OECD Economic Surveys

IRELAND

OECD

Volume 2009/17
November 2009

OECD Economic Surveys: Ireland 2009

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

ISBN 978-92-64-05453-0 (print)
ISBN 978-92-64-05454-7 (PDF)

ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

Also available in French.

Photo credits: Cover © Pat O'Hara/The Image Bank/Getty Images.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.
© OECD 2009

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

Table of contents

Executive summary . . . 8

Assessment and recommendations . . . 9

Chapter 1. **Restoring macroeconomic and financial stability** . . . 17
Unwinding imbalances . . . 18
Resolving the banking crisis . . . 28
Financial regulation and supervision . . . 36
Macroeconomic stability and macro-prudential policy . . . 38
The housing market needs to be reformed . . . 39
Potential output is crucial for the outlook . . . 41
Notes . . . 46
Bibliography . . . 46

Chapter 2. **Rebuilding the public finances** . . . 49
Fiscal conditions have deteriorated abruptly . . . 50
Revenues need to be raised and the tax system reformed . . . 57
Reducing public spending and increasing efficiency . . . 64
Strengthening fiscal rules and institutions . . . 71
Notes . . . 76
Bibliography . . . 77

Chapter 3. **The labour market: Getting people into work** . . . 79
Short-term labour market adjustment . . . 80
High levels of unemployment will be hard to cut . . . 85
Migration has begun to reverse . . . 101
Policies to raise employment in the long term . . . 105
Notes . . . 113
Bibliography . . . 114

Chapter 4. **Boosting competitiveness and raising living standards** . . . 117
Competition is weak in some sectors . . . 119
The infrastructure has improved but further investment is required . . . 122
Education and skills are the key to long-run growth . . . 124
Research and development (R&D) activity has increased . . . 126
Sustainable development and climate change . . . 127
Bibliography . . . 129

Annex 4.A1. Progress in structural reform . . . 130

Boxes

1.1. How big is the Irish banking sector? 30
1.2. The National Asset Management Agency 34
1.3. Re-estimating potential output for Ireland 42
1.4. Summary recommendations to restore macroeconomic stability 45
2.1. The Commission on Taxation 58
2.2. Report of the Special Group on Public Service Numbers and Expenditure Programmes 64
2.3. Summary of recommendations of fiscal policy 75
3.1. Falling nominal wages are rare in OECD countries 87
3.2. Agencies dealing with the labour market 96
3.3. Main employment programmes in Ireland 99
3.4. Labour market measures taken to deal with the rise in unemployment 100
3.5. Summary of recommendations on labour markets 112
4.1. Summary of recommendations to promote sustainable long-run growth 128

Tables

1.1. Economic performance in the most recent expansions 19
1.2. Key macroeconomic developments 25
1.3. Aggregated balance sheet of retail clearing credit institutions 29
2.1. Budget deterioration and discretionary action 51
2.2. Dealing with adverse debt dynamics 54
2.3. Long-term public pension projections 57
2.4. Breakdown of tax revenues 59
2.5. Costs of tax credits, allowances and reliefs against personal income tax 60
2.6. Costs of tax allowances and reliefs against corporation tax 62
3.1. Changes in employment by sector 81
3.2. Unemployment benefit recipients and survey-based unemployment 94
3.3. Spending on active labour market programmes 98
3.4. Employment as a share of population by group 105
4.1. Progress in structural reform: Competition policy 123
4.2. Progress in structural reform: Upgrading infrastructure 124
4.3. Progress in structural reform: Education 126
4.4. Progress in structural reform: Research and innovation 127

Figures

1.1. The economy is experiencing a severe contraction 19
1.2. Household indebtedness has risen 20
1.3. Housing market developments 22
1.4. Household wealth 23
1.5. Household saving and indebtedness (average 2005 to 2007) 24
1.6. Competitiveness indicators 27
1.7. Wages and productivity (2008) 27
1.8. Alternative measures of banking sector size (2008) 30
1.9. Trade in financial services (2006) 43
2.1. The fiscal position has deteriorated sharply 50
2.2. Revenue and spending have become misaligned 51
2.3. Discretionary, cyclical and underlying influences on fiscal stance 53

2.4. Gross and net government debt 54
2.5. Debt sensitivity to growth, interest rate and primary balance assumptions 55
2.6. Ten-year government bond spreads compared to Germany 56
2.7. Distribution of income tax payment by income 60
2.8. Effectiveness of value added taxes as measured by the VAT Revenue Ratio, 2005 63
2.9. Public sector employment and average earnings 65
2.10. Annual average growth in real per capita expenditure on health and GDP, 1997 to 2007 67
2.11. Remuneration of healthcare professionals, 2007 68
2.12. Occupancy rate of acute care hospital beds, 1995 and 2007 69
2.13. Public subsidies for tertiary education, 2005 70
3.1. Labour market adjustment in the current downturn 81
3.2. Cyclical variation of output and employment 82
3.3. Labour market regulations encourage flexibility, 2008 84
3.4. Long-term unemployment is likely to increase 85
3.5. Average hourly earnings by sector 86
3.6. The minimum wage is high by international standards 90
3.7. Lower-skilled unemployed workers face high replacement rates 92
3.8. Replacement rates are high for low-earners experiencing long-term employment, 2007 93
3.9. Net inward migration rates 102
3.10. Female employment and part-time employment rates, 2007 106
3.11. Employment rates for parents 108
3.12. The number of disability recipients has increased 109
4.1. Aggregate regulation (integrated PMR) and its dispersion across countries over time 119
4.2. Electricity is expensive in Ireland, 2007 120
4.3. Price level indices for consumer goods and services, 2006 121
4.4. Infrastructure 125
4.5. PISA scores in science are lower than in many countries 125

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Ireland were reviewed by the Committee on 17 September 2009. 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 23 September 2009.

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes and with research assistance from Annette Panzera and Joseph Chien, under the supervision of Patrick Lenain.

The previous Survey of Ireland was issued in 22 April 2008.

This book has...

Look for the *StatLinks* at the bottom right-hand corner of the tables or graphs in this book. To download the matching Excel® spreadsheet, just type the link into your Internet browser, starting with the ***http://dx.doi.org*** prefix.
If you're reading the PDF e-book edition, and your PC is connected to the Internet, simply click on the link. You'll find *StatLinks* appearing in more OECD books.

