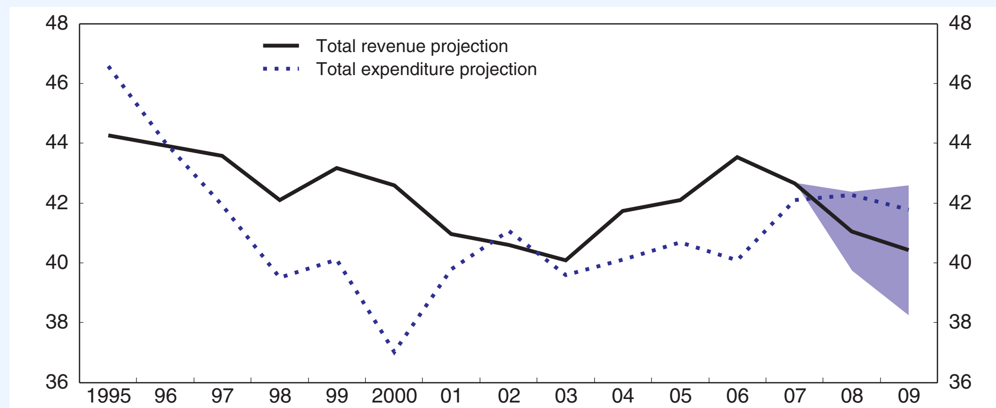
The budget balance is inherently hard to predict. During a slowdown, the lull in economic activity leads to a slowdown in tax revenues but spending tends to rise as more people claim social benefits and as discretionary fiscal policy is used to stimulate demand. Forecasts often miss the scale of such effects. This can lead to a large and unexpected deterioration in the budget balance.

There are a number of standard approaches to assessing the outlook for government finances. It is common to try to identify "structural" and "cyclical" components of the fiscal balance, either based on a "bottom-up" evaluation of how different tax revenues vary with the cycle given how the tax system is constructed (Girouard and André, 2005) or using "top-down" econometric analysis of how tax receipts have varied with GDP or the relevant tax base (Morris and Schuknecht, 2007).

Projections show that tax revenues are likely to decline as a share of national income (Figure 4.5), leading to a fiscal deficit as the share of expenditure does not contract. This slowdown in revenue is broadly in line with Girouard and André (2005), although the exact timing is influenced by the particular characteristics of this economic slowdown. The uncertainty around all these forecasts is large. Figure 4.5 gives an indication of revenue uncertainty based on a simple econometric model that allows for the difficulty of forecasting several different taxes and their respective tax bases. For example, a forecast of housing transactions is used to predict stamp duties but there are unknowns in predicting both the tax base and the resulting revenue. This basic approach suggests that there is a substantial risk that revenues will fall more sharply than anticipated and that there will be a larger-than-forecast deficit if expenditure does not adjust.

Figure 4.5. **A larger fiscal deficit is a risk**

As a percentage of GNI



StatLink http://dx.doi.org/10.1787/285314558113

Note: The shaded area shows indicative one standard error bands around the revenue projection.

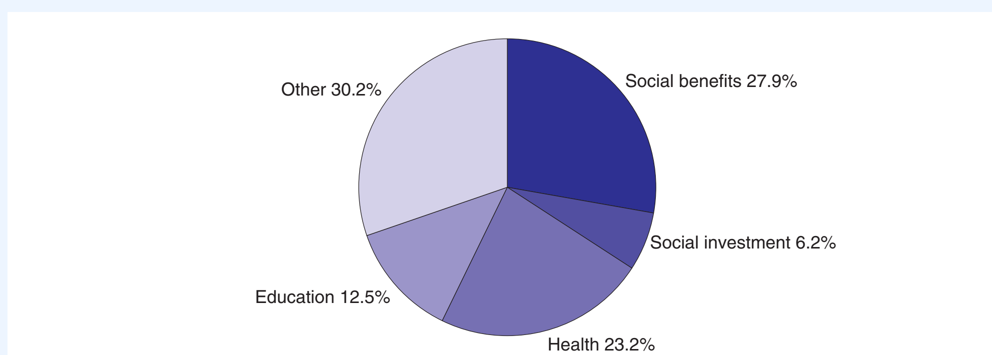
Source: Department of Finance, *Budget 2008*; OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Box 4.1. **Uncertainty around the fiscal balance as the economy slows** *(cont.)*

Such a shortfall in receipts would weaken the fiscal balance. The overall impact would depend on how government expenditure is managed. The government is committed to capital spending as part of the five-year envelopes and has said that the NDP will have priority in terms of government spending in coming years. Public expectations for better healthcare and education are running high. Figure 4.6 suggests that there is little room for manœuvre on the spending side because the share of spending that is not related to major government priorities or commitments is small. A relatively large change in other elements of government spending would be needed to offset the growth in these priority areas. Furthermore, as in many other countries, the wage bill is around two-thirds of current spending which highlights the importance of controlling public sector wages. Given the vulnerability of government revenues and the size of commitments on public expenditure, great vigilance is required in setting fiscal policy.

Figure 4.6. **Spending is heavily committed to priorities**[1]

Per cent of total spending, 2005



1. Social benefits include social security and welfare payments and housing (excluding investment). Social investment includes capital formation for transport, health, education and housing. Health and education refer to current spending. Shares of government spending exclude debt payments.

Source: Central Statistics Office, National Income and Expenditure Tables.

Ireland is committed to the EU Stability and Growth Pact as the medium-term fiscal framework to ensure sustainability. The anticipated fiscal deficit in the coming years would not compromise Ireland's commitments under the Pact, either in terms of the 3% of GDP limit for the actual deficit or the 1% cyclically-adjusted deficit that it is allowed because of strong government investment. The Budget for 2008 anticipates a cyclically-adjusted deficit of 0.6% of GDP in 2010, giving some limited room for manœuvre under the Pact. It is particularly important for Ireland, as a small member of a much larger monetary union, to maintain a sound medium-term fiscal position to allow the automatic stabilisers to operate freely as its particular circumstances will have little impact on how monetary policy is set. The cyclically-adjusted fiscal position has been relatively volatile compared with other OECD countries, which suggests the discretionary use of fiscal policy.[4] The Budget for 2008 usefully contributed to mitigating the impact of the slowdown in housing construction by reducing stamp duty, bringing forward infrastructure investment and raising social benefits. By contrast, the Budget for 2007 was overly expansionary and put additional pressure on the supply capacity of the economy over the past year when

aggregate demand was already strong and which may eventually limit the room for manœuvre in future years. Given that Ireland has a very open economy and a relatively low share of government activity in national income, which requires larger proportional changes in revenue and expenditure to achieve a given change in the government deficit as a share of GDP, the scope of discretionary fiscal policy to be effective is relatively narrow.

The medium-term position can be assessed with the cyclically-adjusted fiscal stance, which takes into account the estimated gap between actual output and the economy's long-run supply potential. Nevertheless, the rapid pace of economic growth in past years and the unexpectedly large inflow of migrants make the structural supply capacity of the economy hard to assess. Labour productivity growth of around 3% per year over the past five years offers a very different outlook for sustainable public spending growth than the average of over 5½ per cent annual growth in the late 1990s. Expansionary fiscal policy should not be used to stimulate demand if supply has in fact slowed. The 2007 Agreed Programme for Government, which runs to 2012, gives priority to keeping low income earners out of the income taxation and average earners below the higher band, but also commits to abolishing the cap on Pay Related Social Insurance (PRSI) contributions and lowering the rate of employee contributions from 4% to 2%,[5] subject to the overall economic and fiscal framework. This would lead to a more rational and fair system. Once these commitments are met, the government aims to lower the standard rate and higher rates of income tax to 18% and 40% respectively by the end of the term of the current parliament if conditions allow. These tax cuts were not made in the Budget for 2008 and should only be considered if medium-term economic circumstances allow.

The long-term outlook for the public finances is relatively strong as Ireland has a very low level of public debt compared with most other OECD countries. The current fiscal settings would, however, eventually become unsustainable due to the pressures from ageing as shown in the 2007 Actuarial Review of the Social Insurance Fund (Department of Social and Family Affairs, 2007). As discussed in Chapter 5, there are a number of options for dealing with the rising budgetary cost of pensions. These include greater pre-funding, increases in taxes and cutting back on other forms of spending, but changes to the pension system itself and encouraging adequate private pension saving must play a major role.

Additional resources should be used effectively

Despite the anticipated slowdown in government spending, the rate of public investment will remain high and the increases in government expenditure will be substantial compared with most other OECD countries. This makes it particularly important that additional resources are well used. The scale of additional government spending in past and future years puts pressure on the public sector's ability to manage the resources effectively and the economy's ability to deliver the additional services.

It is clear that Ireland has a need to improve its public service and infrastructure but it is important that the overall level of spending and the projects are a good use of limited resources. It is of concern that the NDP set overall spending at a higher level than recommended by the Economic and Social Research Institute's (ESRI) *Ex ante Evaluation of the Investment Priorities for the National Development Plan (2007-2013)* on the basis of its assessment at the time of how much additional investment the economy was able to deliver. In the event, the subsequent downturn in house-building has eased this constraint but specific bottlenecks may remain, for example with respect to some skills (ESRI, 2007).

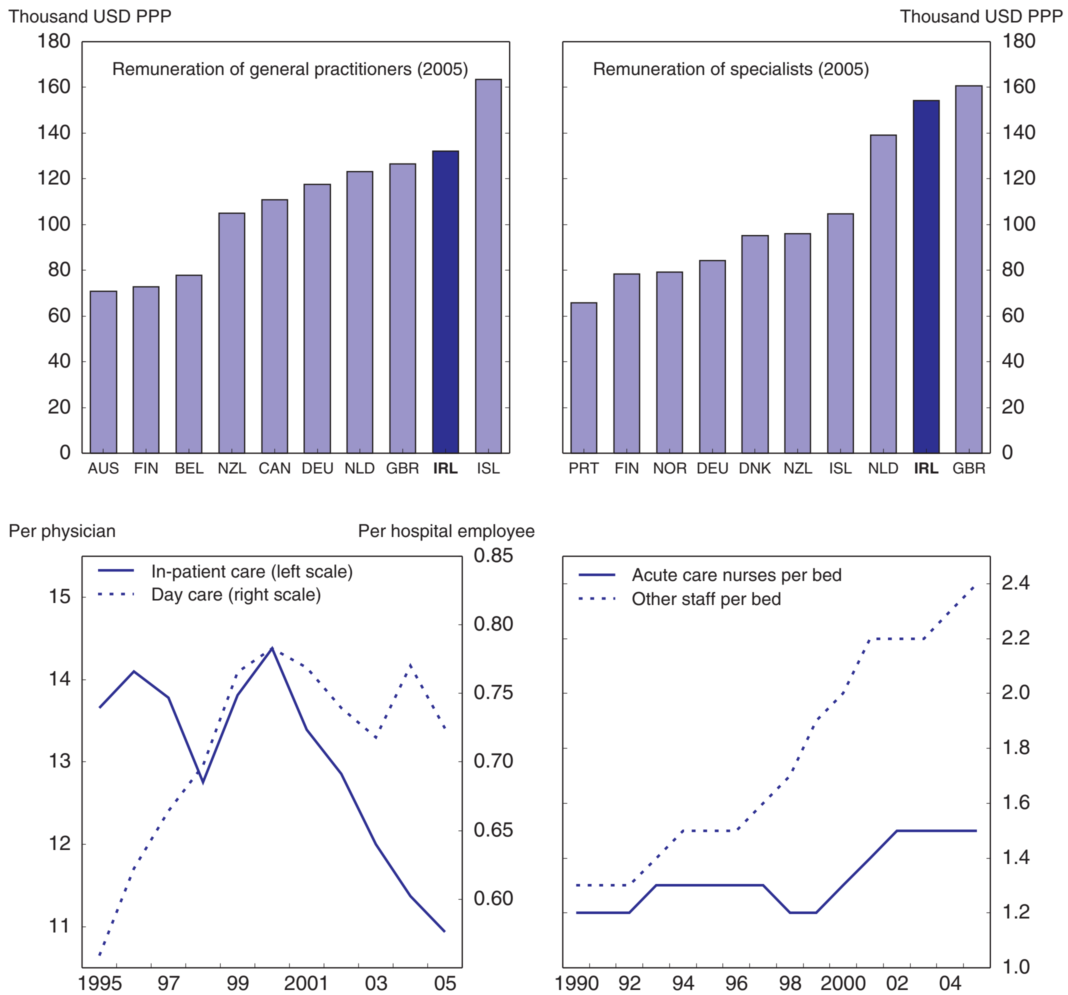
Non-residential construction has remained firm and Ireland faces competition for construction capacity from the boom in the North and major projects elsewhere such as the London Olympics.

Higher wages have absorbed much of the increased funding in the past. In particular, the first Public Service Benchmarking Body (PSBB) report in 2002 recommended an overall increase in public service pay costs of 8.9% (PSBB, 2002), leading to a sharp relative increase in public sector wages. These pay increases were tied to the elimination of many inefficient working practices, such as the system of linking pay in different parts of the public sector, and a greater volume of output. In practice, progress is hard to evaluate: although reports were published that show compliance with the agreed changes in working practices, no evidence was made available to demonstrate that better outcomes had been achieved and changes in working practices were found to be acceptable in almost every case. Furthermore, doubts were raised even at the time about whether public sector wages were actually out of line with the private sector (O'Leary, 2002). The first benchmarking report did not produce clear evidence to justify its conclusions and the generosity of public sector pensions was not taken into consideration (Chapter 5).

By contrast, the second PSBB found that "in general public service salaries compare well with the private sector" and recommends a limited number of specific pay increases representing just 0.3% of overall pay costs. This is based on a wide-ranging and transparent analysis of how public sector wages compare with the private sector. It confirms other recent evidence, such as an estimated 7% public sector wage premium for recent graduates, even after allowing for underlying differences in the two sectors and more extensive use of bonuses in the private sector but without taking into account pensions or job security (O'Connell and Russell, 2006). Public sector pensions are estimated by the PSBB to be worth 12% of salary more than the private sector equivalent. The challenge now is to ensure that this is reflected in the next pay deal under the *Towards 2016* social partnership agreement. Locking-in high pay commitments would be risky given uncertainty about future revenues and the need to improve competitiveness.

Public spending on *healthcare* rose by 64% in real per capita terms between 1999 and 2005.[6] Staff numbers have increased by around a third, with salary levels and capital investment accounting for the remainder.[7] The health system has treated more people, with a 50% increase in the number of hospital day cases and a small increase in the number of bed days. There have been significant improvements in life expectancy at birth and mortality. But there is a large gap between the additional expenditure and the growth of outputs. This could be explained by some combination of a change in the composition of treatment towards more expensive activities and a rise in the cost of performing the same activities. The high cost of some new drugs, for example, could explain a shift towards more costly activities, although technological advances that require less time in hospital act in the opposite direction to reduce costs. But some crude measures of productivity such as the number of procedures per physician or the number of staff per bed have worsened in recent years (Figure 4.7). The proportion of procedures carried out as day cases is below the OECD average, and this too can be a sign of inefficiency. Clearly, these indicators are simplistic and it would be unwise to draw any strong conclusions from them alone. They do, however, point to a need to analyse in greater depth whether the additional spending on healthcare has delivered all that it could have done in terms of the amount and quality of healthcare provided to patients. Investment is needed to produce statistical information to track changes in costs and the volume of health services more closely. One

Figure 4.7. **Indicators of healthcare efficiency**



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Source: OECD, *Health Data 2007*.

notable result of the increase in health spending is that Irish healthcare professionals are among the most highly paid in the OECD. Of course, Ireland competes for medical staff with the United Kingdom and any inefficiency there will drive up costs in Ireland (OECD, 2004), but there are also risks to health sector pay from inefficiency and large increases in spending within the Irish system.

The additional resources for healthcare have been provided at a time when the organisation of the health service is in a state of transition. A major reform of the structure of Ireland's health system was undertaken in 2004. This replaced the previous system of regional Health Boards with a single national organisation, the Health Service Executive (HSE). The HSE operates some hospitals directly, while most are owned by trusts/ foundations. Pouring extra money into the system at such a time, before the new organisation has been shown to work, is a risky strategy. The HSE overspent its budget for 2007 by € 216 million, which has led to a cost-containment plan and temporary recruitment freeze. Financial incentives and control in the health system should be

improved to avoid such short-term emergency measures. The newly established Health Forum provides a mechanism whereby the social partners can engage with each other to improve the operation of the health system.

Improving public sector management

Stronger public sector management is crucial to delivering a better public service from existing and additional resources. Previous *Surveys* in 2003 and 2006 (OECD, 2003 and 2006) included extensive discussions of the steps Ireland had taken and could take to get better value for money from public expenditure in line with the Strategic Management Initiative launched in 1994 and the subsequent Developing Better Government programme. Public sector management and procedures have again been strengthened since the previous *Survey*, but the needs of Irish society have also evolved. There has been systematic steady but incremental reform in some areas. Further reforms are necessary to improve how policies are implemented, to raise the agility of the public service, and to make reforms to the public sector more coherent. A review of the Irish Public Service by the OECD, commissioned by the Irish government, is currently underway.

The overall management of public expenditure has been improved. The new unified budget brings together spending and revenue decisions. The Pre-Budget Outlook, published around two months beforehand, provides an update of the economic context and the fiscal position to provide a basis for discussions during the budget round. Expenditure projections are based on the cost of maintaining the existing level of service (ELS), which tends to increase in real terms as population growth and other factors increase the demand for public services. However, by taking current practice as the reference point, the ELS approach does not achieve the tight budget constraints that would encourage departments each year to seek efficiency gains or prioritise more effectively between different activities. In addition, the Pre-Budget Outlook includes an Indicative Unallocated Provision which amounted to 0.75% of GNI for 2008. This is intended to make the overall fiscal projections more realistic by including an indication of likely spending increases over and above the ELS. There is a risk, however, that this creates an undue perception of scope for additional expenditure or tax measures, particularly as the Provision includes the cost of indexing tax brackets and social welfare payments which is common practice. A more effective starting point for negotiations with departments would be a top-down publicly-stated, rather than internal, target for actual overall spending increases without reference to the ELS. This would be a tighter constraint on departments and encourage greater efficiency. Similar measures have been found to be helpful in countries such as Australia and Sweden. The multi-annual budgeting framework should be strengthened to provide a clearer sense of direction for current spending in the medium term.

The newly-introduced Efficiency Review requires each department to submit specific proposals to maximise administrative savings by March 2008, which may help to counterbalance the ELS approach of the budgeting process. Departments that do not engage sufficiently with this process face a lower settlement in the 2009 spending round. This type of incentive could be extended to public spending more generally. It could be made more effective if there were more explicit targets for savings and a clearer benchmark against which outcomes in the 2009 round could be assessed. The effectiveness of this process should be monitored.

Management of public spending should focus on outputs and outcomes, rather than on spending and inputs. Resources should be aligned with the NDP and other major government commitments. The introduction of Annual Output Statements, a list of outputs and objectives submitted to parliament by each department, is an important step towards best practice in this area. These provide clear information about what services government plans to deliver and the cost of delivering each element, in addition to raising accountability and parliamentary oversight. Progress is being made in linking output statements to departmental statements of strategy and improving the overall process, which should help to ensure that the focus is on how key objectives can be achieved rather than simply on what will be done. The 2008 statements will be crucial as these provide the first evaluation of actual performance against the stated objectives. There is scope to improve output statements to make them clearer and more quantifiable. This framework should be extended to cover government agencies. The output statements and evaluation should have a real impact on where spending is directed in future years, including re-directing funds where necessary.

The focus on outputs to improve performance could also be raised by changes to the relationship between departments and agencies. The current system uses strong input controls but there is little emphasis on the level of performance delegated bodies achieve. OECD experience shows that the benefit of agencies lies mostly in their ability to focus on delivering specific results. Efficiency could be increased if agencies had greater managerial autonomy and if departments developed a greater capacity to provide effective oversight of the outcome. A clear rationale needs to be established for the creation, role and accountability of the plethora of different agencies.

Further progress should be made to tie analysis into the decision-making process and use it more actively to decide the effective allocation of resources. The Management Information Framework (MIF) is intended to address this in part. The system has been rolled out across government but further action is needed to exploit its full potential. Staff should be better trained in the use of the system and departments need to take ownership of the process. Furthermore, the MIF should be better integrated with other performance initiatives so that the operational data produced meets the needs of the output statements and strategic plans. This would both make it easier to integrate this information into decision-making and reduce the administrative burden on departments. Given the difficulties experienced with rolling out this programme, pilot studies could be used to develop the approach to be taken.