BASIC STATISTICS OF IRELAND (2009)

THE LAND

Area (1 000 km^2)		Major cities (thousand inhabitants, 2008)	
Total	70	Dublin (borough)	1 661
Agricultural	43	Cork	119
		Galway	72

THE PEOPLE

In thousands (2008)		Total labour force (thousands, 2007)	2 102
Population	4 459	Civilian employment (% of total)	
Natural increase	34	Agriculture, forestry and fishing	5.8
Net migration	70	Industry and construction	25.7
Number of inhabitants per km^2	64	Services	68.5

PRODUCTION

Gross national income (GNI)		Gross fixed capital investment (2008)	
In billion €	155	In % of GNI	25.5
Per head (€)	34 958	Per head (€)	8 903

THE GOVERNMENT

Public consumption (% of GNI, 2008)	20.9	Composition of Parliament (at general election)	
General government (% of GNI, 2008)		Fianna Fail	75
Current and capital expenditure	47.9	Fine Gael	52
Current revenue	39.5	Labour	20
Net debt	13.4	Other	19
Last general elections: May 2007		Total	166

FOREIGN TRADE

Exports of goods and services (% of GNI, 2008)	98.2	Imports of goods and services (% of GNI, 2008)	86.1
Main merchandise exports (% of total)		Main merchandise imports (% of total)	
Food and live animals	8.3	Food and live animals	8.3
Chemicals and related products	14.7	Chemicals and related products	51.6
Manufactured goods and articles	21.8	Manufactured goods and articles	12.3
Machinery and transport equipment	35.5	Machinery and transport equipment	21.4

THE CURRENCY

Monetary unit: Euro		Currency unit per $, average of daily figures	
		February 2008	0.680
		October 2009	0.671

Executive summary

The Irish economy plunged into a severe recession in 2008, following a period of unsustainable growth. Housing investment has slumped and large internal economic imbalances are unwinding, with the effect on demand compounded by the international financial crisis and global slowdown. The adjustment, which is underway, will be prolonged and the economic recovery weak. Irish banks have come under severe pressure, and major support from the government has been required. The downturn has revealed a weak underlying fiscal position. The authorities have already taken important steps to restore stability, but more will need to be done.

Unwinding macroeconomic imbalances. *Housing investment has more than halved and house prices are falling, and more retrenchment is likely. Lower household wealth, high debt and rising taxes exert a drag on household spending. International competitiveness needs to be restored, and prices and nominal wages are already falling. In addition, rebalancing the economy will require relative price changes, including lower real wages and lower unit labour costs.*

Restoring financial stability. *The priority is to return the banking sector to good health. The National Asset Management Agency should be implemented with assets purchased at the appropriate price with risk-sharing mechanisms to protect the taxpayer. Further recapitalisation may be necessary, which could involve greater public ownership. Strengthening banking regulation and supervision is needed to reduce the risk of future new financial tensions. More effective macro-prudential policy instruments should be developed. Reform of the taxation of housing would limit future housing cycles.*

Securing fiscal sustainability. *There is a large underlying mismatch between tax revenues, which have shrunk with the collapsing property market, and the level of expenditure. It is appropriate that fiscal consolidation has already begun and very substantial further measures will be required, although there is a balance to be struck with the negative effects on economic activity. This should take place within a credible multi-year framework as the authorities have outlined. Restoring the budget to a sustainable path will require both increases in revenues and cuts in public expenditure. Tax rates have increased and the tax base should now be broadened by reducing inefficient tax expenditures, introducing a property tax and making more people pay income tax. Further reductions in the overall level of government expenditure will also be required. The public-sector pay bill should be further curtailed and benefit payments should be reduced at least in line with falling prices. There is scope for efficiency-improving measures, focusing on improving value for money and modernising the public service.*

Avoiding long-term unemployment. *Labour market regulations are flexible in many respects. Reductions in nominal and real wages appear to be taking place. Nonetheless, there is a risk that unemployment rates will remain high over time because there are weaknesses in activation policies and unemployment replacement rates are rising. This has a particular impact on the low-skilled and in this context consideration should be given to reducing the minimum wage over time. A more streamlined benefit system and greater focus on activation should help those groups with low labour-market attachment historically.*

Achieving sustainable long-run growth. *Living standards are likely to be permanently lower as the result of the unwinding of economic imbalances, which built up during the recent period of unsustainable activity. Hence, structural policies that encourage sustainable growth for the long run are of even greater importance. Competition in the domestic sheltered services sector should be increased, which will help to improve competitiveness in the near term. Although public resources are limited, continuing to upgrade the infrastructure and raising human capital remain a priority where the benefits can be clearly established.*

© OECD 2009

Assessment and recommendations

The economy is experiencing a severe contraction

The Irish economy has slowed very sharply and a severe contraction both by international and historical standards is underway. Housing investment has fallen precipitously. Consumption and business investment are shrinking. The sharp fall in demand results from the unwinding of large domestic imbalances, compounded by the effect of the global downturn in reducing exports and by the international financial crisis. The overall fall in economic activity since the beginning of the downturn will be very large and some of the reduction in living standards is likely to be permanent. The downturn will continue for some time and the recovery is projected to be slow. Just as the boom had an impact on many aspects of the economy, the necessary economic adjustment will have wide ranging and painful consequences. Reductions in wages appear to be taking place and prices are currently falling. Substantial fiscal consolidation, which has begun, is required to bring government revenues and spending into line. In the absence of changes to policies towards the unemployed, high current unemployment creates the risk of sustained high rates of joblessness. Policies are required in the longer term to avoid domestic imbalances on this scale from building up in the future. Without the boost from credit and asset prices, appropriate policies to encourage long-run sustainable growth will be more important for raising living standards.

A major rebalancing of the economy is underway

The sharp slowdown in activity contrasts with the rapid expansion from 2002 to 2007. Although output and employment grew at a fast pace, underlying developments were less robust than during the 1995 to 2000 expansion, with weaker growth and much heavier reliance on domestic demand, as well as a slowing in the rate of productivity improvement. The recent expansion was driven in large part by easier and cheaper credit, and rapidly increasing property prices. Increasing indebtedness was encouraged by low interest rates and an easing of credit conditions. Irish banks expanded their balance sheets at a heady pace, increasing their reliance on wholesale market funding and becoming heavily exposed to property-related lending. The strength of demand, particularly house-building, induced a rise in labour costs and a loss of competitiveness, while the public finances became heavily dependent on housing-related tax receipts.

The housing cycle began to turn in early 2007. The effect on the wider economy was aggravated by financial market turmoil from mid-2007, which led to a tightening of credit conditions, and the sharp slowdown of the world economy from the autumn of 2008. While euro area monetary policy has eased substantially, the effect has been blunted by financial

market conditions and it is insufficient to address the build up in slack that Ireland faces. The effective exchange rate has appreciated, in part due to the depreciation in sterling. A substantial retrenchment in the household sector is taking place, reflecting falling wealth and a weaker economic outlook, and the savings ratio is rising very quickly. This is adding to the negative impact on demand of fiscal consolidation and weaker trade prospects. *The necessary fiscal consolidation, which has begun, should proceed, although there is a balance to be struck with economic activity*. As a result of the large amount of slack in the economy, prices are falling and a mild deflation is likely. A reduction in nominal wages appears to be taking place. This is contributing to improving competitiveness. There are, however, risks that prolonged deflation would increase the real burden of outstanding debts and may more generally add to the weakness of the recovery. Although Ireland has experienced tough economic circumstances before, the challenges are different within monetary union and more difficult in the context of a weak global economy and current financial conditions. The scale of imbalances built up during this cycle is also unusually large.

Measures are in place to restore the financial system to health

A normal flow of bank credit is necessary for economic recovery. Credit conditions for households and firms have tightened as the result of conditions in international financial markets and the severe difficulties of Irish banks. As liquidity in financial markets declined, the Irish system was heavily exposed due to its reliance on this source of funding. More fundamentally, Irish banks expanded their balance sheets at an extraordinary pace during recent years, allowing Irish households and firms to become highly-indebted and leading the banking system to be heavily exposed to residential and commercial property-related lending. As a result, banks face large losses on their loan portfolios.

A range of policy actions has been taken to stabilise the banking system. A government guarantee has been extended to banks covering most liabilities, while deposit insurance has been made more generous and effective, although *consideration should be given to increasing the speed of pay-out further*. The provision of liquidity by the European Central Bank (ECB) has also been important in sustaining bank funding. To restore the health of bank balance sheets, the Irish authorities have injected capital in the form of preference shares into the major banks and one institution has been nationalised. As part of this process, the state of the banks was assessed, although the results of these "stress tests" have not been published. Ireland has gone further than most other countries in resolving uncertainty about losses on banks' assets by creating the National Asset Management Agency (NAMA), to hold property development-related loans. *This should be implemented swiftly and assets should be transferred to NAMA at the appropriate price with risk-sharing mechanisms to protect the taxpayer. Sound and professional management of these assets to maximize value will be important. Further recapitalisation may be necessary as assets are being purchased below book value. Banks should explore all options to raise capital. This could involve greater public ownership. Public capital injections should be provided in the form of common equity. While it cannot be ruled out, nationalisation would carry significant costs and risks and should only be undertaken with the utmost reluctance. Any publicly-owned institution should be run on a commercial basis with the objective of maximising the return to taxpayers*. To deal with any problems that arise in the banking system in the future, *a special resolution regime should be introduced for banks, giving the authorities the full range of options* to deal swiftly and effectively troubled institutions.

Financial regulation and supervision should be strengthened

Banks' heavy reliance on market-financing and heavy exposure to property-related lending have added to the severity of the downturn, while the rapid expansion in bank balance sheets contributed to the earlier build up of debt and imbalances in the economy. Like elsewhere, it is now clear that *banks should be more tightly regulated and supervised* to ensure that excessive risk-taking does not arise in the future. Many of the required changes in regulation need to occur at international and European level, but there is discretion at national level to ensure that standards are set appropriately. *Additional resources should be allocated to banking supervision and the ability of the supervisor to monitor major institutions should be enhanced, as well as improving the analysis of developments in the banking and financial markets as a whole*. The financial regulator has already made some progress in these areas and further measures are underway. There has been a move away from principles-based supervision to a more intrusive regime. *The emphasis on rules should be increased, including use of quantitative indicators, as in some other countries, as triggers for more intensive supervisory involvement*. *Banks should be required to hold more capital*. The regulation of funding was improved in 2007 and provided some protection for Irish banks during the financial turmoil. *This should be kept under review in the light of developments and the evolution of international best practice*.

More effective macro-prudential policy instruments need to be developed to promote economic stability

There is a need for effective macro-prudential policies to avoid economic imbalances re-emerging, given that these are more likely to emerge in the context of a monetary union and there is less flexibility to deal with the consequences of asset price reversals. Although a number of measures were taken during the expansion to "lean against the wind" of the rising house-price and credit cycles, these were insufficient to dampen the effects substantially. Measures were often limited in scope or introduced too late. *The Central Bank should be given a more explicit macro-prudential mandate*. *The Financial Stability Report (FSR) should continue to be published annually*. To ensure that the tensions identified in the FSR are addressed, *consideration should be given to the development of more effective macro-prudential instruments*. These could include an overall leverage ratio and either dynamic provisioning or counter-cyclical capital requirements, as well as tools regarding liquidity rules and risk-management practices.

Reforming housing policy would contribute to stability

The housing market played a key role in building up the economic imbalances. The immediate challenge is in dealing with the consequences of the correction in the housing market: negative equity is a growing problem and there is a risk that Ireland faces an increase in the number of home repossessions, albeit from very low levels. The new Mortgage Arrears Code will help, but *banks should be encouraged to allow portability of mortgages, while support for the unemployed to meet mortgage payments should be made more*

effective. The aftermath of this housing cycle should be a good time to deal with the poorly-designed policies towards housing that contributed to the over-heating of the economy. The tax system is biased towards property, housing and homeownership. This leads to more expensive housing and greater volatility. A *path towards the reduction of mortgage interest tax relief, beginning with new borrowers, should be set out. The introduction of a property tax would help to ensure that housing is adequately taxed, together with providing a tax base for funding local services*. Policy to provide housing for those in need should be made more effective: *more support should be provided through meeting the cost of accommodation in private housing rather than the construction or subsidised sale of public housing*. The housing downturn may create good opportunities to use private housing to meet public needs.