The expenditure review process should be further strengthened. The Value for Money (VFM) circular letter of 25 January 2006 toughened the existing guidelines for appraisal of capital projects, effectively requiring full cost-benefit analysis for all projects worth more than € 30 million. Separately, Value for Money and Policy Reviews which examine departmental spending were introduced in 2006, replacing the Expenditure Review Initiative. Ninety reviews covering a minimum 10 to 15% of each department's budget have been approved for the period 2006 to 2008. The effectiveness of this approach may be weakened by the fact that departments themselves are mostly responsible for choosing which areas of expenditure to review and evaluating their own performance, although the Department of Finance must approve the choice of areas to be scrutinised and all of a department's spending would fall for review over a period of several years. A best practice guidance manual has now been published to help departments (Department of Finance, 2007). In line with recommendations in earlier *Surveys*, a centralised Efficiency Unit has been established in the Ministry of Finance and this should help to strengthen the evaluation process for VFM Reviews, as well as capital projects, by building up centralised

expertise. This role should be strengthened. It is important that evaluations produced under this initiative actually have a substantial impact on budgeting decisions: VFM Reviews should systematically be taken into account in resource allocation decisions.

The accounting framework for public expenditure should be improved. The Exchequer accounts are calculated on a cash rather than accruals basis.[8] Departments are not charged for the cost of capital, making it difficult to allocate capital efficiently and creating few incentives to minimise on capital such as office space. An opportunity to remedy this is presented *via* the inter-departmental working group which is reviewing the structure of the annual Departmental financial statements, in particular the notes on assets, accruals and liabilities, including pension and contingent liabilities. Although consistent with Eurostat national accounts guidelines,[9] there is no fully comprehensive statement of all future government liabilities accumulated under Public-Private Partnerships (PPPs). This would be useful for understanding the fiscal position, even if there are many other implicit government liabilities that are also excluded from the accounts, because one potential risk with PPP funding is that the legal contract to purchase services from the provider may be less flexible than other forms of funding if needs change or spending needs to be cut.

The ability of the public service to provide services effectively depends on a well-motivated and well-equipped workforce. The share of the workforce employed in the general government and state-funded sectors is not high among OECD countries, despite recent increases, and a lack of capacity has sometimes been apparent. Ireland's exceptional level of *ex ante* controls on personnel numbers and costs hinders flexibility to hire appropriately. These should be rebalanced as the stronger requirements on departments to report on their output performance come to the fore. There is also a lack of mobility across the public service. A unified labour market would help to create more opportunities for individuals to develop within the relatively small public-sector labour market, as well as allowing skills and experience to be allocated more widely. In terms of attracting talent from outside the public service, open recruitment procedures have been extended and now include middle and senior management positions. This, however, has resulted in very few external hires. Pay is determined according to centrally-determined pay scales and this reduces the flexibility of individual departments to set salaries as a function of their needs, in particular for staff with specialist skills such as IT, finance and project management. There has been substantial progress through the now well-developed Performance Management and Development System, although this should be better integrated with decision-making about human resources policies. There is a need to professionalise human resource functions, making more use of specialists rather than relying on generalists to carry out these activities.

The decentralisation programme aims to move eight full government departments and a range of other civil service functions and public service agencies (some 10 000 posts) out of Dublin into the regions. Although the original deadline of 2007 was shown to be unrealistic, projections for progress towards the new goal of 2009 have consistently been revised down. The number of staff transferred was approximately 2 000 by the end of 2007. Progress so far appears to have been evaluated in terms of the process of decentralising-acquiring property, construction and persuading staff to move. When the implementation of the programme has progressed substantially, the programme should be evaluated in terms of its overall benefits and costs. Now that substantial numbers of staff are moving, there is a new challenge in terms of making the new locations work and avoiding any fragmentation in government operations.

The search for value for money needs to go wider than central government. Inefficiencies at the local government level are also a concern, especially when rising costs are passed on to the business sector. Local government monopolies could become more efficient by contracting out service delivery and by making more use of full-cost user charges while ensuring they are levied fairly on the households and businesses that actually use the services. Incentives could also be improved by using *ex ante* estimation of standard costs, increasing co-financing of earmarked grants by local authorities and moving towards block grants for projects without spill-over effects. Local government finances will be reviewed by the Commission on Taxation.

The use of outsourcing is relatively limited, partly because the lack of information makes it hard for government to evaluate the cost of providing services itself. A central unit should be established to share good practice and provide technical assistance to departments in contracting out services that would benefit from this type of procurement.

Public-Private Partnerships

Public-Private Partnerships involve the private sector in the provision of public services through a number of different mechanisms. Ireland is making extensive use of these arrangements to deliver improved public services and infrastructure. The importance of this mechanism should not be overstated as it still represents only a small part of spending on infrastructure under the NDP (Table 4.3), where it is mostly concentrated in road building. PPPs have also been used for projects such as new schools and prisons. The recent experience of PPPs for road construction, where many projects have been delivered on budget and ahead of schedule, indicates the benefits of this method of procurement.

Table 4.3. **Spending on economic infrastructure under the National Development Plan**

Total spending from 2007-13 as a percentage of GNI

	Exchequer	PPPs	Local authorities and other state bodies	Total
Transport	1.4	0.5	0.4	2.4
Roads				*1.3*
Public transport				*0.9*
Air transport and ports				*0.2*
Energy	0.0	0.0	0.6	0.6
Environmental services	0.3	0.0	0.1	0.4
Communications and broadband	0.0	0.0	0.0	0.0
Government. infrastructure	0.1	0.0	0.0	0.1
Local authority development	0.0	0.0	0.2	0.2
Unallocated capital reserve	0.1	0.1	0.0	0.3
Economic infrastructure, total	2.0	0.7	1.3	4.0

Source: National Development Plan 2007-2003 (2007), OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Ireland has moved towards best practice with respect to PPPs (Box 4.2), having made similar mistakes to other countries such as Australia and the United Kingdom when this type of procurement was initially used. A Central PPP Policy Unit has been established at the Ministry of Finance. Its key function is to develop the legislative framework, technical and policy guidance to support the PPP process and to disseminate best practice in PPPs. It is not directly involved in projects which are a matter for the procuring agencies. In the

Box 4.2. **OECD principles for private sector participation in infrastructure**

First, the decision to involve the private sector has to be guided by an assessment of the relative long-term costs and benefits and availability of finance, taking into account the pricing of risks transferred to the private operators and prudent fiscal treatment of risks remaining in the public domain.

Second, authorities need to ensure an enabling policy framework for investment.

Third, the success of private involvement in infrastructure depends on public acceptance and on the capacities at all levels of government to implement agreed projects.

Fourth, the public authorities and the private sector need to establish a working relationship toward the joint fulfilment of the infrastructure needs.

Fifth, insofar as they are not rooted in formal legal requirements, governments' expectations regarding responsible business conduct need to be clearly communicated by governments to their private partners.

transport area PPP procurement is managed by two procurement agencies: the National Roads Authority (NRA) and the Railway Procurement Agency (RPA). In addition, a centre of expertise to procure PPP projects on behalf of ministries and agencies funded directly by central government has been established within the National Development Finance Agency (NDFA). State authorities are expected to obtain financial advice from NDFA on all public investment projects over € 30 million, including PPPs.

Conclusion: Fiscal policy must adapt to a more challenging environment

Strong revenue growth in the years leading up to 2006 allowed Ireland to maintain a sound fiscal position and repay debt while substantially increasing public investment, social spending and welfare benefits. The rapid turnaround in revenue growth in 2007 has led to a deterioration in the public finances and expenditure growth will need to slow as the Budget projects. There are substantial risks around future tax revenue, both in the short and longer term. The slowdown in revenue growth implies that the need to improve public services and infrastructure will have to be met by raising the performance of the public service. A wide range of measures has already been taken to improve the management of public resources and value for money but much remains to be done.

Box 4.3. **Summary of recommendations on fiscal policy**

Public spending growth should slow to reflect lower revenue growth. Upgrading infrastructure should be given priority over current expenditure.

Further steps should be taken to reconsider the large number of tax expenditures and those that are shown to be inefficient by cost-benefit analysis should be eliminated. This includes phasing out tax distortions that favour housing (Chapter 2).

Expensive commitments on public sector pay should be avoided. The conclusions of the second Public Sector Benchmarking Body report should be implemented in the next pay deal under the *Towards 2016* social partnership agreement. The link between higher pay and improved performance in the public service should be more explicit and transparent.

Box 4.3. **Summary of recommendations on fiscal policy** *(cont.)*

A transparent, top-down budgeting process should be adopted to strengthen the emphasis on value for money, building on the potential of the new Unified Budget approach. Multi-annual budgeting should be strengthened for current spending in line with the existing approach to capital expenditure. A balance sheet for the government should be produced.

Public sector management should be improved:

- Improve the flexibility of human resource management, enhance mobility within the public service, and make human resources management more professional.
- Move further from input control to output management. The output statement framework should be improved and extended to cover agencies. The Management Information Framework (MIF) should be developed further and the information it produces integrated with other initiatives.
- Use analysis more systematically for decision-making. The Value for Money initiative should be strengthened and the outcome of the process should be systematically applied in setting budgets and lessons learned applied to future decisions.

Notes

1. The main figures produced by the Department of Finance for the budget and other documents are presented on an Exchequer basis. This differs from the national accounts basis used in the *OECD Economic Outlook* and there are differences in the headline numbers from the two sources, including the fiscal balance.
2. Based on budget estimates.
3. In December 2006, 604 830 working-age people were receiving a weekly social welfare payment.
4. However, this could also reflect the relatively volatile nature of government revenues that is not accounted for in standard methods of cyclical adjustment.
5. The rate of PRSI contributions paid by the self-employed would fall from 3% to 2%.
6. See *OECD Health Data 2007*.
7. Employment in hospitals increased by 35% over this period. The remuneration of general practitioners increased by 64% in real terms (compared with a 12% real increase in the manufacturing sector and financial sectors). Salary figures for specialists and nurses in 1999 are not available. Increased investment spending accounts for 5.3% of the total increase in public expenditure on healthcare over that period.
8. The Exchequer account is cash based, but some Budget documentation is produced on an accruals basis in accordance with the European System of National Accounts ESA 95 standard.
9. If risk is transferred to the private sector, the guidelines do not require the government's liabilities under the contract to appear on the government's balance sheet.

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Chapter 5

Setting the pension system on the right track

Ireland currently has a relatively young population but faces similar, if more distant, long-term pressures from population ageing as other countries. The pension system is founded on a basic state pension but relies heavily on private saving to provide adequate replacement incomes in retirement. Large increases in the state pension have reduced poverty, although many pensioners still have low incomes. There is a large retirement savings gap for many households between the close to flat-rate state pension and a reasonable replacement income in retirement. Private pensions saving may be too limited to close this gap for many low- and middle-income earners. There are large tax incentives to save for retirement, but these are poorly targeted and the overall effect on saving is likely to be limited. Against the background of the pressures that ageing will eventually impose on public finances and the wider economy, this chapter outlines options for pension reform.

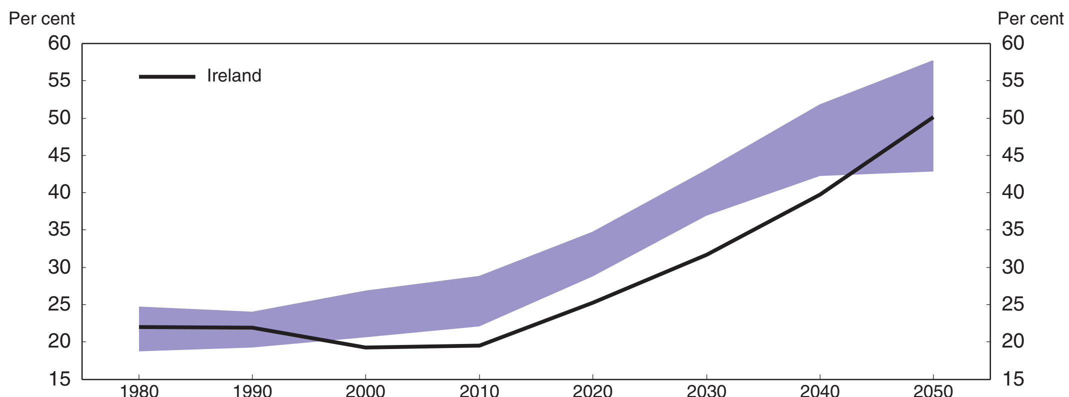
The pension system combines a basic state pension with an important role for private saving. The government in effect provides a universal, flat-rate pension from age 65 or 66.[1] Second-tier private provision is available to close the gap between the modest state pension and the income necessary to sustain a defined level of consumption in retirement. Voluntary private pension saving takes the form of funded defined-benefit (DB) or defined-contribution (DC) occupational schemes, Private Retirement Savings Accounts (PRSAs) and private pensions. There is a very generous system of tax incentives for pension saving and favourable tax treatment for those aged over 65.

The 1998 *National Pensions Policy Initiative* (NPPI) set out objectives for the coverage and adequacy of the pension system: a minimum level of retirement income from the state pension of 34% of Gross Average Industrial Earnings (GAIE) and a target post-retirement income of 50% of pre-retirement income before tax, subject to the minimum basic pension. In relation to coverage, a target was set of 70% of those in work between the ages of 30 and 65 by 2013. Progress has been made to achieving these goals, which are not official government policy. The state pension has now reached the minimum level envisaged by the NPPI, with a commitment under the 2007 Agreed Programme for Government to increase it further to approximately 38% of GAIE by 2012. Coverage has increased in recent years and now stands at 62% of the target group. The NPPI targets were confirmed in 2006 by the Pensions Board (Pensions Board, 2005) under the National Pensions Review (NPR), with a reservation from the representative of the Minister for Finance.

The impact of the pension system on the wider economy today is relatively small as Ireland has a young population: almost 45% of the workforce is aged under 35 and government spending on pensions as a share of GNI is consequently among the lowest in Europe. But the old-age dependency ratio will rise substantially over the coming decades and be close to the OECD average by 2050 (Figure 5.1). Pensions in Ireland therefore present

Figure 5.1. **Old-age dependency will eventually match other countries**

Population aged over 65 relative to working-age population



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Note: The shaded area indicates the interquartile range of OECD countries.

Source: OECD, *Demographic and Labour Force Statistics databases*.

a slightly different policy challenge from that in most other developed countries. The problem is not how to fund an immediate increase in the number of retired people, but rather that ageing will require a large long-term change in the way resources are allocated. Decisions taken now about the role of the state pension and how to encourage Irish people to save sufficiently to meet their retirement income objectives, taking account of the associated risks, could make it easier for the economy to adapt.

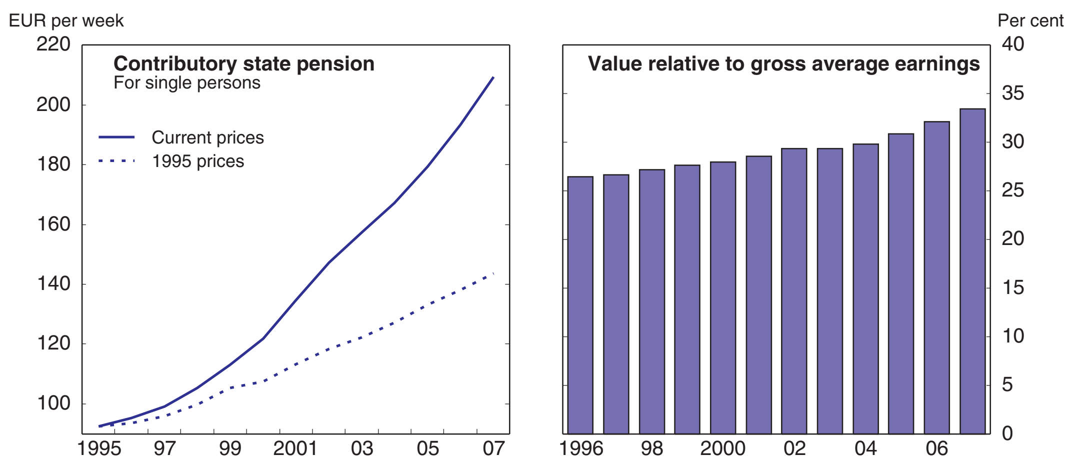
The basic state pension is the foundation of the system

The state pension is similar in effect to a universal payment to those of retirement age. It is the foundation of the system, providing the main source of retirement for many pensioners, and it is typically integrated with the funded DB pension schemes run by some employers.[2] Although the basic structure of the pension system has remained unchanged for decades, its *de facto* impact has been substantially modified in recent years by the continuing increase in the real value of the state pension facilitated by the economic boom. The system has been broadly moving away from providing minimal pensions funded by social security contributions towards paying a more substantial retirement income, which will become dependent on financing from general tax revenues and the National Pension Reserve Fund (NPRF) if contribution rates are not eventually raised.

More generous pensions have reduced pensioner poverty

The value of the contributory and non-contributory state pensions is around € 220 per week for a single pensioner and € 440 for a pensioner couple.[3] There are additional cash payments for some groups such as the Living Alone Increase and the Over Age 80 Allowance. There are also in-kind benefits worth around € 1 000 per year for each household aged 70 and over, means-tested for those aged 66 and above, and a Fuel Allowance worth around € 500 per year for pensioner households. Paying benefits in this way is inefficient and undermines consumer choice, although it may contribute to other social objectives and these schemes have public support (Quinn, 2000). It would be simpler to replace these allowances and raise the state pension by an equivalent cash amount. The value of the state pension has increased rapidly in recent years both in real terms and relative to average earnings (Figure 5.2). This has

Figure 5.2. **State pension**



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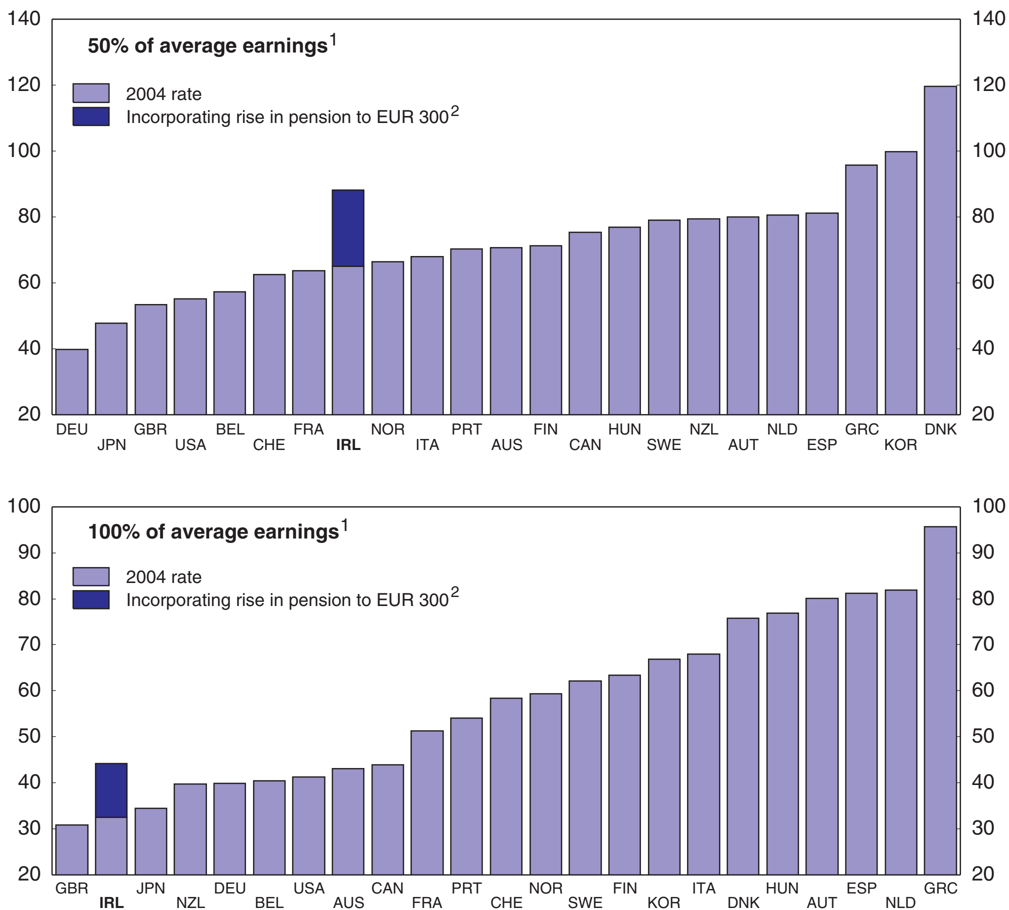
Source: Department of Social and Family Affairs; Central Statistics Office; Eurostat Pensions Indicators.

substantially reduced the proportion of older people living in households in the poorest quartile of the income distribution. The at-risk-of-poverty rate for pensioners has fallen and the share of those aged 65 and over in "consistent poverty" at the 60% of median income threshold dropped from 5.8% in 2003 to 2.2% in 2006, although by some measures the proportion of older people living on relatively low incomes is still fairly high by European standards.