Substantial fiscal consolidation is needed

The large deficit requires a *major fiscal consolidation over a sustained period* and this has already begun. Revenues have shrunk rapidly as property-related receipts have collapsed, while real expenditures have been on a strong upward path for several years and there is further pressure from rising social spending related to unemployment. Debt service costs have also risen. Restoring the budget to a sustainable path will require both increases in revenues and cuts in public expenditure. The introduction of an Income Levy has raised additional revenue. *There is scope to widen the tax base. Consolidation through spending cuts will also be required*. The Report of the Special Group on Public Service Numbers and Expenditure Programmes is of importance in this regard. Weaknesses in the fiscal framework are partly responsible for the current situation and reforms would add to the credibility of the consolidation. *Multi-annual plans for current spending should be made permanent and overall expenditure ceilings introduced. Consideration should be given to the creation of an independent body to advise on fiscal sustainability issues*. Stronger budgetary institutions could help make policy more counter-cyclical.*Consideration should be given to the publication of a complete balance sheet for the public sector in line with practice in some other countries*.

The tax base should be broadened

Tax revenues became too dependent on construction and housing transaction-related receipts as the market boomed, while the revenue-raising capacity of the income tax system was weakened by rate cuts and a narrowing of the tax base. There is an extensive and inefficient system of tax reliefs, thus allowing many people to pay little or no income tax at all, although they are taxed in other ways. A comprehensive review of tax expenditures has recently been undertaken by the Commission on Taxation. *Many should be eliminated or deductibility limited to the standard rate and capped*. While direct tax rates have been increased now through various levies, *these should be integrated with income taxes when the tax base has been repaired. Personal allowances should be reduced with the objective of widening the tax base*. There is little scope to raise indirect taxes in general.

Spending should be contained and value for money improved

Public spending increased rapidly while revenues were growing and there is now strong upward pressure from unemployment-related social spending. Substantial cuts in

spending are warranted as part of the fiscal consolidation. *Investment spending should be reduced in line with current plans but maintained at a reasonable pace to continue upgrading the infrastructure. Public-private partnership funding should be used only where this increases efficiency*. The largest items of public spending are wages and social welfare. *Public-sector wages should be reviewed independently in the light of the developments in the private sector and falling price levels, and wages and government employment should be reduced. Public-sector pensions should be overhauled in the light of private-sector arrangements*. Benefits where entitlement does not depend on household resources retain an important role in social welfare policy. *This approach should be reconsidered. Benefits should in general be subject to income tax. The level of benefits should be reviewed in light of falling wages*. The public sector has over-expanded and there is scope to increase efficiency. *Health spending can be reduced by cutting costs and redeploying manpower more effectively. The Medical Card scheme should be reviewed to ensure that it is meeting its objectives in the most efficient way*. There is also scope for better value-for-money in education spending. Secondary-level class sizes could be raised without necessarily reducing the quality of education. *Third-level tuition fees should be introduced, supported by a system of loans, to raise funding, improve incentives and make the system fairer*. Further modernisation of the public service and measures to improve efficiency, including implementation of recommendations made by the OECD in the *Towards an Integrated Public Service* report, would help to maintain and improve services even as overall spending is reduced. These include measures to increase mobility, managerial flexibility, the effectiveness of staff performance management and the use of E-government. *Public sector management should be further strengthened and mechanisms such as Output Statements should have a greater impact on the allocation of scarce resources. Outsourcing should be increased where it is proven to be more efficient. Greater flexibility and managerial accountability is required within the public service. The number and effectiveness of agencies should continue to be reviewed and departments should improve their oversight of agencies.*

There is a risk of high long-term unemployment without more effective policies towards the unemployed

Labour market conditions have deteriorated rapidly in the downturn. Employment has fallen, and the unemployment rate has risen sharply and is now at a high level. The Irish labour market is flexible in terms of regulation and a remarkable reduction in the level of nominal wages appears to be underway. However, there is a risk that high rate of unemployment could be sustained due to a combination of weaknesses in activation policies and replacement rates from unemployment benefit for those with below-average wages that are likely to become even higher as wages fall. *Unemployment-related social benefits should be reduced in line with falling prices and disincentives to return to work avoided. Consideration should be given to allowing benefits to fall as the duration of the unemployment spell increases*. Ireland is unusual in the number of agencies involved with helping the unemployed: *a single organisation should deal with paying unemployment benefits and managing activation programmes*. Under the National Employment Activation Plan, activation requirements are an important part of helping the unemployed back to work. This approach should be strengthened by *requiring early and regular interaction for all unemployed with the employment services and improving follow-up, backed by stronger sanctions. Claimants should ultimately be required to enter an effective work programme if other options are not taken up*.

The large rise in the number of unemployed has fundamentally changed the profile of this population. *Active labour market policies targeted at job-search, raising employability and keeping the unemployed close to the job market should be further modified and expanded to meet these needs, while taking into account fiscal constraints. Costly existing programmes, such as the Community Employment scheme, should be limited.* The minimum wage is high by international standards and may become more binding as wages fall. *The level of the national minimum wage should be re-assessed, and reviewed on an annual basis. The system of sectoral minima should be re-considered.*

The fall in labour demand is leading to net outward migration, a reversal of the strong inward flows of recent years. The number of foreign nationals in the workforce, however, will remain higher than it has been historically. Continued efforts will be required to ensure their successful integration *through providing appropriate training* and to continue to attract highly-skilled workers with specific skills that are needed in Ireland *with multiple entry visas*.

Helping those with weaker labour market attachment

Some groups continued to have low rates of employment even during the years of strong labour demand. It is common experience in OECD countries for these groups to have more marginal attachment to the labour market and to be more vulnerable to slowdowns or unfavourable policies. The incentive to work for those with below-average earnings potential would be enhanced by *eliminating high taper rates and moving towards a single social payment for working-age adults* to simplify the system, improve the incentive to work and strengthen activation requirements. To boost female participation, *support should be more targeted at those who work. The impact of higher tax rates on second-earners should be carefully assessed and consideration given to moving to full individual taxation*. Lone parents have particularly low employment rates, which contributes to high rates of poverty among these families. *Greater support should be provided to lone parents, by raising their priority in access to childcare, and they should be required to seek work once their children reach school age*. The number of disability benefit recipients has increased rapidly to reach a substantial share of the working-age population, while employment rates for those claiming these benefits are low. There is a risk that this could become a pathway away from the labour market, especially for older workers. *Assessment for eligibility to these benefits should be carried out independently and include an assessment of work capacity. Illness benefit should not last more than one year. Incentives and support for those with disabilities to participate in the workforce should be improved and consideration should be given to extending conditionality to some. Engagement with this group needs to be more systematic and focussed on access to mainstream employment.*

Young people have been severely hit by the contraction in labour demand and higher unemployment. Those with less experience are also more vulnerable to the relatively high benefit replacement rates and minimum wage. *Training and activation measures will need to focus on this group*. Early school leavers and those with limited education are particularly prone to being neither in the labour force or training. In addition to enhanced training and activation measures, *consideration should be given to raising the school leaving age to 18*. The employment rate falls off sharply for older workers and there is a risk that job losses now will be permanent. Stronger activation measures would provide more encouragement to those close to retirement to find new jobs. *Tax and benefit incentives to stay in the workforce beyond age 65 should be improved.*

More can be done to promote sustainable long-run growth

After the severe economic adjustment, Ireland's potential output is likely to be permanently lower and recent developments call into question how much of the good performance over the most recent years was structural rather than cyclical. This underlines the importance of policy settings that promote sustainable long-run growth. Policies to boost competition in the sheltered services sector would make the economy more efficient in the long run, but would also contribute more immediately to reducing costs and improving international competitiveness. *The effectiveness of competition law should be enhanced. Restrictions and barriers to competition should be removed in the electricity market, the retail sector, doctors, pharmacies, the licensed trade, the legal professions and bus transport. To increase retail competition, planning laws should be changed to remove barriers to entry and facilitate new types of store.*

Further investment in infrastructure and human capital are needed to continue improvements in productivity. Public investment has been exceptionally high in recent years. Given the immediate pressures on the public finances, *government spending in these areas may be moderated over the coming years, albeit remaining at relatively high levels. It should be subject to rigorous prioritisation through cost-benefit analysis and adaptation in the light of the changed economic outlook. User charges should be applied more widely.* Tax credits for research and development (R&D) have been increased: *the cost effectiveness of this support should be evaluated and direct support should be concentrated in fewer centres of world-class excellence and with improved coordination between researchers and industry*.

© OECD 2009

Chapter 1

Restoring macroeconomic and financial stability

Ireland is in severe recession, following several years of high but ultimately unsustainable growth and rising imbalances. A fast expansion of bank credit encouraged a boom in construction activity and property prices, which fuelled domestic spending more widely. This cycle has now reversed dramatically. Output is expected to contract sharply and unemployment is likely to reach 14%. The banking sector, which was at the heart of the credit expansion, has been severely hit by the crisis in international financial markets and faces large losses on heavy property-related lending. Credit conditions have tightened. A return to normal functioning of the financial system is needed and a range of policies is in place to restore the banking system to good health. An economic recovery is likely to begin next year but a protracted period of adjustment will be needed to resolve economic imbalances built up during the expansion. Competitiveness deteriorated during the upswing and the strong real exchange rate is hindering the return to growth. Restoring competitiveness inside monetary union will occur through downward adjustment in wages and prices, which appears to be already underway. With fast-rising public debt, fiscal consolidation, which has begun, will be needed over an extended period. For the longer term, lessons should be learnt to avoid macroeconomic imbalances arising on this scale again.

The economy is experiencing a severe contraction as large domestic imbalances are unwound in an environment of global recession and financial crisis. By the second quarter of 2009, Ireland's GNP had fallen by 13.6% from its peak and industrial output (excluding the mostly foreign-owned "modern" sectors) was 21% below its peak by July. This contraction in activity is the largest in the OECD and has a very strong domestic component, although exports have also fallen somewhat. Unemployment has risen fast, to reach 12.6% of the workforce by September 2009. The fiscal position has deteriorated sharply, even after substantial discretionary tax increases. OECD projections suggest that the peak-to-trough reduction in economic activity is likely to be close to 13% with some signs that the downturn is beginning to bottom out. Economic adjustment on this scale is extremely painful. Ireland has experienced difficult economic times before but this is the first recession since it joined European Economic and Monetary Union (EMU). A substantial adjustment in wages and prices will be needed to restore competitiveness. It is likely that income will be permanently lower than previously assumed. Lessons will need to be learnt and applied about how macroeconomic and macro-prudential policy can avoid the risk of imbalances building up again in the future.

This chapter sets out the main macroeconomic and financial challenges facing the economy, both in achieving short-run stabilisation and ensuring that the economy is put on a more stable path for the future. This includes reform of the financial system and the housing market. The impact of recent developments on potential output and future prospects is also outlined. The macroeconomic outlook is intimately connected to the need for substantial fiscal consolidation, discussed in detail in Chapter 2. The implications of the recession for the labour market and the necessary policy measures are examined in depth in Chapter 3. Competitiveness and long-run growth prospects would be boosted by more favourable structural policy settings, as discussed in Chapter 4.