The government's commitment to raising the state pension for a single person to € 300 per week by 2012 implies a further large increase in real terms. Building on previous increases, the replacement rate from the state pension will switch from being among the lowest in the OECD to being relatively high for those with below-average earnings (Figure 5.3).

Figure 5.3. **Gross replacement rates**

2004



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1. Average earnings based on OECD data and not the Gross Average Industrial Earnings (GAIE).
2. The impact on gross replacement rates of raising the state pension to EUR 300 is estimated by assuming that average earnings increase with nominal GDP from 2007.

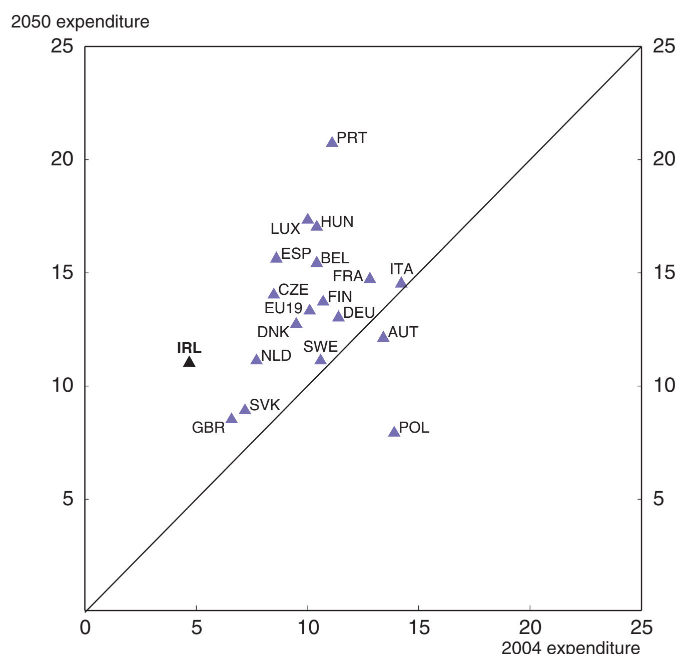
Source: OECD (2007), *Pensions at a Glance: Public Policies across OECD Countries* and OECD calculations.

Government spending on pensions will rise

The budgetary cost of the state pension system is currently around 5% of GDP, the lowest in the EU19, reflecting the young workforce and relatively low level of the state pension. This is projected to rise substantially by 2050 as the population ages, even before taking account of the increase in generosity programmed by 2012 (Figure 5.4). The peak of expenditure in Ireland would come after 2050, later than in most other EU countries. As the old-age dependency ratio rises, the burden of financing would shift away from social security contributions (PRSI contributions) towards general taxation if contribution rates are not raised.

Figure 5.4. **Public expenditure on pensions**

Per cent of GDP



StatLink http://dx.doi.org/10.1787/285550648381

Note: EU19 excludes Greece.

Source: EPC (2006), "Impact of Ageing Populations on Public Spending on Pensions, Health and Long-term Care, Education and Unemployment Benefits for the Elderly", ECFIN/EPC(2006)REP/238 final.

The National Pension Reserve Fund (NPRF) was established in 2001 to build up reserves so that the fiscal costs of ageing could be smoothed through time. By law, the Exchequer contributes at least 1% of GNP each year and *ad hoc* contributions have been made from the sale of government assets. At the time of its establishment, it was envisaged that the fund should cover around one-third of the projected increase in pension costs from when the fund can first be accessed in 2025 to 2055 when the scheme ends, and a lower proportion if some reserves are held back to meet liabilities after 2055. The asset allocation strategy relies heavily on investment in equities and other risky assets, which are expected to yield a higher rate of return than government bonds. This allowed the accumulated reserves to rise to almost 13% of GNI by 2006, but the greater risk associated

with these assets should also be taken into account when evaluating the likely contribution of the NPRF to meeting pensions-related costs in the long term.

Although government spending on pensions as a share of GDP will be around average for the EU19 in 2050 on current projections, the change for Ireland will be relatively large. This implies that, under the current pension system, Ireland would have to make very substantial changes, either by reallocating large parts of government expenditure from other activities or by substantially raising taxes. This would occur even allowing for additional funding from the NPRF. The reduction in government investment as the upgrading of infrastructure is completed, as well as the increase in national income derived from this investment, will only meet part of the increase in pension costs. In addition, the demand for medical and social services is likely to rise in tandem with the greying of the population.

The long-term objectives for the state pension are unclear

A Green Paper on Pensions (Department of Social and Family Affairs, 2007) has recently been published with a view to establishing a framework of long-term objectives and commitments in relation to pensions policy. A clear framework is important to assess the fiscal sustainability of the system, to evaluate how government aspirations for pension coverage and adequacy are likely to be met, and to allow individuals to plan their retirement. It can be argued that there are two major gaps in existing practice. Firstly, there is no formal commitment by the government about the long-run value of the state pension. Whether the promise to raise pensions to € 300 by 2012 turns out to be reasonable depends on inflation, and the impact on the replacement rate depends on future wage developments over the next five years. Over the very long term, there is no explicit commitment to reach the NPPI targets for pensions. Formal indexation of pension benefits or a commitment to an objective in terms of average earnings would make clear the projected value of future pensions and help clarify the associated fiscal liability. This is common practice in other OECD countries. Indexing the value of the pension to prices aims to guarantee the purchasing power of older households but means that their incomes will tend to fall relative to those of the working population. Recent gains in reducing pensioner poverty would therefore be eroded as the relative value of the state pension declined over time. Although it is more costly, some form of indexation to earnings would avoid this. Many countries have adopted some hybrid form of indexation that weighs these considerations together, although such long-term commitments do present some risks in terms of affordability over the long run if circumstances change unexpectedly.

The second aspect for which long-term objectives should be considered is the statutory retirement age. This is currently fixed at the age of 65/66, which is at the upper end of standard retirement ages in OECD countries. However, the number of years that people are likely to enjoy in retirement is rising. The average life expectancy at 60 rose by 3.6 years between 1995 and 2005. This is a major risk for the pension system: the increase in longevity has been consistently underestimated in demographic projections. With its young population, Ireland is particularly exposed to this risk as mortality rates are less predictable further into the future. Indexing the retirement age to longevity over the longer term would provide a way of managing this risk by tending to reduce the time over which benefits are paid and increasing overall contributions. Raising the retirement age would also reflect the increased number of years of good health that is likely to accompany higher life expectancy. Combined with a clear objective for the level of benefits, this would give a

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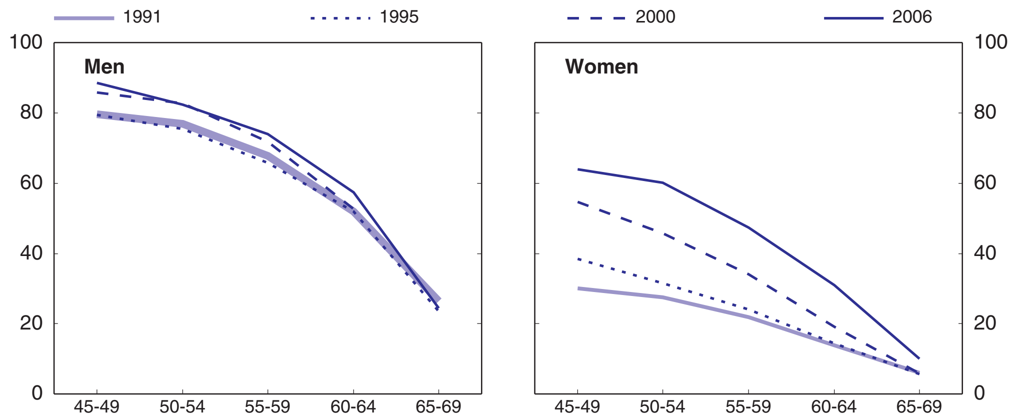
clear signal to workers about the value of their retirement income and the possibility of having to work longer as life expectancy increases. Pension reforms in Denmark and France have linked pension eligibility age or the required number of years of contributions to increasing longevity in this way, and other countries such as Germany and Sweden have made a more general link between benefits and life expectancy. The recent Green Paper on Pensions has laid out options for reform and the Government has committed to producing a long-term framework for pensions following a consultation process.

Work incentives could be improved

The effective (or average) retirement age in Ireland is almost 65, having increased by around one year since 2001,[4] and the employment rate of those over 65 is above the OECD average. But high employment at older ages is partly the legacy of a past pattern of rural life and employment rates fall sharply above the age of 55 (Figure 5.5), reflecting in part the low average level of education of older people in Ireland. The incentives to work to the standard retirement age are strong as the state pension cannot be claimed at a younger age. The State Pension (Contributory) provides good incentives to work after age 66 as it is paid regardless of whether the individual continues to work or not. As the level of the pension is relatively low for many people, there may be little impact on the willingness to work from the extra welfare benefits and continuing to work can provide a way to earn additional income for those with limited other resources.

Figure 5.5. **Employment rates by age**

Per cent



StatLink http://dx.doi.org/10.1787/285572672527

Source: OECD (2008), *Labour Force Statistics – online database* (January).

A number of policies can be used to encourage the employment of older workers further. These include improving their employability through lifelong learning and more employment services to help them find a job. These were discussed in the *Ageing and Employment* review of Ireland (OECD, 2005b). Regarding pensions policy, some progress has already been made towards the elimination of remaining incentives to retire before the age of 65 by phasing out the PRETA, which allowed some currently outside the workforce to retire from age 55. Extending active labour market policies to target older workers through the preventive process of unemployment assistance has also removed a channel from unemployment into effective early retirement. Means testing of labour income under the

non-contributory pension has been relaxed but further progress would be desirable.[5] Offering an actuarially-equivalent increase in the state pension for deferred retirement would make it easier to stay in the labour force and the 2007 Agreed Programme for Government includes commitments to raise the state pension for each year worked beyond the age of 66.

With more restrictions on older workers leaving the labour force, it is important to ensure that disability does not open up as an alternative channel into effective early retirement as has happened in several other OECD countries. Although there are safeguards in place such as assessment of new claimants by doctors appointed by the Department of Social and Family Affairs, the number of recipients of a broad range of disability benefits has increased by three-quarters since 1990. The upward trend can be partly explained by the widening of qualifying conditions in the mid-1990s and a move from short to long-term payments. Almost three quarters of Invalidity Pension recipients are aged 55 to 66 (Department of Social and Family Affairs, 2006). The strong work disincentives for those on benefits are a major policy concern. Disincentives can arise for some from the loss of secondary benefits, such as the loss of the Medical Card that guarantees free health care for the whole family, when taking up work. While it is now possible to keep the Medical Card for three years, other secondary benefits will still be lost. In addition, the assessment process puts little focus on work capacity and active labour market policy does not do much to help the disabled to find a job. A pilot in one region is developing a customer-oriented intensive engagement upon claim application, but there is no conditionality so the chances of success are relatively low. In the United Kingdom, for instance, the Pathways to Work programme is compulsory for new incapacity benefit claimants.

Public sector pensions will become increasingly costly

There are currently 90 000 pensioners in public service DB pension schemes. These schemes are financed on a pay-as-you-go basis. The increase in payouts from public sector pensions will account for less than one-third of the overall rise in pension spending by the government by 2050, and will partly be financed by some of the accumulated NPRF reserves. Reforms in 2004 partially addressed the problem of public service workers retiring before the age of 65, although the increase in the minimum pension age from 60 to 65 only applies to those who joined the public service after 2004 and so will take a long time to take effect. In addition, employees now make some contribution to pension costs. Other elements of the system, however, remain relatively generous and will place a burden on future taxpayers. In particular, pensions in payment to existing pensioners are uprated in line with the wages of workers currently doing jobs similar to those previously undertaken by the retired person (pay parity), rather than prices as is typical in private DB schemes. There is scope to bring the uprating of public service pensions more into line with other pensions and thereby reduce the future cost.

Private pension saving needs to increase

Private savings are required to fill the retirement savings gap

There is a substantial gap between the flat-rate state pension and the level of retirement income needed by most people to replace a sufficient proportion of their pre-retirement income. The pension system relies heavily on private pension saving to close this gap. In aggregate, there is substantial saving by households: the net saving ratio is

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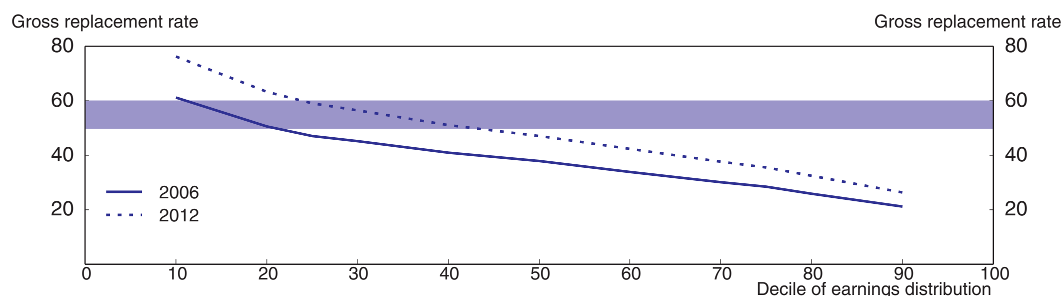
almost 10% of disposable income, which is not far behind the economies with imminent ageing pressures such as France, Italy and Germany and way above the United States and the United Kingdom. Private pension assets are also larger in relation to GNI than in most OECD countries and similar in size to some other countries where second pillar private pensions are important such as Australia and the United Kingdom. But the healthy picture for the household sector as a whole masks the problem that many people may not be saving enough to fill the gap between the state pension and a decent retirement income. Data on aggregate household wealth and its distribution in Ireland is limited at present, although owner-occupation of houses among older households is very widespread. This implies that a high proportion of pensioners do not have any rent to pay and that, in aggregate, pensioners own a considerable stock of wealth.

Occupational pensions are the most widely used mechanism for closing the retirement savings gap. Together with personal pension provision, the coverage of private pensions has risen to 62% of employed persons aged 30-65. However, such limited coverage is well below the NPPI target of 70% coverage by 2013. This suggests that some low- and middle-income earners, those who are not fortunate enough to have a private pension and for whom the state pension is less than half their pre-retirement income, will not achieve the targeted replacement rate of at least 50% of their pre-retirement income as they lack pension coverage (Figure 5.6).[6] Furthermore, even workers with DB pensions may struggle to reach the 50% target if they have an incomplete history of pension contributions or have changed employers.[7] But the 50% target itself is not an ambitious goal as it would provide a replacement rate below the OECD average from mandatory pensions alone and be considerably below the maximum two-thirds replacement that is typically targeted under an occupational DB scheme. Evaluation of the extent of the retirement savings gap is difficult as there is limited evidence of what replacement rate future pensioners are currently likely to achieve. Furthermore, the assessment is very sensitive to the targeted replacement rate as many workers earn at around the level that the state pension would replace 50-60% of their pre-retirement income. For everyone to have a replacement rate of at least 60% would require a large increase in the number of low- and middle-income earners making private retirement provision, even with the effect of the state pension rising to € 300 per week.

Figure 5.6. **Gross replacement rate from state pension**



StatLink http://dx.doi.org/10.1787/285576836821

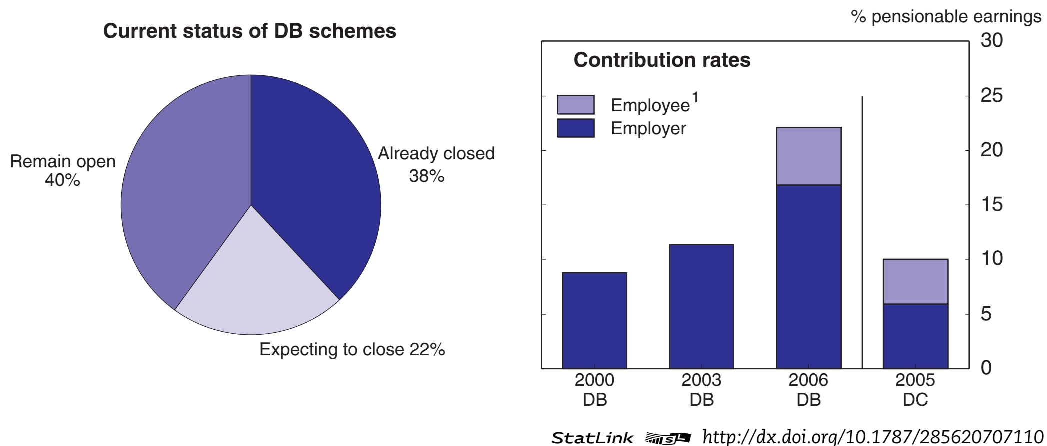
Note: The shaded area represents a target replacement rate of 50 to 60%.

Source: European Community Household Panel (ECHP) Survey (2001); Central Statistics Office and OECD calculations.

It is important that private pensions are adequate to help close the gap between the state pension and the desired level of replacement income in retirement. Most members of

public sector and private DB schemes should receive pensions in excess of 50% of their pre-retirement income. However, there has been a marked shift towards DC schemes for those currently saving for retirement (Figure 5.7). Average contribution rates in DC schemes are on average around 10% of pensionable earnings, which is often contrasted with the higher average contribution rates of DB schemes. But is this rate of contributions inadequate? This is difficult to assess. Estimates in *Pensions at a Glance* suggest that this rate of contribution would be consistent with closing the retirement savings gap if annual real returns were 3.5% and a full contributions record is achieved, although this would require people to save for a pension from an early age (OECD, 2007a). Furthermore, there are large risks around these estimates depending on future unexpected changes in longevity and investment returns. It may be that DC contribution rates do not need to match the very recent rise in the contribution rates to DB schemes brought about by lower investment returns and rising longevity that lead to gaps in the funding of these schemes (Mercer, 2005, 2006). On the other hand, there is a substantial risk that 10% contribution rates will be too low to deliver the expected retirement income. Unlike DB schemes, all of the life-expectancy and investment risk is carried directly by the individual in DC schemes. It is important that workers properly understand this implication of the move from DB to DC pension schemes. This risk is particularly salient in Ireland as the flat-rate state pension is not particularly generous for those with above-average earnings and for whom a relatively large share of anticipated retirement income must therefore be generated from private saving.

Figure 5.7. **Occupational pension schemes**



StatLink http://dx.doi.org/10.1787/285620707110

Note: DB: Defined benefit; DC: Defined contribution

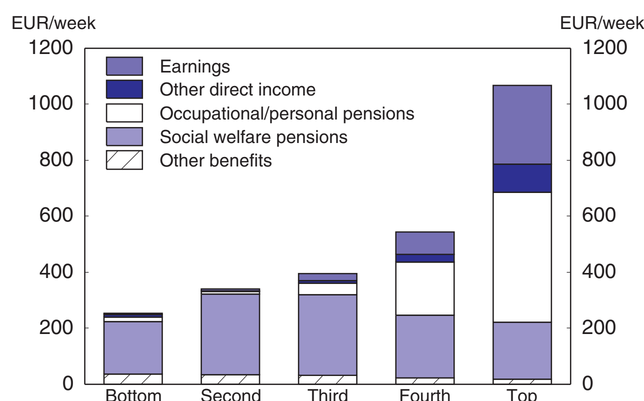
1. No available data for employee's contribution for 2000 and 2003.

Source: Mercer Human Resource Consulting (2005), *Defined Contribution Benefits Survey for Ireland.*

It is unclear how far non-pension resources may contribute to providing adequate pension incomes in old age. Many of these additional resources appear concentrated among richer households who already have sufficient resources (Figure 5.8): saving by employees appears to be concentrated in the top quartile of the earnings distribution (Moreno-Badía, 2006). Owner-occupation rates are high, partly as a result of favourable tax treatment, and this could provide a considerable stock of wealth for pensioners. However, this wealth cannot necessarily be easily converted into retirement income. The home equity release market is poorly developed and it may not be easy for pensioners to release cash by trading down to a dwelling of the appropriate size in the same area.

Figure 5.8. **Sources of retirement income by quintile**

Gross income of pensioner couples, 2005



StatLink http://dx.doi.org/10.1787/285646541208

Source: Department of Social and Family Affairs (2007), *Green Paper on Pensions*, Stationery Office, Dublin, Table 4.4, based on CSO analysis of 2005 EU-SILC Survey.