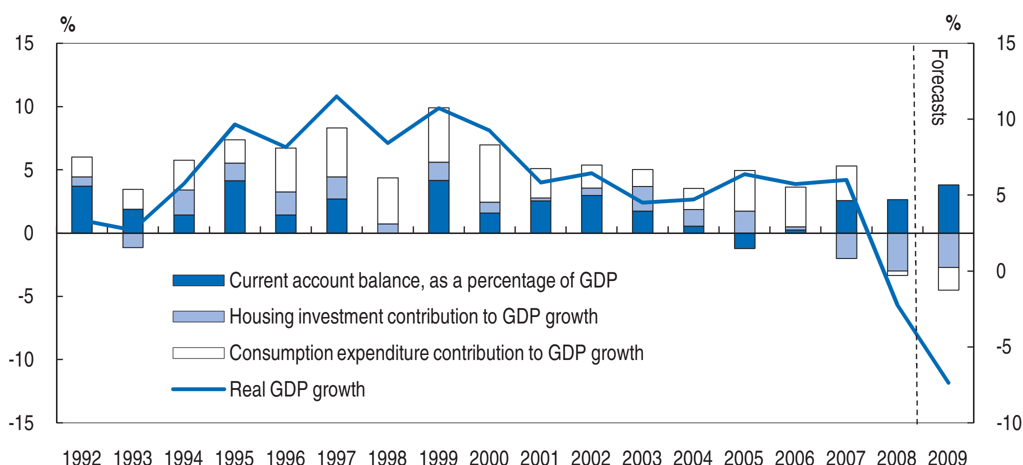
Unwinding imbalances

Ireland is experiencing one of the most severe contractions in activity among OECD countries (Figure 1.1). Growth turned negative in 2008, well before the global slowdown took hold, and the economy began to contract substantially in the second half of 2008. Housing investment peaked in 2006 and fell already by 15% in 2007 and then a further 30% in 2008. Experience of previous banking and financial crises in the OECD suggests that they lead to large losses of output and tend to be more severe when combined with falls in housing and business investment (Haugh *et al.*, 2009). Based on six previous episodes in OECD countries, peak-to-trough output losses range from 2.6% to 10.2% with the length of the downturn ranging from 9 to 16 quarters. The current contraction in Ireland, which has been larger, is therefore particularly severe by historical standards.

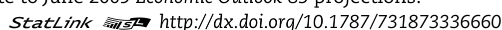
The building up of economic imbalances

The economic expansion from 2002 to 2007 was very strong: GNP grew by 5.4% per year on average in real terms. Even allowing for rapid population growth, both natural and

Figure 1.1. **The economy is experiencing a severe contraction**



Source: *OECD Economic Outlook Database* and provisional update to June 2009 *Economic Outlook* 85 projections.


StatLink http://dx.doi.org/10.1787/731873336660

from inward migration, per capita incomes rose by an average of 3.2% per year. Inflation measured by the HICP index averaged just 2.8%, only 0.7 percentage points above the euro area average. This was partly depressed by the appreciation of the euro against sterling and the US dollar, and inflation measured by the CPI (which includes a large component related to housing costs) rose at a higher average annual rate of 3.6%. More generally, economic growth was heavily dependent on developments in the property and housing markets. By contrast to the period 1995 to 2000, economic performance was weaker on most measures and more domestically focussed (Table 1.1). In particular, productivity growth was sharply lower, although still strong by euro area standards. This pattern of slowing underlying economic performance combined with strong investment in real estate and borrowing has many parallels to the "bubble economy" of Japan in the late 1980s (Hayashi and Prescott, 2002).

Table 1.1. **Economic performance in the most recent expansions**

Average annual growth rate, per cent

	1995 to 2000	2002 to 2007
GNP per capita	7.9	3.2
Labour utilisation	3.9	2.8
Capital services	8.9	6.5
Output per hour worked	5.5	2.6
Real wage (consumption deflator)	1.6	2.8
Export volume	17.7	5.1

Source: OECD (2009); *Economic Outlook 85 Database*.

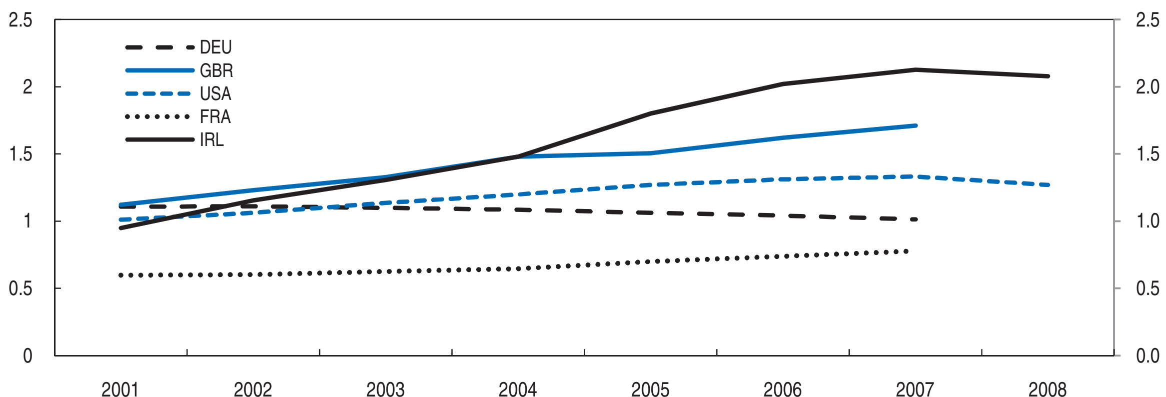
The strong economic performance was predicated on a large increase in borrowing and asset prices. Private sector credit increased from 128% of annual GNP in 2002 to 215% in 2007, growing at an annual average rate of 20%. Mortgage lending was particularly buoyant: it expanded at an average annual rate of around 25%. Housing investment became extremely strong: residential construction reached 13% of GDP in 2006, more than twice the OECD average and a higher share than in any other OECD country, including Spain where there was also a major housing boom. Yet, housing supply was able to

respond only partially to rising demand and so house prices rose dramatically. Ireland had a small housing stock in the mid-1990s (OECD, 2008) and, having experienced strong nominal growth in previous years, it is likely that expectations of future price increases were widespread. The dynamics of the housing market created their own momentum: increases in prices raised the amount of collateral which households could use to bid up prices further, while generating bank deposits from those trading down that could be used to fund additional lending. This is a particular example of the wider phenomenon of the credit channel of monetary policy transmission (Bernanke and Gilchrist, 1995): the balance sheet channel operates as the rising value of collateral eases constraints on the ability to borrow, while the bank lending channel comes as the supply of loans is increased by favourable conditions for banking profits and capital.

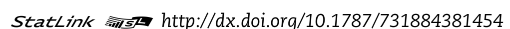
The expansion of borrowing, particularly for property, was encouraged by changes in the Irish economy, weak risk-management inside the banks and lax bank supervision. Overall, credit standards for mortgage lending were eased: loan-to-value (LTV) ratios for first-time buyers increased, leading to the share of 100% or more LTVs rising from just 6% in 2004 to 26% in 2007, while, for all buyers, the proportion of new mortgages with terms of more than 25 years increased from 38% to 54% over the same period.[1] As a result, household indebtedness rose substantially and reached a historically and internationally high level (Figure 1.2). Ireland largely managed, however, to avoid the creation of a sub-prime mortgage market through a tightening of consumer protection laws. Other domestic policy errors, however, contributed to the housing expansion. Banks were allowed to expand their lending rapidly and some aspects of financial regulation and supervision were weak, as discussed below. Policies towards housing were generally very favourable and created few disincentives to further increases in borrowing and prices. In addition, a variety of property-related tax reliefs and incentives was provided at different times that contributed to demand for housing and real estate.

Figure 1.2. **Household indebtedness has risen**

Ratio of loans to net household disposable income



Source: *OECD Economic Outlook 85 Database.*


StatLink http://dx.doi.org/10.1787/731884381454

Interest rates set by the European Central Bank (ECB) were clearly too low for the state of the Irish economy given the strength of the upswing. Estimates suggest that the ECB policy rate was on average almost one percentage point lower than a standard Taylor rule would suggest for Ireland over the period 2001 Q3 to 2006 Q4, the most expansionary setting

experienced by any euro area country (Ahrend *et al.*, 2008). There is clear positive relationship between this lack of fit of policy rates, and the growth in household lending and increase in housing investment. Secondly, global financial conditions were marked by plentiful liquidity and very low risk aversion across many markets (Guichard *et al.*, 2009). Thirdly, Irish financial intermediaries were able to borrow heavily in international financial markets to help fund the expansion of domestic credit. By December 2007, securitised loans had expanded 4.5-fold over the previous five years, rising to account for 12% of mortgage lending.

The effect on demand and activity of strong credit growth was large and wide ranging. Although it is difficult to assess empirically and some studies do not find a link, cross-country analysis suggests that consumption in Ireland is sensitive to the housing market (Catte *et al.*, 2004). At the same time, a very large share of economic resources was diverted towards house-building and construction. As discussed in Chapter 2, housing generated very large tax receipts that led to reductions in direct tax rates and reductions in the tax burden, while financing a large increase in public spending. Inflationary pressures appear to have been relatively weak compared with the pressure of rising demand because these were moderated by increases in supply resulting from inward migration and possibly some of the effects of the asset price boom itself on money demand (Boone *et al.*, 2004). Inflationary pressures were also partly absorbed by the strengthening of the effective exchange rate. However, the current account balance moved further into deficit to reach around 5.4% of GDP in 2007, putting Ireland among the OECD countries with relatively large deficits and either very strong internal demand (Australia, Hungary, Iceland, Spain) or poor competitiveness (Greece, Portugal).

The on-going economic correction will be prolonged

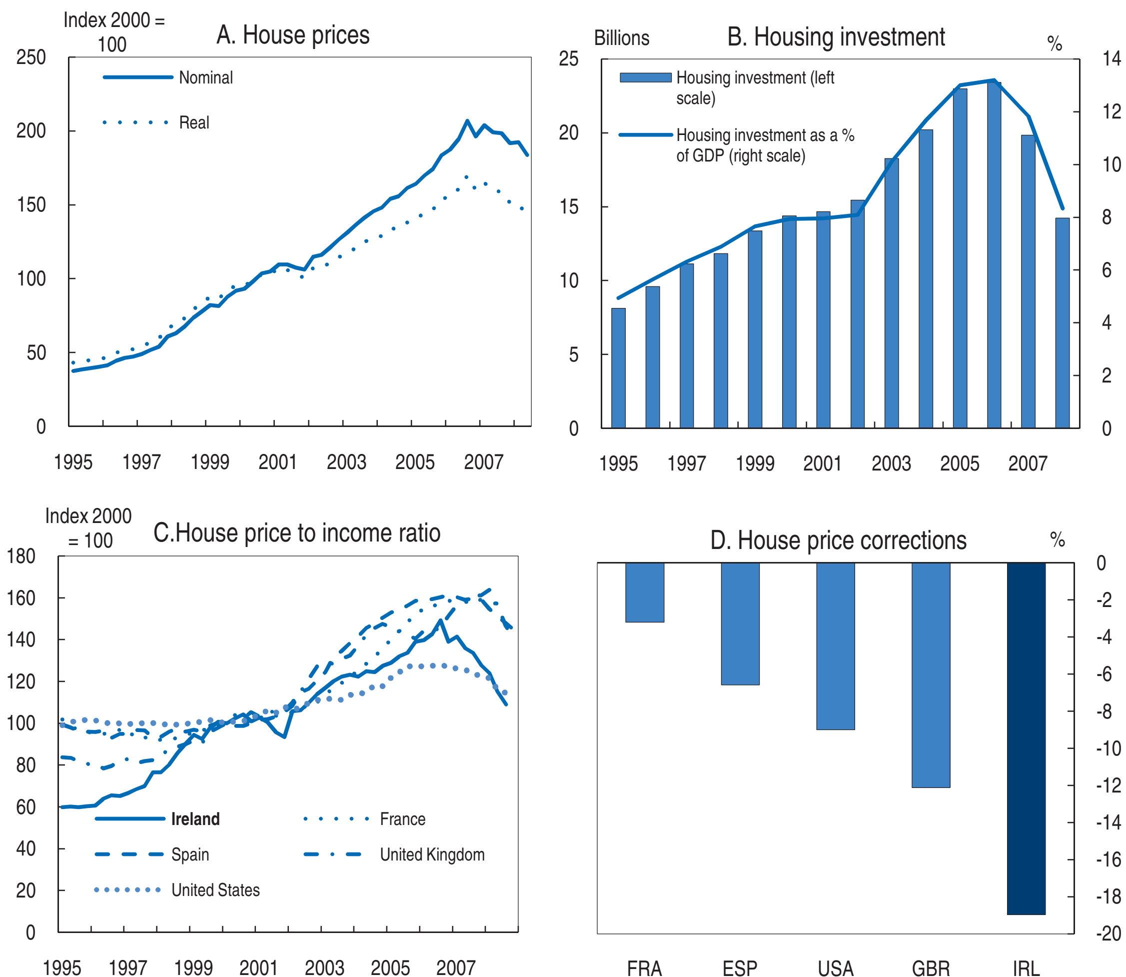
The economic recession has largely unfolded in the aftermath of a sharp tightening of financial conditions, both globally and in the euro area. This has occurred despite the reduction of the ECB refinancing rate to 1% and changes in the conduct of monetary operations that imply a large increase in liquidity at a given interest rate. From the perspective of the Irish economy, this tightness is two-fold. Firstly, turmoil in the money markets and the financial crisis impaired the continuous access to these markets and increased the spread between policy rates and the rate at which private sector agents can borrow. Secondly, the depth of the economic contraction in Ireland would of itself warrant more radical monetary policy action than for the euro area as a whole. The impact of the financial crisis on Irish households has been partly mitigated by the prevalence of "tracker" mortgages, which follow the ECB policy rate directly and so insulated some households from higher interbank interest spreads. Although pressures on Irish banks have been severe, the importance for overall Irish economic output of foreign multinational companies, which are typically not dependent on local sources of finance, implies that much of Irish economic activity is not affected by domestic credit conditions and is more sensitive to global capital markets. In addition, the appreciation of the effective exchange rate adds to the tightness of monetary conditions. Models for other OECD economies suggest these types of contractionary forces are very strong: equivalent to around a 4% reduction in GDP for the euro area as a whole (Guichard *et al.*, 2009) and so likely to stronger be still for Ireland.