Raising pension saving

Current private pension saving seems unlikely to close the retirement savings gap for some low and middle-income earners, particularly in industries with low coverage of occupational schemes, and there is a risk that some DC scheme members are not saving sufficiently or for long enough. Raising the state pension is a blunt instrument to tackle this problem: large increases in the flat-rate pension have relatively little impact on the replacement rate for those with above average earnings and increased public provision may crowd out private saving. There are also deadweight losses from transferring additional income to those whose pensions are already sufficient.

The current system emphasises voluntary pension saving. This has only a limited ability to raise pension saving further: voluntary pension saving at present is scarce and most private provision takes place as part of employer-based schemes, where joining the pension fund can be a condition of employment under Irish law. Low rates of coverage appear to be concentrated in certain sectors where employers are less likely to offer an occupational scheme. These sectors are characterised by low wages, small firms, part-time work and high rates of female employment. Where employees do not have the possibility to contribute to a work-based scheme, employers are required to facilitate the provision of PRSAs. There is no obligation on employees to join these schemes nor for employers to make contributions. The take-up of PRSAs since their introduction in 2002 has grown steadily but slowly, and only accounts for a small part of the rise in coverage. Survey evidence suggests that the main reason for not having private pension coverage is "never [having] got around to organising a pension" (CSO, 2006). Even in the 55-65 age group, this explanation is offered by one-fifth of those without coverage, ahead of not being able to afford a pension. This suggests that the number of people with private pensions could be increased by making PRSA arrangements "opt out" rather than "opt in". Behavioural economics has found that default options in retirement saving schemes strongly influence behaviour in countries where these have been studied such as the United States (Beshears *et al.*, 2006). This requirement could be imposed on those who are not already part of an occupational scheme and whose income is above the threshold for which the state pension would replace an adequate share of pre-retirement income. At a minimum, an "opt out"

system would provide a clear signal to those low- and middle-income earners who need to save but are not doing so. The relatively high fees of PRSAs, typically a 5% entry charge and a 1% annual management fee, could also be lowered if the state acted as an intermediary between pension savers and the investment institutions in a similar way to private employers offering DC schemes. More generally, occupational DC schemes and PRSAs should be made more uniform and transparent to help individuals assess the future value of their pensions and the associated risks, particularly where contribution rates imply benefits that are lower than past DB schemes.

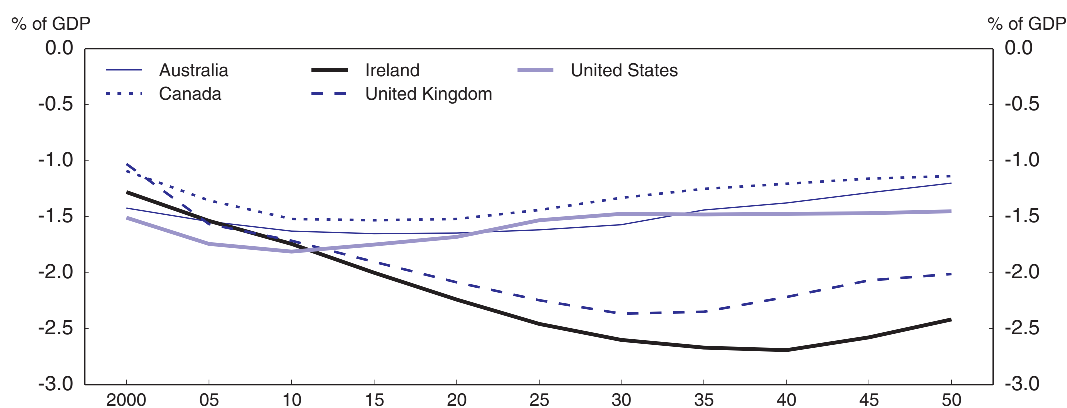
Tax incentives to pension saving are large but poorly targeted

Tax incentives may provide a useful mechanism for raising pension saving, although it is important that they actually raise the overall amount of saving rather than simply diverting funds from other types of investment. International experience suggests that tax incentives are likely to be more effective at raising overall savings if targeted at low- and middle-income earners and if designed so that the incentives are easy to understand (Hawksworth, 2006). The tax incentives to pension saving in Ireland are very large. Pension contributions are deductible at the marginal rate of income tax and PRSI contributions are calculated on earnings excluding pension contributions. Capital gains on pension investments are not taxed. Some pensioners qualify to receive part of their private pension as a tax-free lump sum at age 65.[8] The foregone revenue from these tax subsidies is already very large at around 1.5% of GDP. Although pension income is in principle taxed, the tax exemption limit for those aged over 65 is € 34 000 for a couple. This implies that few older households will pay any income tax and many of those who do will pay less than younger people with the same income. As a result, a tax system that aims for pension savings, returns and income to be subject to an "exempt-exempt-tax" (EET) regime is in effect fairly close to being an "exempt-exempt-exempt" (EEE) system where income channelled through pensions is unlikely to be taxed at any point of the life-cycle.

This system of tax incentives does not provide an effective way of achieving adequate private provision, despite the generous level of support. Marginal tax relief on pension contributions is worth more than twice as much to the minority of high-income households paying the higher-rate of income tax of 41% than for those paying the marginal standard rate of 20%. Similar effects arise for the other forms of support. As richer households are more likely to save and to be covered by generous occupational schemes anyway, it is inefficient to target tax subsidies at this group. Furthermore, some people may find it difficult to understand the incentives to save created by these tax concessions. Experience in Australia, Canada and the United States shows that households respond well to incentives presented as matching contributions from the government for each amount paid into retirement savings accounts. The high take up of Special Savings Investment Accounts (SSIAs) suggests that households in Ireland might respond to a system of matching contributions, although it is unlikely that the same take-up rate could be achieved for retirement accounts as for the SSIAs because pension funds must be committed for much longer periods.[9] Given the generous level of current support, these incentives should replace rather than add to existing tax subsidies.

The overall level of tax subsidy for pension savings should also be reconsidered. These already absorb a large share of national income, but this is projected to rise very sharply as the population ages and people build up retirement savings (Figure 5.9). Indeed, Ireland is projected to have the largest share of income committed to these schemes in 2050 of any

Figure 5.9. **Projected net fiscal revenues from tax-favoured retirement savings plans**



StatLink http://dx.doi.org/10.1787/285664667886

Source: Antolin, P., A. de Serres and C. de la Maisonneuve (2004), "Long-term Budget Implications of Tax-Favoured Retirement Plans", *OECD Economics Department Working Papers*, No. 393.

OECD country.[10] Reducing the level should be accompanied by a better targeting of subsidies. Consideration should be given to reducing not just tax subsidies to pension contributions and returns, but also the generous taxation exemption limit for those aged over 65. Whereas tax relief on paying into a pension essentially redistributes from non-savers to savers within a cohort of the population, this favourable taxation for the old redistributes between the old and young, which will become more costly as the old-age dependency ratio rises.

Rules on private pensions should encourage adequate provision

The design and regulation of pensions should make it simple for firms to provide employment-based schemes and encourage individuals to save sufficiently. The current system accords an important role to annuities: pension funds are required to meet a Funding Standard that is partly based on hypothetical purchases of annuities, and some individuals are required to make purchases of annuities with pension savings at the age of 65. This makes it important for pension provision that the annuities market works well. This is hard to assess as it requires judgments about a reasonable assessment of the risks around long-term investment returns and demographic developments. It is notable, however, that very few people in Ireland purchase annuities by choice (Indecon/ Lifestrategies, 2007). This could be due to preferences or a lack of understanding by individuals of the real risks, but it might also reflect the limited number of firms competing in the Irish annuities market. It could also be that people already have sufficient guarantees of retirement income through public and private DB pensions. Such issues raise the question of how appropriate it is to give annuities such a central role in the pension system, even if the insurance against longevity risk provided by annuities should in principle be a good policy to ensure that retirees do not exhaust their funds while they are alive.

The Funding Standard for private sector DB schemes is defined on a discontinuance or "wind-up" basis: to avoid any shortfall if the sponsoring employer were to become insolvent, pension funds should be able at all times to arrange for an insurance company to pay the benefits of existing pensioners and to pay a transfer value for the pension

liabilities of those who are not yet retired. This provides a high degree of protection for the current liabilities of the scheme towards its members but is not the most appropriate requirement in other respects. Firstly, if funding were calculated on a continuing or on-going basis, pension schemes would have to take into account future rises in salary that will increase the already accrued rights of current employees. Secondly, the link to annuities raises the cost of providing pensions if annuities are not competitively priced. Thirdly, the "wind-up" standard creates incentives for pension funds to invest in low-yielding assets with low-variance returns to meet the rule consistently rather than to purchase higher-yielding, more volatile assets such as equities, although Irish pension funds do currently hold around two-thirds of their assets in equities. In the long run, these incentives could imply that pension assets would grow more slowly and that more needs to be invested to achieve a given expected level of benefits than would otherwise be the case. The "wind-up" funding standard may be particularly inappropriate for a country such as Ireland, where the population is relatively young, because this should increase the focus on the long-run growth of pension assets rather than protecting the, on average, relatively few scheme members drawing pensions or being close to retirement. As a young population means that pension liabilities lie further into the future, this would allow more time to take corrective action if returns were lower than anticipated.

The Funding Standard is currently under review by the Pensions Board. Adopting the standard that schemes should be sound on an on-going basis would be compatible with the OECD *Guidelines onFunding and Benefit Security in Occupational Pension Plans* and is the practice in several other countries. Alternatively, the interpretation of the "wind-up" standard could be further eased so as to remove the constraining hypothetical requirement to purchase annuities. There is already some flexibility built into the system as the regulator can allow pension funds to be underfunded for up to ten years, one of the longest periods in the OECD. Although it is important that private pension provision is sufficiently well-funded, the apparent strength of the guarantee currently embodied in the Funding Standard is in any case misleading given that a large number of the schemes covered do not currently meet it.

At retirement, private pension wealth is accessed either as a lump sum, through purchase of an annuity, or placed in a post-retirement Approved Retirement Fund (ARF) which is similar to a pension fund in that capital gains are not taxed. Pay-As-You-Earn (PAYE) workers with DC pensions are required to use most of their pension fund to purchase an annuity.[11] Annuities provide insurance against the risk that people outlive their resources. However, if the annuities market is inefficient, pensioners would have a higher level of retirement income in the absence of this requirement. This requirement is a distortion given that it does not apply to Additional Voluntary Contributions, non-PAYE workers and other private pension arrangements such as insurance policies. The requirements to purchase annuities on retirement should be reconsidered, although it is important to maintain some minimum level of annuitisation and that people are aware that the annuities market may take a more realistic approach to assessing likely longevity than their own or actuarial assessments; the higher apparent cost might actually be a better reflection of the true cost. Retaining some element of compulsion may be helpful to address adverse selection effects. Allowing all retirees to invest in an ARF or similar instrument would also increase flexibility about when pensioners draw down their retirement income, allowing people to defer their pension or, for the financially sophisticated, to choose a more desirable time profile for their retirement income.[12]

Private pensions should contribute to labour market flexibility

Regulation of private pension schemes should help workers move between jobs and stay in employment beyond the age of 65 if they wish. As in other countries, private schemes often make it difficult to integrate entitlements from the pension scheme of a previous employer with that of the current employer. Occupational pension schemes and PRSAs should be encouraged to allow members to defer the standard retirement age and receive an actuarial-adjustment to their future benefits. Changes in the tax system should be made to allow workers to stay with the same employer after the age of 65 and enjoy favourable tax treatment.

Options for pension reform

Ireland is well-placed to cope with the challenges stemming from ageing. Given the favourable demographics, pension payments will start to surge later than in most other OECD countries. Ireland is among the few OECD countries with very low government debt, and it is accumulating assets in the NPRF. Moreover, taxation is relatively low, while the sizeable public investment programme will eventually be scaled back when the public capital stock reaches the targeted level. But these favourable conditions should not lead to complacency. When ageing starts in earnest, the rise in pension payments will be especially sharp, while spending on health and elderly care will also rise considerably. Moreover, changes to the pension system need to be phased in and clear long-term commitments are needed to guide decisions on private savings.

A Green Paper on Pensions was published in October 2007 (Box 5.1) and the government is committed under the *Towards 2016* social partnership agreement to making

Box 5.1. **Green Paper on Pensions**

The Green Paper on Pensions, published by the government in October 2007, provides a comprehensive and detailed overview of all elements of the pension system including the contributory state pension, incentives to private saving, public sector pension and pension regulations. It defines the objective of the pensions system as:

- Adequacy – to achieve an adequate level of income in retirement relative to pre-retirement income.
- Sustainability – to restrain the cost of the pension system in the face of demographic change.
- Modernisation – to adapt to changes in the labour market such as rising female participation.

The options for reform of the social welfare pension include indexing the state pension to prices to limit costs, raising the pension age and introducing means-testing. A wide range of detailed changes to the social security pension are discussed including: maintaining the current arrangements; moving to a universal standard rate payment; backdating the Homemaker's Scheme introduced in 1994 for those with contribution histories limited by periods outside the workforce to look after children or incapacitated people; replacing the average contribution test with a total contributions test as a simpler and fairer way of determining pension benefits; and other changes to the parameters of the system.

Box 5.1. **Green Paper on Pensions** *(cont.)*

Four approaches for closing the gap in retirement saving are set out:

1. The current voluntary system but with enhanced incentives to save through matching contributions.
2. Mandatory pension saving for workers without adequate alternative arrangements. Contributions would be 15% of eligible income including a 5% contribution from the Exchequer in lieu of PRSI and tax relief.
3. A soft mandatory system with employee contributions of 5% supported by employer contributions and a capped government contribution. Workers would be able to opt out of this scheme under certain conditions.
4. Enhancing the social welfare pension so that there is less need for private saving.

It is important in assessing the merits of different options to compare like-with-like in terms of the pension benefits delivered for a given level of cost. The options in the Green Paper, based partly on a mix of proposals from previous studies, do not always do this. Although the cost of some approaches is shown as being higher, this is in some cases because the benefits are also higher and this does not provide a good basis for judging the relative effectiveness of different systems rather than different levels of pensions. It is vital that comparisons adequately take the different risks into account.

proposals within a year. Despite an on-going debate and several substantial reports, Ireland has not succeeded in carrying out a major reform over the past 15 years, unlike most other OECD countries. The current opportunity to reform the pension system should be seized. The rising demands of an ageing population will require substantial changes to the state pension and public finances. The cost of the pay-as-you-go state pension will have to be met by some combination of reducing the entitlement, higher saving through the NPRF, raising taxes or lower government spending on other activities. Although the NPRF will help and it is reasonable that government spending on pensions should rise from its current low level, measures to manage the overall level of pension spending are likely to be required. One option is to raise the retirement age, preserving the replacement rate of income once people do retire. Given that people will live longer and healthier lives, it seems natural the retirement age should rise to reflect this.

The retirement savings gap between the current state pension and a decent replacement income in retirement needs to be addressed. Raising the essentially flat-rate state pension would be an expensive and wasteful way of achieving this. It is therefore important to ensure that individuals make sufficient retirement saving to close the retirement savings gap. The existing system provides decent private pensions for a large number of people, but leaves many low- and middle-income earners without adequate savings. There are several options for addressing this problem: mandatory, "opt out" or voluntary schemes. The current system of voluntary saving supported by sizeable tax expenditure is not effective at raising pension coverage of low- and middle-income earners. It needs to be reformed and better targeted. Alternatively, some degree of compulsion may need to be considered to raise pension saving and close the gap.

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Box 5.2. **Summary of recommendations on pension reform**

Use the opportunity provided by the Green Paper on Pensions to establish long-term objectives for the state pension. In particular:

- Set an official long-term target level for the state pension (in terms of the average wage) to provide more certainty.
- Link the standard retirement age to longevity.
- Replace in-kind allowances with an equivalent cash increase to pensions.

Offer an actuarial-equivalent increase in the state pension for deferred retirement and consider making the value of the contributory pension more sensitive to the number of years of contribution to increase the incentives to work longer. Further limit the means-testing of labour income in the non-contributory pension.

Eliminate incentives for older workers to exit the labour market through disability schemes, improve the assessment of work capacity for new claimants and improve active labour market support for the disabled.

Reconsider the basis for up-rating of pensions in payment under the public service pension scheme. Ensure that public-sector pensions evolve in line with changing needs and practice in other sectors. Phase in more rapidly the increase in the minimum retirement age to 65.

Make Personal Retirement Savings Account (PRSA) membership "opt out" for workers not covered by appropriate occupational schemes and with income above a threshold where the state pension offers a high replacement rate.

Replace tax breaks for pension contributions with a system of (capped) matching contributions. This would allow the level of subsidy to be lowered and targeted better. Tax breaks for households aged 65 and over should be reduced as part of the same package of reforms.

Consider changing the funding standard for defined-benefit (DB) pension schemes to a continuing basis.

Reconsider the requirement to purchase annuities with retirement savings by allowing access under all schemes to Approved Retirement Funds (ARFs) or similar instruments.

Increase the flexibility for working past age 65 in occupational pensions and change tax rules to allow people to continue to work for the same employer.

Notes

1. More precisely, there is 1) the flat-rate State Pension (Non-Contributory) and 2) the State Pension (Contributory). Although different conditions apply, the value of the two pensions only differs in 2008 by € 11.30 per week and only a short contribution history is needed to draw the full contributory pension, so the system is approximately a flat-rate payment (OECD, 2005a). Most pensioners qualify for the contributory pension. The two pensions are referred to throughout this survey as the "state pension" where no distinction is necessary. Both pensions are available from age 66, although the state pension (transition) is available from 65 for those who retire and meet similar conditions to those for the contributory pension.
2. In an integrated scheme, the benefits under a defined benefit scheme take into account the value of the state pension so that an increase in the state pension reduces the amount that needs to be paid by a DB scheme with no effect on the overall level of retirement income.
3. These figures reflect the average rates under the two state pensions for those aged 66 to 79 years of age. For couples, the calculations assume that both spouses qualify for that type of pension. The rates for couples are lower if both do not qualify and also if the other person is under the age of 66.

4. 2005 European Union Statistics on Income and Living Conditions (EU-SILC).
5. Disregards in the means-testing of labour income were doubled to € 200 in the Budget for 2007.
6. The target is for 70% supplementary pension coverage for those aged 30-65 in employment. The target for 35% of persons in employment aged under 30 to have private provision is currently being met (CSO, 2006).
7. Because the pension is based on the final salary in each job, changing jobs reduces pension entitlements (OECD, 2005a). The average length of a job in OECD countries is around seven years.
8. Although tax relief on earnings is now capped at an income of € 254 000 and the maximum allowable pension fund for retirement for tax purposes is limited at € 5 million, these imply large tax concessions up to a very high level of wealth compared to the average citizen.
9. The National Pensions Review discussed such a system of matching contributions but the proposed rate of a one-for-one matching contribution seems excessively generous. This was derived on the basis of extending the same level of subsidy currently available to higher-rate tax payers but it is not clear that this is an appropriate objective.
10. Assuming no change in the use individuals make of the system of tax advantages.
11. PAYE workers, which excludes proprietary directors and the self-employed.
12. Changes in the 2006 Budget partly addressed the tax aspects of ARFs by introducing a 3% annual deemed distribution, although the favourable treatment of bequests to children made from ARFs could be reformed as it is not a necessary part of helping people to save for old age.

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Chapter 6

Integrating migrants: Learning from OECD experience

Immigration has soared in recent years. The immigrants tend to be young, well educated and work. But they often work in basic jobs. Immigration policy should thus focus on better integration. This chapter reviews Irish immigration policy in the light of international experience. It also highlights the uncertainties about future migration flows and the challenges they pose for infrastructure planning.

For most of its history Ireland has been a country of emigration. An astounding 5 million people emigrated in the 150 years since the end of the famine, though emigration was the normal state of affairs even before then. This changed dramatically in the mid-1990s. The economic boom of the Celtic Tiger years put a break on emigration and led to a substantial pick-up in immigration. The diaspora came home and foreigners hitched on to the economic bandwagon in large numbers. Immigration received another massive boost after 2004 when Ireland opened its doors to the new members of the European Union.

Migration brings benefits and challenges. The gains for the Irish people have been substantial. Put simply, the boom would not have lasted without immigration. It has boosted growth, helped alleviate labour shortages and has been an essential part of the policy package that makes Ireland attractive to multinational companies. Compared with experiences in other OECD countries, there have been few problems so far. The majority of migrants are young and employed, so they have not been a drain on the public purse or put major demands on public services and the welfare system. It has also been helpful that the cultural and religious background of most immigrants is similar enough to the Irish themselves, keeping a lid on the types of social tensions that have been seen in other countries. Perhaps the most visible negative impact has been that rapid population growth has added to infrastructure bottlenecks, especially transport but also private infrastructure such as housing.

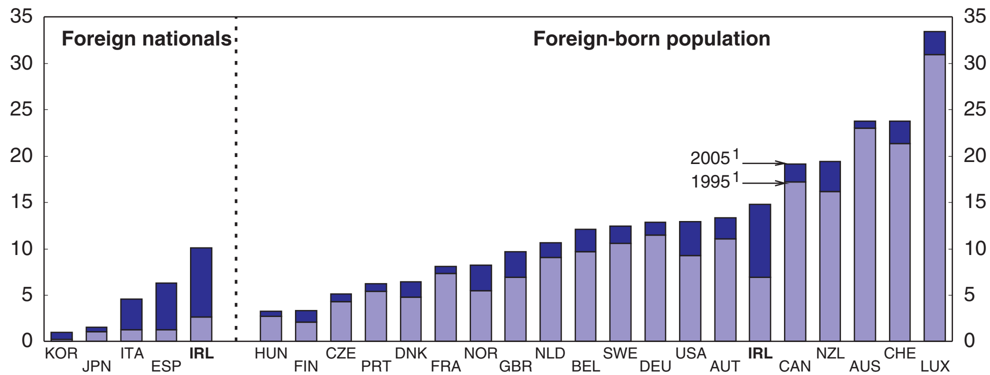
While the side-effects from immigration have been minor so far, the honeymoon may not last forever. As more migrants settle permanently and bring over their spouses and children, public services such as education and healthcare will continue to face even greater challenges. Immigration is more likely to have adverse impacts during an economic downturn and, while the economy is expected to slow only mildly over the next year or two, there is a risk of a more severe downturn. With free movement between Ireland and most other EU countries, there is little the government can do to control migration flows. It therefore needs to focus on developing strategies that seek to ensure the most efficient use of this very valuable resource. This chapter reviews Ireland's migration experience and discusses the emerging policy challenges.

Migration trends

Around 15% of people living in Ireland were born outside the country (Figures 6.1 and 6.2). The proportion of foreign-born has doubled in the space of a decade, which by OECD standards is an extremely rapid change in the population mix. Ireland has now surpassed the United States, the United Kingdom and France, three countries with much longer immigration histories. The number of foreign nationals in the country is less than the number of foreign born, at around 10% of the population. The difference is mainly accounted for by the children of the diaspora who were born abroad to Irish parents, and who are entitled to Irish nationality.[1]

Figure 6.1. **Foreign-born population**

Per cent of total population



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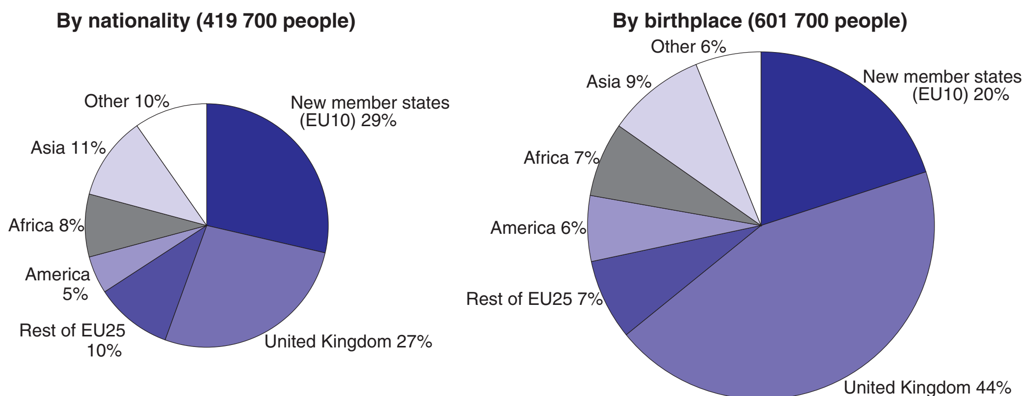
1. 1995 or earliest available data and 2005 or latest available data. Data for Ireland is 1996 and 2006.

Source: OECD (2007), *International Migration Outlook: Annual Report*, Tables A.1.4 and A.1.5; Central Statistics Office, Census.

Figure 6.2. **Immigrants by nationality and birthplace**

Number resident at time of 2006 Census



StatLink http://dx.doi.org/10.1787/285706585814

Source: Central Statistics Office, Census 2006.

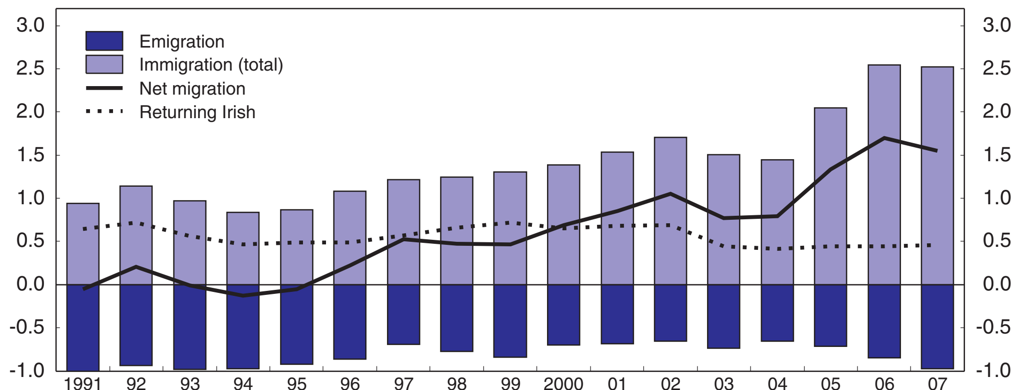
The different waves of immigration

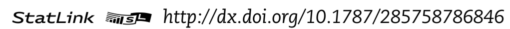
The turning point in migration came in the mid-1990s in response to the economic boom. In 1996, net migration turned positive and has tended to increase ever since. While emigration has been fairly stable, the main change has been a sharp jump in the number of immigrants (Figure 6.3), which is very high by OECD standards.

To understand the impact of migration and the policy challenges that it brings, it is helpful to distinguish between three broad groups of immigrants. The first group consists of Irish return migrants and their descendants and British immigrants – namely, Irish emigrants who came back, Irish nationals born overseas and British nationals. This group dominated the migration wave in the 1990s: over that period, about half of the immigrants were returning Irish migrants[2] and another 18% were British nationals, reflecting the traditionally close two-way flows between Ireland and the United Kingdom. They have integrated into the labour market pretty much immediately, earning at least as much as

Figure 6.3. **Migration over time**

In per cent of population, April data




StatLink http://dx.doi.org/10.1787/285758786846

Source: Central Statistics Office; Hughes, G. and E. Quinn (2004), *European Migration Network - The Impact of Immigration on Europe's Societies: Ireland*, ESRI - EMN.

comparable "natives". One study estimated that Irish people who emigrated in the 1980s and who returned in the 1994-97 period were better educated on average than the local population and better educated than the average person who emigrated, suggesting that the best and brightest were more likely to return (Barrett, 2001). They came back with better experience, skills and knowledge, judging by their 15% wage premium relative to comparable non-migrants (Barrett and O'Connell, 2000).[3] This group provides few policy challenges.

The second group consists of migrants from the new EU member states. This cohort has dominated the surge since around 2004. The government expected perhaps 15 000 to 20 000 migrants in the first year after EU accession, and for the rate to slow down after that, but the inflow turned out to be much higher (Killeen, 2006). On census night (April 2006), around 120 000 EU10 citizens were living in Ireland, three-quarters of whom were Polish or Lithuanian, and most of these people are likely to have arrived after accession.[4] Nor has the inflow slowed down. Based on the number of social security (PSS) numbers issued, the inflow from the new member states has been steady right through to June 2007. Tax data show that about 70% of these people entered the labour force at some stage, though some would have been students working part time or people on seasonal and short-term contracts. It is not known how many have returned home. This group is well educated and has a very high employment rate but their jobs are relatively low paid. The policy challenge is to help them get jobs that better match their skill levels.

The third group consists of migrants from the "rest of the world" – that is, outside Europe and the United States. It is a group that is sometimes ignored in the public debate because it is dwarfed by the inflow from Eastern Europe. Even so, it is still sizeable by international standards: immigration from the rest of the world is about as large as the total immigration rate into the typical OECD country.[5] The group is diverse. It covers highly skilled migrants entering under one of the employment channels as well as asylum seekers and refugees. While the number of successful asylum seekers is small, they present the toughest integration challenge.

All three groups are well attached to the labour market, though to varying degrees (Table 6.1). Migrants from the new member states have an extraordinarily high

Table 6.1. **Labour force status of those aged 15 and over**

Per cent of total, April 2006

	Total	Irish nationals	Non-Irish nationals	*Of which...* United Kingdom	EU15 (excl. Ireland and United Kingdom)	10 new EU member states	Other[1]
Employed	57.2	56.1	66.6	56.7	74.2	84.3	54.3
Unemployed, looking for first regular job	0.8	0.6	2.8	0.6	1.4	4.3	3.0
Unemployed, having lost or quit previous job	4.5	4.2	6.4	6.1	4.0	4.5	8.4
Total participation rate	62.5	60.9	75.7	63.3	79.6	93.1	65.7
Not in labour force	37.5	39.1	24.3	36.7	20.4	6.9	34.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Total number (000)	*3 311.5*	*2 909.4*	*367.2*	*96.9*	*39.7*	*110.5*	*155.0*

1. The major sources in the "other" category (excluding those for whom no nationality is stated) are Africa (19%), the United States and Canada (8%), China (6%), other Asia (19%), Romania (4.2%) and Australia and New Zealand (3.1%).

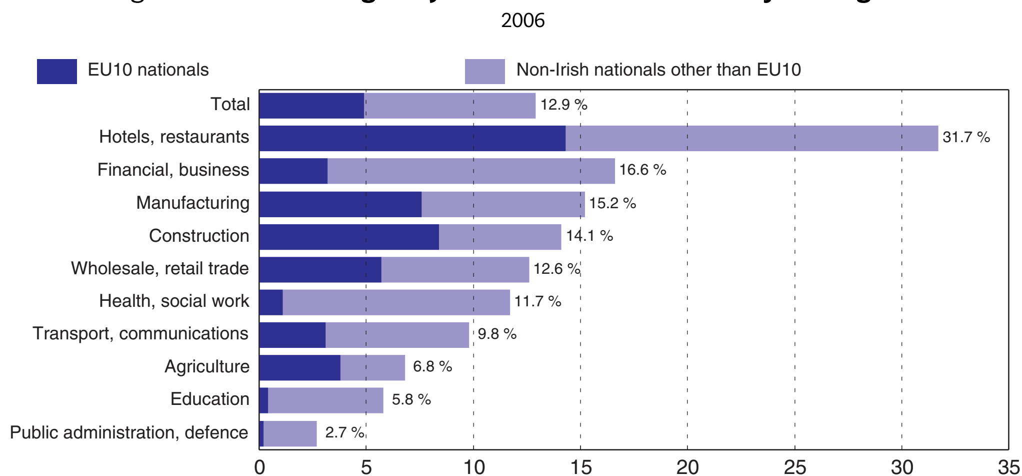
Source: Central Statistics Office, Census 2006.

participation rate (93%), while those from the United Kingdom and outside the European Union are similar to the native population (63%). Overall, immigrants are substantially more likely than Irish nationals to have a job. However, there is a wide variation in unemployment rates across migrant groups. For EU citizens, and especially those from the new member states, the difference relative to the native Irish is largely because a greater share are unemployed while looking for their first regular job, rather than having been laid off or quit their previous job. Thus, it probably reflects the fact that so many are recent arrivals, and it takes time to get a foothold in the labour market. In contrast, migrants from outside the European Union are more likely to be unemployed after having lost or quit their previous job. This suggests they may be a relatively vulnerable group. Surprisingly, UK immigrants show the same pattern.

Like in many countries, immigrants are heavily over-represented in the hotel and restaurant industries (Figure 6.4). They are slightly over-represented in finance and manufacturing but, despite the public perception, only marginally so in the construction

Figure 6.4. **Percentage of jobs in each sector held by immigrants**

2006



StatLink http://dx.doi.org/10.1787/285812685856

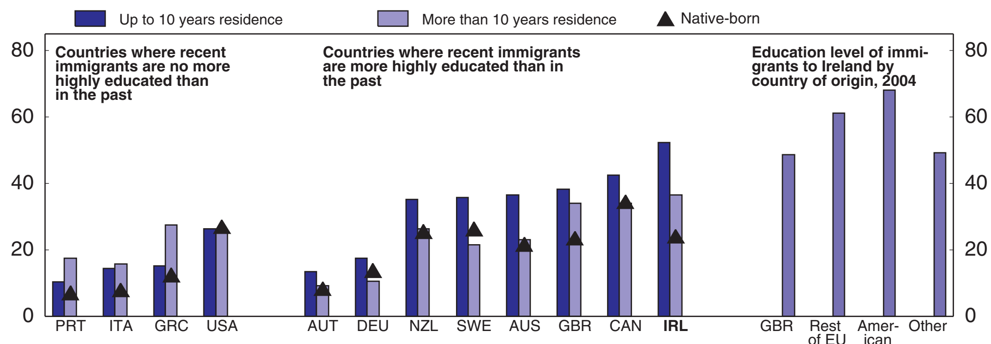
Source: Central Statistics Office.

industry.[6] Aside from the hospitality sector, immigrants from the EU10 are more likely to be found in low-skill manufacturing and construction while those from other countries are more prevalent in finance and healthcare. Overall, job quality does not seem much different to Irish nationals. While migrants are more likely to do shift work or work in the evenings and weekends, the difference compared with the Irish is small (Barrett and Bergin, 2007).

A common feature of all three groups is that their average education level is high both when compared with the native Irish, and with migrant streams going into other countries (Figure 6.5). The most recent migrants, who are mostly Eastern Europeans, are less likely than earlier cohorts to have a degree, but they are still a well-educated group on average.[7] But as noted above, they are not necessarily using those skills. It is not unusual for immigrants in OECD countries to work in jobs they are over-qualified for, especially when they first arrive, but the occupational mismatch in Ireland is relatively high (Figure 6.6).[8] Migrants from outside Europe and the United States are also likely to be over-qualified for their jobs, though the mismatch is smaller than for EU10 workers.

Figure 6.5. **Share of immigrants with a tertiary-level qualification**

Percentage of persons aged 15 and above, circa 2000



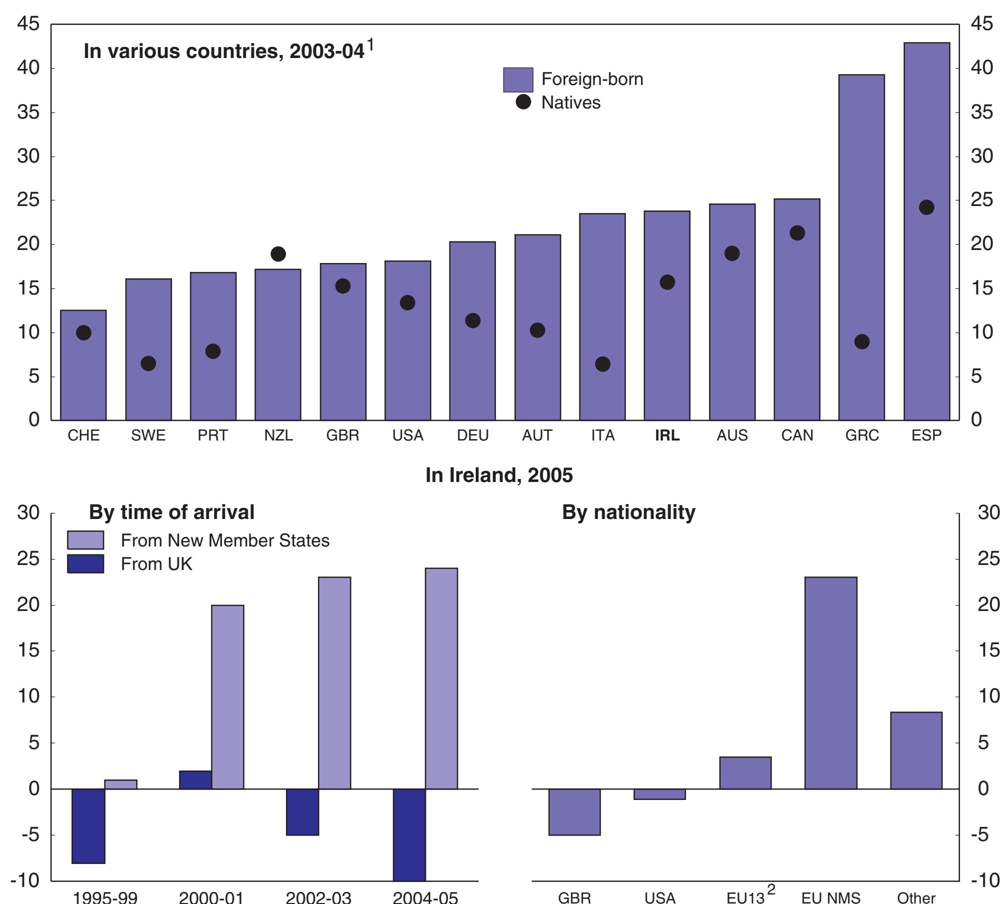
StatLink http://dx.doi.org/10.1787/285835428770

Source: OECD (2007), *International Migration Outlook: Annual Report*, Chart I.12 for the two left panels; A. Barrett and A. Bergin (2007),The Economic Contribution of Immigrants in Ireland, Chapter 5, Table 7 in B. Fanning (ed.), *Immigration and Social Change in the Republic of Ireland*, Manchester University Press for the right-hand panel.

This pattern means that Ireland is not making the best use of its migrant workforce. But it matters for source countries as well. While a brain drain is undoubtedly a problem for them in the short term, the longer-term impact can be positive if enough migrants return home with greater skills, experience and wealth. Countries with a tradition of high migration in both directions, such as Australia, New Zealand and Ireland itself, have benefited from this two-way flow. But the gains for the source country are reduced if migrants are stuck in basic jobs.

While this points to integration problems for some migrants, it may simply reflect the fact that many are recent arrivals and perhaps work in basic jobs while they improve their language skills, for example. It is also possible that some migrants from the new EU member states are seeking to learn English, travel and earn a sum of money over a short period of time, rather than trying to build a career in Ireland. The problem is that policymakers are operating with little information. Little is currently known about whether migrants become more integrated over time. One study found that the earnings gap

Figure 6.6. **Over-qualification rates**



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1. Survey data, population 15-64 for all countries except Canada and New Zealand (Censuses and Population Registers, population over 15, circa 2000). For the United States, the survey data are from 2002.
2. EU15 excluding Ireland and the United Kingdom.

Source: OECD (2007), *International Migration Outlook: Annual Report*, Table II.2; Barrett, A. and D. Duffy (2007), "Are Ireland's Immigrants Integrating into its Labour Market?", *ESRI Working Papers*, No. 199, June, Tables 5-8.

shrinks with the number of years worked, which is encouraging, but the effect is small.[9] The study also found that EU10 migrants who arrived in the 1990s or early 2000s had, by 2005, a smaller occupational gap than the ones who had just arrived. Again, this is consistent with improved integration over time, but the apparent improvement is not statistically significant and, because the study is not based on longitudinal data that tracks the same individuals through time, the result may be caused by a survivorship bias (the "losers" have gone home) rather than by improving job outcomes. However, there are some optimistic signs coming out of the United Kingdom, which has had a similar experience to Ireland regarding migrants from the new member states. There are indications in Britain that migrants are moving up the occupational ladder and becoming more choosy about jobs.[10] This may be true in Ireland as well.

All in all, the evidence for improved labour market integration is weak. However, this should be kept in perspective. First, there is little evidence that analysts can draw on, which is different from saying that there is evidence integration is not happening. It may

be that many migrants only intend to stay for a short period of time and are not planning to build a career in Ireland. Second, labour market integration issues in other countries can be tougher: they often refer to whether migrants have a job at all. In Ireland's case, more than 80% of immigrants from the new member states are employed; the question is whether their job fully matches their skills and whether they manage to work their way up the job ladder over time.

The policy approach and recent reforms

Citizens of European Economic Area (EEA) countries[11] except Bulgaria and Romania are free to work in Ireland without restriction. Non-EEA nationals need a work permit. There is a so-called green card for skilled migrants with salaries over € 60 000 and a more restrictive work permit regime for other occupations (see below and Table 6.2 for details). With this policy, Ireland has effectively decided to meet most of its needs for low skilled and high skilled labour from within the EEA. Green cards and work permits allow migrants to work for a specific employer, though they can change jobs after one year.[12] As in most other European countries, and contrary to Australia, Canada and the United States, there is no permanent immigration policy (*i.e.* there is no permanent visa). The Immigration, Residence and Protection Bill 2008 will introduce changes to the current system.

Table 6.2. **The main migration channels**

An empty cell means that no information is available

Category	Main features	Numbers			
		2004	2005	2006	2007[1]
EEA citizens	Under EU Treaties, most citizens of the EEA have free entry to work in Ireland. Ireland has imposed restrictions on migrants from Bulgaria and Romania until 2012.	25 600	48 900	63 600 (77 800 according to census)	
Green cards	This is the main channel for skilled migrants from outside the EEA. The applicant must have a valid job offer, usually with a salary of at least € 60 000 per annum.	1 444[2]	2 585[2]	1 045[2]	2 705
	Also available for jobs paying between € 30 000 to € 60 000, but only for certain occupations (*e.g.* in IT, healthcare, engineering, science and finance).				
	Issued to employees for two years and will normally be renewed indefinitely.				
	Immediate family reunification is possible.				
	No labour market needs test is required.				
	Since 2007, this gives faster access to long-term residence status.				
Work permits	Available for certain occupations with a salary of € 30 000 or more. Many occupations are not eligible (including clerical, retail, production and hospitality staff and most tradespeople). Can be granted for a very restricted number of occupations paying less than € 30 000 per annum.	10 020 (plus 23 246 renewals)	7 354 (plus 18 970 renewals)	6 289 (plus 14 258 renewals)	5 112 (plus 12 099 renewals)
	A labour market needs test must be met (which in practice means the vacancy must have been advertised with the Irish employment agency, the European EURES network and local newspapers and that no suitable EEA candidate was found).				
	Granted for 2 years initially, and then for a further 3 years.				
	A new permit is usually required if the migrant wishes to change employer.				
	Family reunification permitted after one year provided salary is above a certain threshold (around € 29 000 for a family with two children).				

Table 6.2. **The main migration channels** *(cont.)*

An empty cell means that no information is available

Category	Main features	Numbers			
		2004	2005	2006	2007[1]
Intra-company transfers	Allows for the transfer of senior management, key personnel and trainees from an overseas branch of a foreign multinational. The scheme was suspended in 2002 but resurrected in 2007.	376[3]			374
	Issued for two years. Can be renewed for a maximum of five years.				
	People on the scheme will not build up rights to permanent residency.				
Spouses and dependents	Spouses and dependents of those with green cards, work permits and intra-company transfer permits can apply for a work permit. A labour market needs test is not required.			1 357	1 274
Business permits	Available to someone who wishes to set up a business, provided they transfer at least € 300 000 to Ireland and employ two EEA nationals.	97			
	Available for one year, and may be renewed for a further year.				
Students	Can work 20 hours per week while studying, or full time during the vacation, without a work permit.		27 000[4]		
Graduates	From 10 April 2007, tertiary students may stay and work in Ireland for 6 months after graduation. This allows them time to find employment and apply for a work permit or green card.				
Working holiday visas	For people aged 18-30 from Australia, Canada, Hong Kong, Japan and New Zealand. Permit lasts for one year. Must not work for any one employer for more than three months.The number of permits is capped.	Unknown (but approximately 3 000 in 2003)[5]			
Asylum seekers	Not entitled to work (except for those who arrived before July 1999).	4 265	4 320	4 314	
		Accepted as refugees:			
		1 138	966		

1. Partial year figures, at an annual rate.
2. Refers to work visas and authorisations (the predecessor of the green card scheme).
3. 752 permits were issued in 2003 and 2004. This figure has been arbitrarily split equally between the two years.
4. Number of registered non-EEA students (who may or may not be working).
5. IOM Consulting (2007), *Managing Migration in Ireland: A Social and Economic Analysis*, NESC, p. 92.

Source: Department of Finance; Department of Employment Annual Reports; Department of Justice Annual Reports; Irish refugee council, *www.irishrefugeecouncil.ie/stats.html*.

Aside from the decision to open up to workers from the EU10, the main policy initiatives over the past five years include the following:

- The work permit scheme was changed to put more focus on the higher-skilled. Until 2003 the system had been largely employer driven, with few restrictions on recruitment from outside Europe except a labour market test that was designed to be an irritant rather than a major barrier. Up until then, around three quarters of permits were for relatively low skilled or low paid jobs, especially in the service industry. From 2003 onwards, the government has limited work permits to a very restricted list of jobs.
- In 2004, the constitution was amended by referendum, removing the automatic right to citizenship for anyone born in Ireland.
- In 2007, several changes were made to the various employment permit schemes:
  - A "green card" system was introduced for skilled workers, replacing the work visa and work authorisation programmes (work visas and authorisations were designed for skilled

and temporary work respectively; they differ from the work *permit* programme, which is more general). A green card is issued for two years for jobs paying at least € 60 000 per annum (and for lower paying jobs in some strategic sectors). It is more restrictive than a US green card because it restricts the immigrant to working for the employer and the site named on the card. It is an improvement on the previous regime in at least two respects. First, the duration of the first permit has been increased because employers and employees felt that one year was too short. And second, migrants can bring their spouses and families immediately and the spouse will have the right to work without having to apply for a work permit. Finally, the 2008 Immigration, Residence and Protection Bill will give faster access to long-term residence status to holders of the new green cards.

- ❖ The work permit scheme was modified. It covers occupations in the € 30 000 to € 60 000 range (and jobs below € 30 000 in exceptional cases only). As with the green card, the permit is now issued to the employee. A tougher labour market test must also be met. The employer must advertise locally and in Europe to show that the position could not be filled from within the EEA. The family can join them after one year.
- ❖ The intra-company transfer scheme, which was suspended in 2002 because it was being abused, was re-instated. It allows for temporary management transfers within multinationals.
- ❖ Tertiary level students will be able to stay and look for work for six months after graduating. They can then receive a work permit or green card depending on the salary level.

- In order to cope with the significant migration that was already taking place, Ireland decided that for a seven-year transition period Bulgarian and Romanian nationals would not have free access to the labour market after joining the European Union in 2007. They would have to apply for work permits like non-EEA nationals, though according to EU provisions, Bulgarian and Romanian nationals need to be given preference over third country nationals with respect to labour market access.

The economic impacts of migration

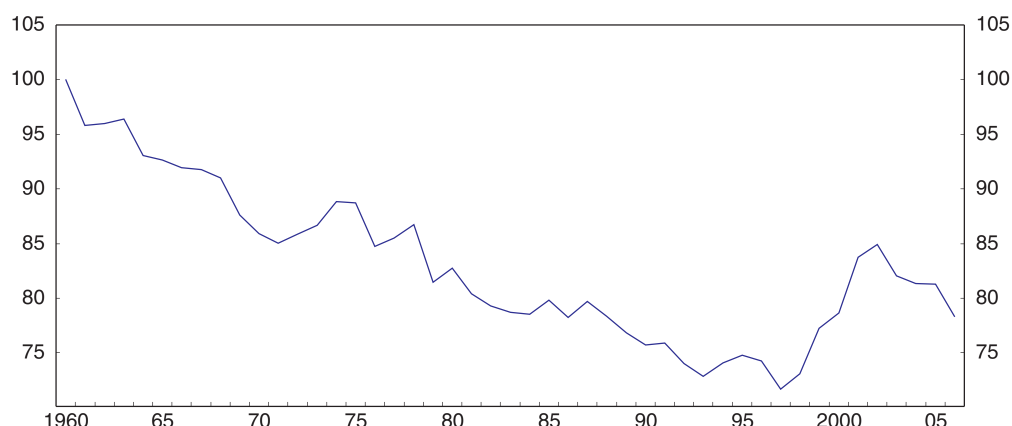
Impacts on employment, wages and the income distribution

At an aggregate level, immigration has clearly not crowded the native-born population out of the job market, considering that the unemployment rate has fallen from 16% in 1993 to around 5% at present. Instead, it has allowed a fully employed economy to continue growing. This pattern is consistent with OECD research and the empirical literature which finds that immigration generally has little influence on unemployment and wages of local workers, especially where they complement rather than substitute for the native-born population (Jean *et al.,* 2007 ; Jean and Jiménez, 2007 ; Manacorda *et al.,* 2006).

Nonetheless, there are distributional issues as some groups of Irish workers are more affected than others. Because the wave of immigrants in the second half of the 1990s were highly skilled and tended to work in skilled occupations, they are likely to have reduced, or slowed the rate of increase of, the relative wages of the high-skilled and thereby reduced earnings inequality (see Figure 6.7 and Barrett, 2001). It probably raised the demand for unskilled labour at the same time as they tend to be complements rather than substitutes (Barrett *et al*., 2006). Immigration of skilled workers has been a necessary counterpart to foreign investment. Ireland has been unable to produce enough home-grown graduates, so

Figure 6.7. **Ratio of unskilled wages to the average wage**

Index 1960 = 100



StatLink http://dx.doi.org/10.1787/285865888735

Source: ESRI calculations based on CSO data.

some companies would have had to move their production elsewhere if they had not had access to skilled migrants. If such immigration helps keep production in Ireland, it benefits the job prospects of native-born workers as well.

The more recent wave of migration would have had different effects since immigrants are competing with less-skilled Irish workers. Recent labour market outcomes for the less-educated have been weaker than among the well educated (Table 6.3), and while this is consistent with their being displaced by migrants, the same pattern in the data would be observed as older less-educated workers retire, and it is difficult to disentangle the two effects.

Table 6.3. **Employment performance by education level**

Change in rates 2004Q1 to 2007Q1, percentage points

Highest education level attained	Employment rate	Unemployment rate	Participation rate
Males aged 15 to 64			
Lower secondary	–0.6	0.1	–0.6
Upper secondary	2.1	0.1	2.2
Tertiary	1.0	–0.3	0.7
Total	**1.9**	**–0.2**	**1.8**
Females aged 15 to 64			
Lower secondary	0.5	0.3	0.6
Upper secondary	2.6	0.5	3.0
Tertiary	2.3	–0.4	2.0
Total	**3.9**	**0.0**	**4.1**

Note: The totals are not simple weighted averages of the components because they are also influenced by compositional effects.

Source: Central Statistics Office.

However, immigration may have allowed or compelled Irish workers to change industries. For example, over the past three years the number of Irish nationals working in manufacturing and in the hospitality sector has fallen while in both sectors the number of foreign employees has risen (Table 6.4). Irish workers have shifted towards the government sector and construction.

Table 6.4. **Change in employment by nationality**

Between 2005Q1 and 2007Q1, in thousands

	Irish nationals	Foreign nationals	*Difference: Irish minus foreign*
Agriculture	3.5	0.4	*3.1*
Manufacturing	–22.9	16.6	*–39.5*
Construction	29.1	19.8	*9.3*
Wholesale and retail trade	12.2	11.5	*0.7*
Hotels and restaurants	–6.6	14.4	*–21.0*
Transport, storage, communications	3.2	4.5	*–1.3*
Finance and business services	8.0	11.8	*–3.8*
Public administration	9.2	–0.1	*9.3*
Education	20.6	1.5	*19.1*
Health	18.5	8.1	*10.4*
Other services	–1.3	4.4	*–5.7*
Total	**73.7**	**92.8**	***–19.1***

Source: Central Statistics Office, *Quarterly National Household Survey*.

Regarding the impact on wages, it is hard to imagine that migration on this scale would not have had an impact on relative earnings. It is likely to have dampened wage growth at the lower end of the income distribution, especially in the hospitality and construction industries, since that is where most of the migrants have ended up, notwithstanding their skill levels. Indeed, there is some evidence that this has been the case. Figure 6.7 shows that the long-term trend decline in the wages of the low-skilled relative to average wages was re-established around the time that migration from Eastern Europe picked up. Moreover, there is some evidence that wage growth has been lower in industries where immigrants are more prevalent (Figure 6.8). Nonetheless, any impact of immigration on wage levels has easily been dwarfed by the underlying increase in average earnings of more than 50% since 1998.

Figure 6.8. **Earnings growth and immigrant share**

StatLink http://dx.doi.org/10.1787/285868306132

Note: Industry abbreviations are: Real – Real estate; Retail – Retail trade; Const – Construction; Fin – Finance; Manuf – Manufacturing; H&R – Hotels and restaurants. Wholesale trade, business services (excluding financial intermediation), land transport, other transport, real estate and renting are not labelled individually.

Source: Central Statistics Office.

Impacts on output and productivity

Immigration raises output as it increases both supply and demand. The effect on output per capita, which is one way of measuring how much of the gains spill over to the local population, is less obvious. Ireland is unusual in that the immigrants are not much younger than the local population (Table 6.5) and are at least as well educated. By attracting people who are similar to the native-born population, the aggregate impact is, to a first approximation and provided they integrate well, largely one of scale – *i.e.* adding to the workforce. For there to be any benefits for the local population, there must either be spillovers, such as economies of scale, or complementarities between immigrants and the native-born population. Modelling exercises that try to estimate the macroeconomic impacts of immigration typically do not take one or both of these factors into account, and therefore tend to find that the gains for the local population are modest. For example:

- Barrett *et al.* (2006) looked at the wave of migration from 1993 to 2003 and concluded it was certainly positive for GNI and probably positive for GNI per capita and employment of the native Irish. Their simulation model takes account of complementarities between low-skilled and high-skilled workers, and shows that immigration of high-skilled workers raised demand for and wages of low-skilled workers as well. The effects of immigration are not negligible, but they are pale in comparison with the underlying growth of the economy: the study estimates that, of the 93% rise in real GNI over that period, around 3.5 percentage points can be attributed to immigration.
- Barrell *et al.* (2007) used a global macro model to look at the most recent wave of migration from the new member states. Their results suggest that it may raise Ireland's GDP by more than 3% in the long term (Table 6.6).[13] Most of the gains accrue to the migrants themselves but GDP per capita rises by around 0.7% in the long term. In the short term, while the adjustment is taking place, the expansion in labour supply puts downward pressure on wages, reducing inflation and temporarily slowing growth in per capita GDP.

Table 6.5. **Age of immigrants compared with the native-born population**

In 2004, excluding migrants aged under 15

	Median age of immigrants	Median age of native-born population	Difference in age
Poland	39	36	3
Ireland	**29**	**33**	**–4**
Czech Republic	32	39	–7
Luxembourg	31	38	–7
Spain	31	39	–7
Hungary	30	39	–9
Netherlands	30	39	–9
Finland	31	41	–9
Sweden	30	40	–10
Italy	32	41	–10
Austria	30	40	–10
Germany	31	42	–11
United Kingdom	27	39	–11
Denmark	27	39	–12

Note: Figures are approximate as they are estimated from 5-year age bands. Migrants under 15 are excluded because they usually will be accompanying their parents. Data for Ireland comes from Census 2006.
Source: Eurostat and Central Statistics Office.

Table 6.6. **Possible macroeconomic impacts of immigration from new member states**

Difference relative to a no-immigration baseline, in percentage points[1]

	2005	2006	2007	2008	2009	Long run (2015)
GDP	0.2	0.4	0.8	1.3	1.8	3.3
GDP per capita	–1.5	–2.3	–2.1	–1.6	–1.0	0.7
Inflation	–0.5	–1.3	–1.7	–1.3	–0.6	0.3
Unemployment	1.7	2.5	2.1	1.4	0.7	–0.6
Productivity	–0.4	–0.9	–1.3	–1.4	–1.6	–1.3

1. Based on a modified version of the simulation in Barrell *et al.* (2007). The modification is to speed up the labour market reaction by assuming that immigrants work in jobs requiring lower than average capital stock. The impacts have been scaled up by a factor of two to account for the greater inflow of immigrants than was estimated at the time the original simulations were run.

Source: National Institute of Economic and Social Research, London.

There are several reasons for thinking that in Ireland's case the gains for the native population may be larger than in other countries and larger than the modelling exercises suggest:

- As noted above, immigration has been necessary to provide the skills required by the multinational sector. This has been an important driver of income and productivity growth during the boom years.
- At least for the first wave of migration, labour complementarities are likely to have been important as evidenced by the sharp decline in structural unemployment over that period as many less skilled Irish workers were able to find employment.
- It has helped clusters to develop, such as ICT in Cork and the IFSC in Dublin. The evidence on the benefits of clusters is not clear-cut, but there is a general belief that they have positive spillovers on local firms in terms of productivity and employment.
- It can have spillover effects on trade and investment. The economics literature has found that immigrants contribute to developing trade links with their home countries.[14] One explanation is that, through their knowledge of their home country, they can reduce the transaction costs standing in the way of trade and investment.
- It can raise labour supply among the native Irish. In other countries, the extra migrant labour supply has led to an expansion of the home help sector such as cleaning, childcare and care for the elderly. This makes it easier for people to enter the workforce. This is not yet an important factor in Ireland but may become more important in the future.
- By increasing the labour supply elasticity, it can act as a safety valve for a booming economy that is unable to control demand with its own monetary policy. However, the effects here are not clear-cut. Immigration boosts aggregate demand as well as aggregate supply, and they can adjust at different speeds. Any mismatch in timing could magnify or stabilise economic cycles depending on circumstances. This issue is especially important for Ireland because swings in net migration are large and appear to be more sensitive to the state of the economy than for any other OECD country (Figure 6.9). In some countries, such as New Zealand, immigration tends to magnify cycles because migrants boost demand straight away while the increase in supply comes later due to the time it takes to find a job, especially one where migrants can work at their maximum productivity. But this may not be the case in Ireland: on the supply side, migrants have

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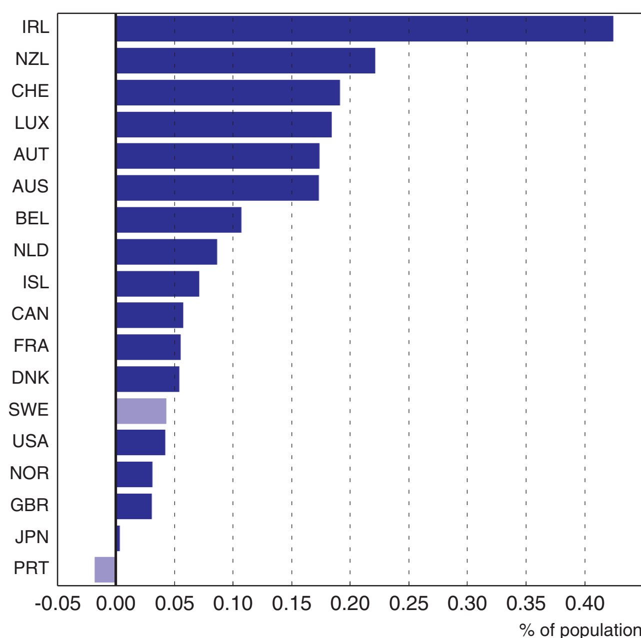
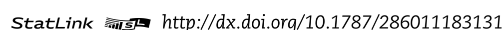
Figure 6.9. **Link between net migration and economic growth**

Impact on the net immigration rate of a 1% increase in per capita GDP growth




StatLink http://dx.doi.org/10.1787/286011183131

Note: Light shading indicates the relationship is not statistically significant.

Source: Estimates are based on regressions of the net immigration rate on the average GDP growth rate over the previous three years over an estimation period of about 30 years. See Annex 6.A1 for details.

high employment rates right from the start; and on the demand side, the most recent migrants brought little capital with them and they send some of their earnings home rather than spending it locally.

- Migrants have had complex effects on the housing market. The increased demand for housing will have increased house prices, probably substantially, but at the same time the greater availability of construction workers is likely to have reduced construction costs relative to what they would have been. This partly explains why prices for new houses have not risen as rapidly as prices of second-hand houses. At the same time, the rise in house prices has probably reduced immigration, shifting the balance of labour market growth from employment to wages (Duffy, FitzGerald and Kearney, 2005).
- Lastly, any negative short-term adjustment effects are likely to be smaller and the long-term gains arrive quicker because of the country's sound framework conditions such as flexible labour and product markets. OECD research shows that migrant integration is more effective where unemployment benefits, the tax wedge and the minimum wage are lower, and that differences in employment protection legislation between temporary and permanent contracts can exacerbate insider-outsider problems that are especially problematic for migrants (Causa and Jean, 2007).

Nonetheless, the distribution of the gains is more complex to assess in the Irish case than it is for other OECD economies. To the extent that immigration has shifted income from labour to capital, much of the productive capital stock in Ireland is owned by foreigners and therefore a portion of the gains accrues to them. This point applies to all policies that are used to attract multinationals, not just migration policy. There is no point

trying to attract foreign investment to Ireland unless some of the gains can be appropriated locally; and the presumption in Ireland, which seems vindicated by experience, is that not all the gains are captured by the foreign owners of capital.

Impacts on public finances

There has been no assessment of the impact on public finances, but it is probably positive. International studies show that the main determinants of the budgetary impact are age on arrival, employment status and the degree of redistribution in the tax-benefit system. The short-term impact is usually positive in countries that are able to select high-skilled migrants, although the initial impact can be negative but turn positive over time as migrants integrate.[15] The fiscal impact is more likely to be negative where a large proportion of the migrants are less skilled or working illegally and where the welfare system is more generous. Most studies find that the long-term impacts are positive but small. In the case of pension expenditure, migration can make the system more affordable in the short to medium term, but if the system is unsustainable to begin with then more people will make it more unsustainable in the long run.

The direct short-term impact depends on the balance between taxes paid and public services received. In Ireland's case, it amounts to the difference between two small numbers. On the revenue side, while most migrants are employed, they tend to be in relatively low paid jobs; with the lowest fifth of income earners paying no income tax, they may therefore not be contributing significantly to government revenues, though they will be paying social security contributions as well as VAT on their consumption. However, to the extent that skilled migrants are a necessary complement to the policy of attracting foreign multinationals, they enable the country to continue receiving the significant corporate tax revenues from this sector.

On the expenditure side, demands on healthcare and education are likely to have been modest on the whole so far compared with the scale of inward migration, as many migrants are young but have not brought families with them. There have been, of course, costs such as the additional € 120 million to fund 1 900 extra English language support teachers. Migrants have also not been a drain on the welfare system. In 2004, working-age immigrants were half as likely as the native Irish to be drawing social welfare benefits,[16] both because they are more likely to be employed and because they have restricted access to income support since a two-year residency requirement was introduced in May 2004.[17] There have been public concerns about the cost of child benefits being paid for children who are still in the immigrant's home country, but the overall amount does not appear to be large.[18] In any case, this is another argument for targeting child benefits on families who actually use formal childcare services, as recommended in the previous *Survey*. Lastly, the scale of the inflow has added to pressure on infrastructure such as roads and public transport. This has prompted a large publicly-funded infrastructure upgrade, though it probably would have taken place anyway with immigration simply hastening the process.

The long-term fiscal contribution is also unclear. That greatly depends on whether migrants stay in Ireland when they retire since the largest fiscal costs such as healthcare are concentrated on the over-65s. A well-educated migrant who arrives young and stays permanently is likely to become nearly fully integrated and so will not be much different from an Irish-born person except that Ireland would have got that person's education "for free". For this reason, immigration will not solve the fiscal problems stemming from an ageing society. Some countries have tried to reduce the long-term fiscal burden by

imposing residency requirements of ten years or more before someone is entitled to a full public pension. In Ireland, by contrast, the pension system has the effect that, for all practical purposes, there are no substantive requirements regarding residency or the numbers of years of contributions (Chapter 5).[19] In any case, European directives mean that for EU migrants the person's full work history in the European Union is taken into account, so for this group tightening up contribution requirements will have no effect on Ireland's fiscal burden.

Policy challenges

The biggest uncertainty for policymakers is how many migrants will continue to come to Ireland. The next biggest uncertainty is how many would leave if the job market were to worsen. On the first question, the inflow may slow now that six other EU15 countries have opened their labour markets to EU10 nationals. But Ireland will remain attractive because it has a dynamic and flexible labour market, it is English-speaking and a beachhead has been established – network effects make it easier for migrants to go where their compatriots are. On the second question, a downturn would lead to some outflow as many of the most recent migrants have not yet brought their families over and Ireland is not an attractive place to be unemployed. Special factors, such as construction in Northern Ireland and for the London Olympics, could also encourage an exodus.

The question is: how many are likely to leave? Little is known about the extent to which recent migrants are putting down roots. Almost all Eastern European migrants rent their accommodation, mainly because houses are so expensive, although real estate agents have reported growing interest among migrants in buying a home. And while a surprisingly large number of Eastern European migrants are married,[20] many have left their family at home. Both these factors suggest that they are still relatively footloose. However, a recent survey of Polish immigrants found that at least half intended to stay in Ireland for at least the next five to ten years.[21] Uncertainty is compounded by poor information about who emigrates, so it is not known how many of the EU10 immigrants have since left. Internationally, there is a long history of countries welcoming workers in times of labour shortages on the presumption that they would leave afterwards, and finding that temporary immigration became permanent. For this reason, there may be major gains from an investment in integration. The importance of integration is recognised by the government, which has recently created the post of Minister for Integration to co-ordinate integration efforts across government departments, agencies and services, although actual delivery of integration services is the responsibility of mainstream government departments. A taskforce on integration will report this year and a Ministerial Council for Immigrants is being established to bring the immigrant voice to the table. Labour market engagement is the major driver of integration, but other policies play a supporting role. Ways to better integrate immigrants, and the way such integration has been achieved overseas, are discussed below, as well as the challenges to infrastructure planning posed by the uncertainties about future migration flows.

Integration policy has many facets

Several countries have introduced welcoming programmes for immigrants, though they vary widely in scope. At one end of the spectrum, Canada has a settlement and adaptation programme that aims to provide essential services for newly arrived migrants, such as reception, orientation, translation and interpretation, counselling and

employment-related services. At the other end of the spectrum, Australia has a range of measures for refugees but other immigrants are directed to mainstream services such as health, housing, education and labour market access. Ireland is closer to the Australian model.

Language training is one of the most important ways to improve integration

Weak English language ability partly explains why some immigrants are employed in relatively low-paid jobs. Overall, after controlling for education, experience and gender, immigrants in 2005 earned around 15% less than natives (Barrett and McCarthy, 2007). This largely reflects the different jobs they take rather than immigrants being paid less than Irish people in the same job and this could be the result of difficulties in accessing the better jobs, as well as the kind of work migrants are seeking. There was essentially no earnings gap for migrants from English-speaking countries but migrants from non-English-speaking countries earn around a fifth less than comparable natives. The earnings disadvantage is larger still for immigrant women. The wage disadvantage is especially large (30%) for immigrants from the new member states.[22] This pattern is consistent with international experience which suggests that, across countries, about a third of immigrants' over-qualification rates can be explained by weaker linguistic skills.

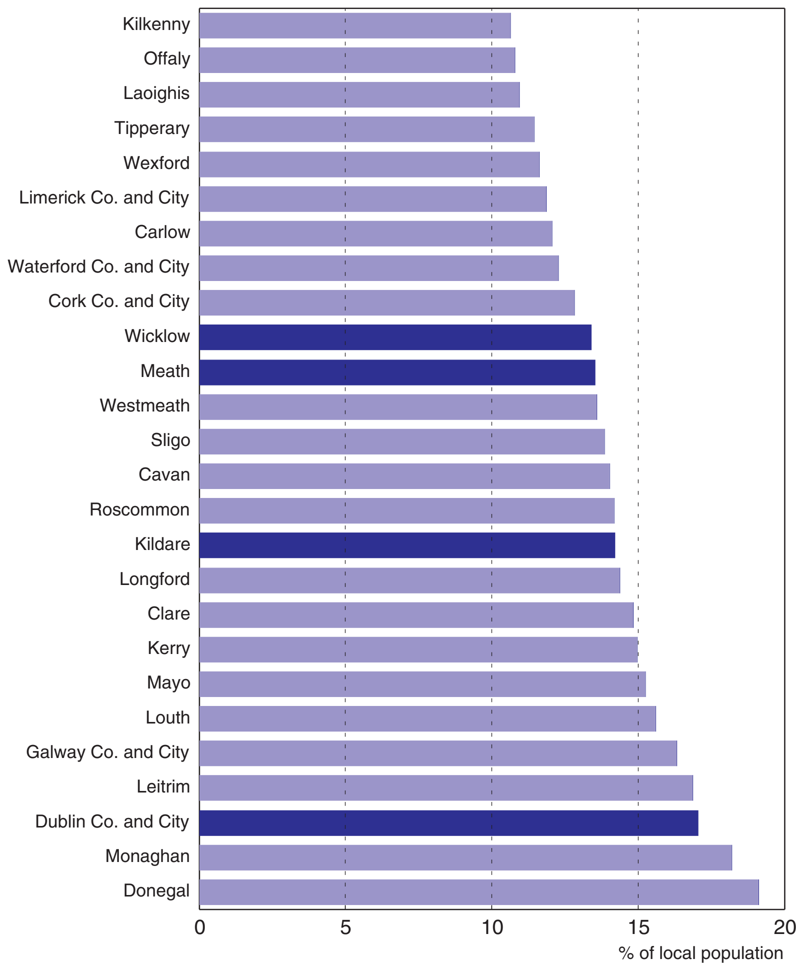
Provision of language classes for migrants is limited (MRCI, 2006; ICI, 2007). There are several publicly-funded programmes for refugees and asylum seekers made available through various providers, as well as privately-run English language colleges, NGO-lead schemes and the national network of libraries. The government provides funding for 12 000 free places in English-language classes through Vocational Education Committees (VECs), which provide further, paying classes. However, the Irish Vocational Education Association, which represents the VECs, has identified several barriers in accessing English language classes, including fees, inconvenient hours and a lack of information on what is available. The Department of Education and Science and the Minister for Integration have commissioned a wide-ranging strategic review on the "Development of a National English Language Policy and Framework for Legally Resident Adult Immigrants" and the government is expected to develop a more coherent policy in 2008.

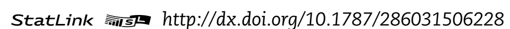
Picking up the language is harder when migrants congregate into geographical "enclaves". It can also impede the language skills of immigrant children, harming their performance at school. Clustering has not been a major problem so far. Migrants are surprisingly well dispersed around the country (Figure 6.10), but there is an understandable and increasing tendency towards congregation in the least expensive suburbs. There are signs of employment enclaves where all employees in a small construction firm, for instance, speak a foreign language at work. There is little that policy can do to stop geographic or workplace concentration, but equally policy should not exacerbate the tendency and should instead focus on the problems that clustering may cause.

International experience suggests that language training on arrival significantly improves future employment prospects. Courses do not need to be long because the payoff diminishes with the duration of the training, and intensive full-time courses can be counter-productive if they keep people out of the labour market.[23] International evidence suggests that language training programmes are more effective if they are combined with work experience, are well tailored to the individuals and are available in the areas and times when migrants can attend (OECD, 2007b). Otherwise, dropout rates tend to be high. For employed adult immigrants, training at the workplace can be convenient, and should

Figure 6.10. **Distribution of migrants across the country**

Number of foreign born as a percentage of the local population, 2006




StatLink http://dx.doi.org/10.1787/286031506228

Note: The dark-shaded bars show County Dublin and the counties that border it.

Source: Central Statistics Office, Census 2006.

be organised in tandem with employers. Mentoring programmes can also help immigrants learn the less formal aspects of the language.

The need to provide language support for migrant children is a recurring theme in OECD *Surveys* (Box 6.1). In many countries, the social disadvantages faced by first generation migrants can be perpetuated through the generations if migrant children receive inadequate help. Evidence from several European countries in the OECD's PISA study shows that students who do not speak the language of assessment at home are two-and-a-half times more likely to be in the bottom quarter of performance indicators. Ireland may need to further improve language support for its immigrant children. The number of special language training teachers has risen rapidly to 1 900 in 2007, up from about 250 in 2001, but there is little training so far for regular teachers. The need to step up language training further is currently being assessed by the Economic and Social Research Institute, the Inspectorate of the Department of Education and Science, and the OECD.

Box 6.1. **Recurring themes: migration issues in other countries**

The impact of migration has been assessed in several OECD *Economic Surveys*. They include Australia (in the 2003 Survey), Belgium (2005), Canada (2003), Denmark (2003), Greece (2005), Italy (2005), Luxembourg (2003), Mexico (2004), New Zealand (2004), Spain (2003) and Switzerland (2007). Several recurring themes emerged:

- Immigration is beneficial for the host country even if most of the gains go to the immigrants themselves.
- Knowing the language is crucial for successful integration.
- Foreign qualifications are discounted, especially from countries that are very different.
- Foreign work experience receives little or no reward in the local labour market.
- It is hard to find any significant impacts on the wages or job prospects of the resident population.
- The children of immigrants often have problems at school. Sometimes this applies to second-generation descendants as well.

Other countries have tried many approaches, and it is unclear what works best. In Belgium and Greece, for example, children of newly arrived migrants can attend reception classes for one year in which they learn the local language and also learn about the education system before joining the mainstream schools. Until 2002, municipal authorities in Denmark were required to provide bilingual instruction to all bilingual students, including descendants. The approach has been different in places such as Australia and Canada. There, resources are targeted on schools in areas of socio-economic deprivation rather than specifically on the children of immigrants. The evidence on all these programmes is inconclusive. In one study of 12 OECD countries, most had set a goal of having immigrant children mainstreamed into regular classes within three months to three years (Glenn and de Jong, 1996). While the countries followed many different strategies, and sometimes changed tack, none achieved clear success in overcoming the weaker school performance of immigrants relative to natives. However, the success in the United States with the Head Start pre-school programme and similar programmes in other countries, which are designed to boost school readiness among disadvantaged infants, suggests that Ireland may wish to design programmes that give a language stimulus to pre-schoolers.

Getting credit for skills and work experience

Immigrants in most countries have trouble getting their foreign qualifications recognised, and this obviously increases the chances that they end up over-qualified for their job. Indeed, OECD (2007c) shows that immigrants who gain a diploma in the host country do just as well as the native born in the labour market (so long as their human capital and literacy skills are the same). In other words, the labour market penalty is very much tied up with language skills and foreign qualifications that are not sufficiently valued by local employers. Getting formal qualifications recognised is only part of the solution since employers also value work experience but tend to discount experience gained abroad. This is especially a problem for some members of the third group of migrants discussed above – those from outside the European Union.

Several OECD governments have set up agencies to evaluate foreign qualifications. In most cases they are simple information services for businesses that want to know whether foreign diplomas are comparable to local ones. Denmark has gone further as its agency provides binding assessments that allow entry to regulated professions. Ireland has created the National Qualifications Authority of Ireland and developed the National Framework of Qualification since late 2003. The National Framework is linked in with similar developments that are taking place in other EU countries and at the EU level. The National Qualifications Authority is also the Irish centre for the recognition of international qualifications. It has established Qualifications Recognitions Ireland, which is a one stop shop for enquiries by employers and immigrants regarding the recognition of qualifications from other countries. It is building an online database that aligns a foreign degree or diploma to the corresponding Irish qualification. Comprehensive bilateral recognition agreements have also been signed with the United Kingdom and China. Regarding the regulated professions, recognition of qualifications of EEA nationals is covered by EU law. A mutual recognition system exists for most European health care workers while other regulated professions are dealt with on a case by case basis. Nonetheless, certain regulated professions have licensing requirements which often involve passing an exam. These need to be set appropriately so that excessively rigorous English requirements are not a hurdle for immigrants who would otherwise be capable of performing the job.

As well as giving more information to employers, the natural policy response when foreign qualifications and work experience are hard to gauge is to reduce the risk and cost of hiring immigrants, at least temporarily while their skills can be assessed and their language proficiency can be brought up to speed. Sweden has introduced an innovative approach that Ireland should consider. Its public employment service runs an on-the-job skill assessment programme whose purpose is to make a quick assessment – less than three weeks – of foreign credentials, individual skills and work experience. After the evaluation, a certificate is issued that can be included in future job applications. It is too early to know whether the programme is succeeding (OECD, 2007d).

In some countries, such as Denmark, temporary wage subsidies and subsidised employer-based training have been found to have favourable downstream employment impacts, despite the deadweight costs (OECD, 2007e). However, there should be little need for wage subsidies in a strong labour market when the main problem for immigrants is not employment *per se* but over-qualification. Ireland should steer clear of them, except perhaps very tightly targeted ones, unless it finds itself with substantial and persistent unemployment among certain groups of immigrants. On the other hand, policies that promote lifelong training (such as refresher programmes and language courses) and occupational mobility (for example reducing the number of regulated professions and jobs closed to foreigners) should be part of the range of tools made available to foster integration (OECD, 2007c).

Mentoring programmes can be helpful

Mentoring programmes are popular with migrants in several countries. In these programmes, an immigrant is matched with a native-born person of similar age, occupation and sex. The local person provides the immigrant with basic information on how things are done in the host country, assists them with the language, and generally helps to build social bridges and get access to networks. Mentoring programmes tend to be

good value for money because the mentors are usually volunteers, though they receive special training.

Family reunification is part of the integration process

Family reunification has not been a major channel of immigration so far, though there are signs that it is picking up. But some migrants may be less willing to make the effort required to fully integrate into the job market and wider society because of uncertainty about whether their family will be able to join them. Nationals from EEA countries have automatic rights to family reunification but the situation for third country nationals depends on the type of work permit and is subject to discretionary decisions by the Department of Justice, Equality and Law Reform. Ireland has opted out of the EU's directive on the rights of third country nationals to family reunification. Those with a green card are entitled to immediate family reunification, but migrants with a general work permit have to wait a year[24] and must have a high enough salary (about 80% of the average wage).[25] Common law marriages (*e.g.* civil unions) or *de facto* relationships are not recognised. The Justice Department issued new guidelines on reunification in February 2006 that have helped clarify the policy, but reunification is not a right and decisions are still subject to discretion. For example, it is uncertain whether the policy would be tightened in the event that the labour market deteriorated.

Temporary work agencies can be helpful but some of them exploit vulnerable migrants

Temporary work agencies are good for the job prospects of migrants because they shift some of the risk away from the employer. For example, evidence from Sweden shows that temporary agencies are an important stepping stone into more regular jobs (OECD, 2007e). Nonetheless, there are concerns that some migrants in Ireland are being exploited or treated badly by agencies. There have been cases of unfair dismissals, coercion and people not being paid proper overtime rates or holiday pay. While these are probably isolated cases, there is a need for better regulation and enforcement of rogue agencies. Ireland is one of the few EU countries without a law that ensures agency workers receive the same pay and working conditions as directly employed workers doing similar jobs. Agency recruitment has also been used to circumvent legally binding registered employment agreements in certain sectors. In response, the number of labour inspectors has been increased, the social partners have agreed to create a new Office of Employment Rights Enforcement, and several agencies now provide information on workplace rights in several languages.

Housing policy can affect the social and economic inclusion of migrants

A well developed rental market helps integration, especially if Ireland wants to avoid the development of enclaves or ghettos where migrants are forced into the cheapest housing at the edge of town.[26] The rental market is also attractive for highly skilled migrants who are unsure how long they will stay in Ireland. However, the private rental sector is small by European standards (Rae and van den Noord, 2006). This partly reflects Irish preferences but it is also due to government policies concerning taxation and housing support that have a strong bias towards home ownership rather than providing rent assistance (Fahey, 2004). There are long waiting lists for social housing, and this affects immigrants disproportionately as they are more likely to be on low incomes. The previous *Survey* recommended shifting towards a more tenure-neutral approach to housing

assistance, for example through housing vouchers or rent subsidies, rather than constructing new houses and controlling the system with queues.

Selection policy cannot be ignored

While better integration is the main issue, migrant selection policy cannot be ignored entirely. In countries that use a points system, it is usually not necessary for migrants to have a job before entering the country (but extra points are given if the applicant has a firm job offer). This gives highly skilled migrants the chance to look for work on the ground, which is easier than landing a job from abroad. Ireland has chosen not to go down this route for non-EEA nationals, mainly because a points system would be overly complex considering how few people it aims to attract from outside Europe. Instead, it lets the job market decide using the salary level as a selection tool. While this is probably the best approach, it has some potential drawbacks that need to be recognised. First, unless it is supplemented with numerical limits, it gives away the small amount of control that is left over the number of immigrants. Second, it may bias selection towards older people since they are more likely to be over the salary threshold. Most countries prefer young migrants as they are more adaptable. Third, by favouring certain occupations in the middle salary ranges it gets into the business of picking winners, and that is hard to do well. Overall though, the approach chosen by the Irish seems to be appropriate but it should be monitored to ensure that these potential drawbacks do not turn out to be more of an issue than expected.

The administration of the new green card and work permit system has not gone smoothly, though it has improved since the initial teething problems. Employers have had difficulties getting work permits for jobs on the list of approved occupations, with permits being refused if the job title does not exactly match the broad job description on the list or if the worker involved has a degree in a subject that does not look directly relevant, no matter what their other work experience or on-the-job training may be. Administration can also be inflexible in several respects. For example, changing positions or being promoted within a company can cause problems because it requires a new green card. In the health sector, certain staff such as junior doctors and consultants who rotate every six months or work at multiple sites must apply for a new green card every time they shift. Given the delays involved, this can be difficult.

Ireland may want to consider even more flexible visa arrangements, such as multi-use, multi-entry visas and lowering the cost of re-entry. These arrangements may be attractive to the most mobile workers and they can be helpful to the source country by encouraging two-way skill circulation rather than a one-way brain drain.

The overall quality of life is important to attract highly skilled migrants

With many countries competing to attract the most highly skilled migrants, the whole quality of life becomes important. This goes beyond the cost of living to cut across all areas of government policy. For families where both partners have careers, a system that allows the spouse to work is important. The changes made this year to the work permit (green card) scheme are helpful in this respect. Most migrant couples are at the age where they have or will soon have children. For them, the availability of reasonably priced and conveniently located childcare facilities is important. This is a problem in Ireland, as highlighted in Chapter 1 and in the previous *Survey*. In addition, highly skilled migrants are attracted by good quality healthcare and education systems that are easy to access. Ireland

may also need to consider creating a permanent residency channel for the highly skilled in order to give a clear path to citizenship (OECD, 2007b). It has gone some way in this direction with its reforms to the green card scheme, as there is an expectation that a permit can be rolled over. And the 2008 Immigration, Residence and Protection Bill implies that the migrant will be granted residency faster. Lastly, migrants from some countries have become accustomed to high standards of infrastructure, so dealing with issues as diverse as public transport, congestion and high-speed internet access all affect the quality of life in Ireland, and therefore influence migration decisions at the margin. Hong Kong provides a useful warning about the importance of getting the whole package right. Despite economic factors being a strong attractor, several multinationals have left or are considering leaving Hong Kong because pollution increased to the point that expatriate staff and their families do not want to live there.

Planning infrastructure projects under heightened uncertainty about population growth

Immigration has put pressure on the physical and social infrastructure

The rapid increase in population has clearly contributed to infrastructure bottlenecks. Migrants are contributing to problems of traffic congestion and are increasing the demands placed on public transport, especially as a significant fraction of the most recent migrants live in commuter belts up to 50 kilometres from the city centres. They are also adding to pressure on waste and water infrastructure, particularly in the new housing areas which have required greenfield investment in infrastructure rather than simply connection to existing networks. However, the magnitude of the pressure from migrants is unknown.

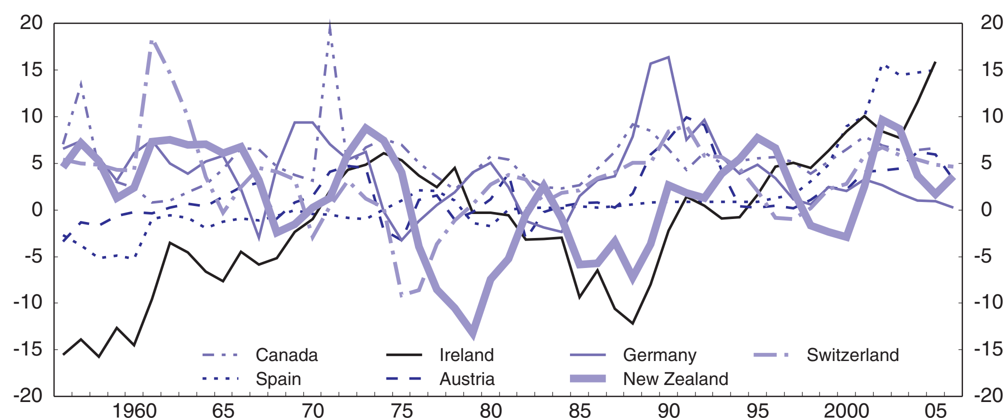
Social services such as schools, hospitals and policing are facing greater demand and diversity. In the education sector, the main issue is diversity as the number of migrant children is small – but growing rapidly.[27] Some schools have had a sudden increase in the number of foreign students for whom English is not their first language and they do not always have sufficient resources to cope, although since last year schools are allowed to have up to six English language support teachers. In healthcare, extra demand is less of an issue, and in fact immigrants are helping boost supply with around one out of every eight healthcare workers being a foreign national. But here too, diversity is creating problems as hospital staff need to communicate with patients from differing cultural and linguistic backgrounds. These issues are common abroad but new to Ireland, and it is only beginning to provide multi-cultural training for staff and to supply information leaflets in foreign languages. Ireland may like to consider a useful service offered in Australia and Portugal that uses mobile-phone technology to provide real-time translation and interpretation services for public administrators, healthcare professionals and private enterprises in their contacts with immigrants.

Migration and population uncertainty

Migration is having a substantial impact on population growth. Uncertainty about the number of migrants and the characteristics of the non-native population raises uncertainty about demographic projections, although there are also important unknowns around longevity and fertility rates (Gonand, 2004). This makes it harder to plan infrastructure projects. Despite some important qualitative differences, the present strong net inflow of migrants into Ireland is unusual but not unprecedented compared with past OECD experience; however, these episodes suggest that such rapid inflows are never sustained (Figure 6.11). Ireland itself has had one of the most volatile net inward migration

Figure 6.11. **Net inward migration rates**

Per 1 000 population



StatLink http://dx.doi.org/10.1787/286057280348

Source: OECD (2008), *Population and Vital Statistics – online database* (January).

rates of any OECD country, although in the past this was largely accounted for by net migration of Irish nationals. Hence, some of the same considerations about the population varying apply as in the past.

Migration rates clearly respond to economic circumstances and net outflows can occur as economies slow. Austria, Germany, New Zealand and Switzerland also experienced net outward migration, very often non-nationals returning home, after the slowdown of the 1970s. Equally, Irish immigrants to the United Kingdom came home to Ireland as the British economy slowed in the 1970s and then as the Celtic Tiger era created new opportunities in the late 1990s.

Uncertainties about migration flows and infrastructure planning

Net inward migration is currently well above the rates assumed in the population projections underlying the National Development Plan for 2007-2013. On average, net migration per annum over 2002-06 was 50% higher than projected in CSO (2005). Over 2005-07, estimates suggest that net inward migration, at 64 700 persons per annum, was more than double the level assumed in the official population projections (CSO, 2007).

If sustained, high levels of net inward migration will add to the existing pressures on physical and social infrastructure in Ireland. The public sector capital stock declined throughout the 1990s on a per capita basis and relative to GDP. Despite the large investment programme, the estimated per capita public capital stock still lags behind the OECD average. Surveys of business executives on the quality and efficiency of transport and energy infrastructure continue to give Ireland a low ranking relative to other OECD economies. Infrastructure deficits can also be seen elsewhere in the economy. Broadband penetration rates in Irish firms and households and average advertised download speeds are low relative to other OECD economies, as of mid-2007 (OECD, 2007f).

The OECD *Infrastructure to 2030* project has identified a number of key policy areas which could enhance the capacity of the government to meet future infrastructure needs (Stevens and Schieb, 2007). Of particular importance is the need for innovative approaches to the financing of infrastructure projects, both in terms of engaging private sector

resources and capital through PPPs as is already done in Ireland, and in terms of user charges for infrastructure use. Enhanced usage of price mechanisms should not only raise revenue, but also result in more efficient use of infrastructure and help to signal where new investment is warranted. In this area, more can be done in Ireland and this would help in restraining future demand.

Bridging the infrastructure investment gap will also require careful attention to be paid to the design and flexibility of regulatory frameworks and the planning process, and also require governments to have adequate capacity for effective analysis and decision making. Project design and planning needs to allow for the uncertainty faced by potential investors making long-term infrastructure investment decisions. Potential sources of uncertainty for the private sector include regulation and planning decisions as well as the likely returns to investment (Saphores *et al.*, 2004).

Demand for infrastructure is likely to continue to strengthen in Ireland, reflecting both the present relative under-provision of infrastructure and also the general tendency for infrastructure usage to rise over time with economic activity (Eddington, 2006). But the extent and type of demand growth is uncertain, reflecting the sensitivity of demand to future population growth, especially net inward migration, the geographical locations in which demand will expand and the mix of services demanded. Such uncertainties about market conditions give firms making irreversible investments an option value from waiting to see what happens; there is a value to waiting if the option to undertake the project remains at a point when more may be known. For example, building a new road or bridge is risky, as the costs of construction cannot be recouped if there is insufficient usage made of the new facility. Equally, new schools or hospitals may turn out to be unneeded, or in the wrong location.

All infrastructure projects are subject to uncertainty. Infrastructure planning and regulation need to build in sufficient flexibility to deal with changing circumstances. Planning and evaluation of projects should include analysis of the optimal timing of projects, including the associated risks, and choose projects that have the appropriate life-span or reversibility. For example, a new bus link may be cheaper to shut down than a new rail link if there is insufficient demand. The Working Rules for Cost-Benefit Analysis in Ireland, although requiring realistic alternative ways of achieving the same objective to be considered in some cases, do not presently explicitly take option value and irreversibility risk into account, as the guidelines have begun to in a few other countries, such as the United Kingdom (HMT, 2003).

The irreversibility of many projects implies that it is easier to scale up existing projects, such as adding an additional wing to a building, than to tear down vacant school or office space. Infrastructure planning should where practicable choose projects with scope for moderating or expanding capacity at a later stage. Planning should also seek to identify other margins where additional demand could be met. As a relatively small country, excess demand in Ireland is small relative to the European supply of infrastructure-related services such as healthcare or electric power. Examples of potential adjustments if demand exceeds domestic capacity include sending some patients for treatments abroad and importing electricity from other countries.

Box 6.2. **Summary of recommendations on migration**

The primary policy challenge is to improve the integration of immigrants. In this respect, Ireland should consider:

- Providing increased support for language training for adult migrants based on the recommendations of the current strategic review on "Development of a National English Language Policy and Framework for Legally Resident Adult Immigrants".
- The level of provision of language classes for all ages of children, including pre-school children.
- Accelerating work on the recognition of foreign qualifications, including bilateral agreements with other EU countries.
- Introducing an on-the-job skill assessment programme for cases where qualifications are difficult to assess.
- Changing the delivery of housing support towards tenure-neutral policies.

Regarding selection policy and with free movement of people across Europe, Ireland is able to influence immigration only at the margins. Nonetheless, it could:

- Introduce a permanent migration channel and create flexible visas, such as multi-use, multi-entry visas.
- Monitor the recent reforms to ensure that a visa policy based on salary is able to deliver the type of migrants that Ireland wants and needs. Ensure that policy is administered flexibility and is not excessively burdensome for employers or migrants.

Planning the infrastructure programme and the size of public services is more difficult due to the uncertainties surrounding future migration flows. To cope with these uncertainties, the authorities should:

- Ensure an effective pricing of services flowing from infrastructure projects.
- In cost-benefit analysis, canvass options that will provide flexibility in the face of demand uncertainties.
- Evaluate the options to import services.

Lastly, better information would help guide policy. Better statistics on immigrants should be collected and greater funding for research into immigrants' experiences in Ireland would be helpful.

Notes

1. A small part of the difference comes from those born in Northern Ireland. Those born before 2005 have automatic rights to citizenship in the Republic while those born afterwards can acquire Irish nationality if one of their parents is an Irish or British citizen or has permanent residency on the island. Around 8% of the foreign-born in Ireland were born in Northern Ireland.
2. Between 1992 and 2005, 324 000 Irish emigrants returned home. This estimate is based on nationality, not place of birth, and includes some Irish nationals who were born overseas to Irish parents and in that sense are not "returning".
3. The 15% wage premium refers to their earnings after they had come back, and applies to males who emigrated for economic reasons. Those who emigrated "to see the world" or "for an adventure" had no wage premium when they returned.
4. Of the 122 000 people who came to Ireland in the year before the census, 53 000 (43%) came from the new member states. Of these, 33 000 were Polish nationals and 8 000 were Lithuanian nationals.

5. The immigration rate into the median OECD country is approximately 0.4% of the population (OECD, 2007a). According to census data, the number of people born outside Europe or the United States who arrived in Ireland in the year to April 2006 amounted to 0.37% of the resident population.
6. There has been some speculation that construction workers are registering as self-employed contractors rather than employees in order to circumvent collective agreements. But census figures show that only 0.9% of EU10 migrants were self-employed in 2006.
7. Barrett and Duffy (2007) estimate that 41% of the cohort that arrived in 2004 and 2005 has a tertiary qualification and 91% had completed upper secondary education. This compares with 57% and 85% respectively for those who arrived between 1995 and 1999.
8. Over-qualification is examined here with a normative-type measure based on the correspondence between level of education and qualifications for the job held. Education and job qualification levels are grouped into three broad categories: low, intermediate and high. An over-qualified individual is one who holds a job that requires lesser qualifications than would theoretically be available to him at his education level.
9. Barrett and McCarthy (2007) estimate that earnings rise by 4% for each additional year worked. While this is a small effect, it is a non-negligible proportion of the earnings *gap*.
10. "Migrant workers choosy about jobs", *Financial Times*, 22 August 2007. The article summarises a report produced by the British Home Office.
11. The EEA consists of the 27 EU countries plus Iceland, Liechtenstein and Norway. Switzerland has a bilateral agreement that is almost identical in content to the EEA agreement.
12. If this is the first employment permit then (other than in exceptional circumstances) the migrant is *expected* to stay with the initial employer for 12 months but may then change employer provided that a new application for a green card or work permit is made.
13. The simulation shown here differs from the one published in their paper. In their original simulation, the short-term impact on GDP per capita and unemployment was quite negative because the capital stock is slow to adjust, so at a given wage labour demand is unchanged. Migrants therefore have to price themselves into the market by bidding down wages or displacing local workers until the required capital is in place. This seems implausible since the recent migrants are predominately employed in hotels, restaurants and construction, where the capital stock is either largely in place or can be purchased quickly. The authors of that paper kindly ran a simulation for the OECD Secretariat which assumed quicker labour market adjustment (through a level shift to the labour demand equation); it is this simulation that is shown in the table. A second difference from the published paper is that the scale of the effects has been doubled as the latest information on the inflow rate from the new member states is considerably higher than the assumption used in their paper.
14. For example, see Gould (1994) for the United States and Girma and Yu (2002) for the United Kingdom.
15. See the OECD *Surveys* listed in Box 6.1.
16. Barrett and McCarthy (2006) show that immigrants are significantly less likely than the native Irish to be on welfare even after controlling for education, gender and years of work experience.
17. Since May 2004, citizens of any nationality must satisfy a "habitual residence" condition to be eligible for benefit payments such as social assistance or disability benefits. In practice, this means two-years of residency in Ireland or the Common Travel Area (the United Kingdom, the Channel Islands and the Isle of Man). Under EU regulations, EEA citizens who have "a history of working in Ireland" are eligible for unemployment benefit, family benefits such as the child benefit and the family income supplement.
18. In 2007, € 4.8 million in child benefit was paid in respect of 4 300 children living outside the Republic of Ireland in another EU/EEA country and Early Childcare Supplement (ECS) payments to the value of € 1.12 million were made in respect of 1 700 non-resident children under the age of 6, although these figures could rise in future years.
19. To receive the full contributory pension, people retiring before 2012 must have contributed for five years; those retiring after 2012 must have contributed for ten years. But if they are not eligible for the contributory pension, they can receive the non-contributory pension.
20. According to the 2006 census, almost a third of EU10 nationals in Ireland are married.
21. See "Half of Poles in Ireland say they intend to stay", *The Irish Times*, 5 July 2007.

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22. In late 2005, one quarter of immigrants from the EU were paid € 8.00 per hour or less, compared with 8.5% of Irish employees (Nolan *et al.*, 2006). At the time, the minimum wage was € 7.65 an hour.
23. See Liebig (2007) on Australia and Lemaître (2007) on Sweden.
24. More precisely, the migrant must have been in continuous employment for at least a year and have a full time job at the time of the application.
25. The threshold is a level of earnings high enough that the migrant would not be eligible to receive the Family Income Supplement. For a two-child family, that amounts to approximately € 29 000 per annum. The income threshold does not apply if the immigrant has been working in Ireland for three years or works in an occupation deemed to be subject to skill shortages.
26. According to the 2006 census, just under two-thirds of Poles and Lithuanians in Ireland rent their home in the private market; a fifth are in social housing; and just 5% own their own home. They are predominantly in new homes: just under half of the homes occupied by Poles and Lithuanians have been built in the last ten years. 78% of the Irish-born population are owner-occupiers. Overall, the private rental market accounts for 10% of the housing stock.
27. From 2000 to 2005, net immigration of people under 15 years of age was 36 000. This compares to a resident population of the same age group of around 840 000.

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ANNEX 6.A1

Do fast-growing economies attract more migrants?

People migrate for many reasons, one of which is better income and job prospects. To assess how important this is in individual countries, the net immigration rate was regressed on per capita GDP growth in an equation of the following form:

$$m_t = c + \alpha m_{t-1} + \beta(y_t - y_{t-3}) + \gamma trend.$$

where m is the net immigration rate as a share of the resident population, y is per capita GDP (GNI in Ireland's case), so $y_t - y_{t-3}$ is the three-year average growth rate; and *trend* is a time trend. The lagged dependent term captures dynamics of adjustment while the constant c and trend are included to absorb other omitted factors. Clearly this is not a full structural model of immigration, since other factors that are correlated with GDP growth (such as wage growth or employment) are not included. Rather, it should be interpreted as no more than a reduced form relationship between economic activity and net immigration.

This equation was estimated for 18 countries using annual data. The sample period was from the earliest possible date for which data was available (usually in the 1960s) until 2005. Outlier dummies were included in some equations. The regression results are

Table 6.A1.1. **Regression results**

	Coefficient on growth	t-value	Lagged dependent	t-value	Implied long-run response to GDP growth
Australia	0.85	4.6	0.51	4.8	0.17
Austria	0.73	1.9	0.58	4.7	0.17
Belgium	0.33	2.7	0.69	6.4	0.11
Canada	0.43	2.5	0.25	3.0	0.06
Denmark	0.42	3.5	0.21	1.8	0.05
Finland	–0.02	–0.3	0.58	2.2	0.00
France	0.16	2.0	0.70	6.4	0.06
Iceland	0.47	3.1	0.34	2.5	0.07
Ireland	**0.63**	**3.3**	**0.85**	**12.2**	**0.42**
Japan	0.01	0.4	0.05	0.3	0.00
Luxembourg	0.70	3.2	0.62	5.9	0.18
Netherlands	0.37	2.9	0.57	0.1	0.09
New Zealand	0.73	2.1	0.67	6.3	0.22
Norway	0.23	2.0	0.27	1.7	0.03
Sweden	0.19	1.1	0.56	4.6	0.04
Switzerland	0.77	3.1	0.59	5.5	0.19
United Kingdom	0.16	2.3	0.49	4.5	0.03
United States	0.08	2.1	0.81	10.6	0.04

shown in Table 6.A1.1. In most cases, the coefficient on per capita GDP has a significant and positive impact on net immigration.

Similar equations were estimated using different measures of economic activity. They include: GDP growth in place of per capita GDP growth (though this has the drawback that GDP growth is highly endogenous since immigration boosts GDP); the output gap; the relative output gap (the local gap minus the OECD gap); and relative GDP growth (local minus OECD). The gap measures did not explain well, which is not surprising since migrants are more concerned with absolute growth than growth relative to potential. The other GDP growth measures gave similar results to the ones reported here.

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Glossary

ARF	Approved Retirement Fund
CBFSAI	Central Bank and Financial Services Authority of Ireland
CPI	Consumer price index
DB	Defined-benefit
DC	Defined-contribution
ECB	European Central Bank
EEA	European Economic Area
EEE	Exempt-exempt-exempt
EET	Exempt-exempt-tax
ELS	Existing level of service
EMU	Economic and Monetary Union
ESB	Electricity Supply Board
ESRI	Economic and Social Research Institute
EU	European Union
EU-SILC	European Union Statistics on Income and Living Conditions
FDI	Foreign direct investment
GAIE	Gross average industrial earnings
GDP	Gross domestic product
GNI	Gross national income
GNP	Gross national product
HSE	Health Service Executive
ICT	Information and communication technology
IFSC	International Financial Services Centre
MIF	Management Information Framework
MIRAS	UK Mortgage Interest Tax Relief
NDP	National Development Plan
NPPI	National Pensions Policy Initiative
NPR	National Pensions Review
NPRF	National Pension Reserve Fund
PAYE	Pay-As-You-Earn
PPP	Public-private partnerships
PRETA	Pre-Retirement Allowance
PRSAs	Personal Retirement Savings Accounts
PRSI	Pay Related Social Insurance
PSBB	Public Service Benchmarking Body
PRSI	Pay Related Social Insurance
RAS	Rental Accommodation Scheme
R&D	Research and Development

SSIAs	Special Savings Investment Accounts
VAT	Value added tax
VECs	Vocational Education Committees
VFM	Value for Money

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