The collapse of the housing market is at the heart of the recession and the unwinding of economic imbalances. The fall of residential construction has already subtracted around 10% from the level of GNI and the negative effects from the correction are much wider. House prices on the main permanent/tsb index have fallen up to August by 24% since the

peak, based on a three-month moving average of prices at loan approval stage. Other measures provide a similar picture,[2] although anecdotal evidence suggests that the fall in underlying prices could be larger. While house prices have fallen in many OECD countries, the correction in Ireland is the largest (Figure 1.3). This is in part because it began relatively early, but it is still larger than in the United States which began around the same time. The scale of house-price appreciation in Ireland was very large by international comparison. It was unprecedented in Irish experience. House prices have never fallen substantially in nominal terms in Ireland, except for a brief period of stagnation in the 1980s, although real house prices experienced a prolonged decline in the first half of the 1980s, falling by around a third. Further correction is now needed in real terms to rebalance the market and further nominal falls can be expected.

Consumption has fallen sharply, by almost 9% from the peak by the first quarter of 2009. It is likely to remain weak as households repair their balance sheets, compounded in the short run by increased precautionary saving due to record-low consumer confidence and fears of unemployment. Although purchasing power has been supported by lower prices, the

Figure 1.3. **Housing market developments**



Source: *OECD Economic Outlook 85 Database.*

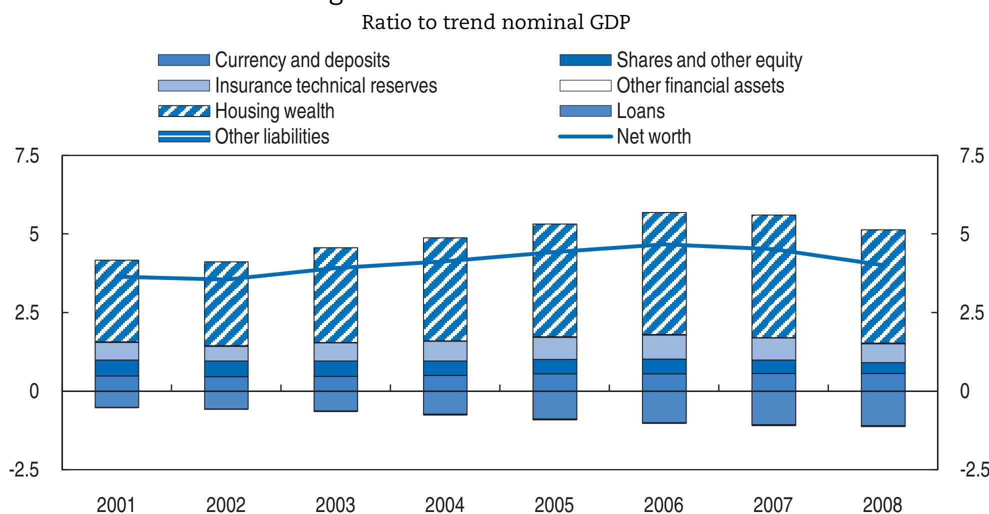
StatLink http://dx.doi.org/10.1787/732050267547

weak labour market has weighed on household incomes. This will intensify as wages fall and taxes increase: OECD projections suggest that nominal post-tax incomes could have fallen by more than 10% by the end of 2010. The savings ratio is also on a sharp upwards path, reaching 8.5% in the fourth quarter of 2008, up 7 percentage points on a year earlier. While some of this increase may be driven by higher uncertainty, much of the increase in saving is likely to reflect a sudden reappraisal of households' circumstances and the burden of outstanding debt. A gloomier outlook in the years ahead and lower incomes will reduce the steady-state level of consumption substantially, even if it takes time for incomes to adjust fully. Furthermore, households should expect lower net incomes in the future as the result of the sharp increase in government debt and the on-going fiscal consolidation.

Household wealth has fallen considerably. Although household assets increased considerably over the economic expansion (Figure 1.4), net worth rose more slowly as the result of increasing borrowing. The household saving rate also declined. Much of the increase in assets was due to rising house prices and higher equity prices, which increased financial assets and pension fund reserves. As a result of sharp falls in equity prices, pension funds recorded large reductions in the value of their assets: indeed, the value of pension funds in Ireland fell by around 40% during 2008, around twice the OECD average, which reflects the relatively high weight of equities in their portfolios (OECD, 2009a). Although this will have been mitigated somewhat by the more recent recovery in financial markets, this vulnerability should be addressed and could have important effects in a country where private pensions are a relatively important part of saving for retirement, even if the population is also young by OECD standards and so there is more time to rebuild savings. While housing wealth is largely redistributive, the redistribution caused by falling house prices may have a depressing effect on consumption. In addition, household debt in Ireland is high by international standards (Figure 1.5). A 30% overall fall in house prices could imply that perhaps one fifth of mortgage-holders would have negative home equity, with the loans on their homes being larger than the debt outstanding (Duffy, 2009).

Figure 1.4. **Household wealth**

Ratio to trend nominal GDP

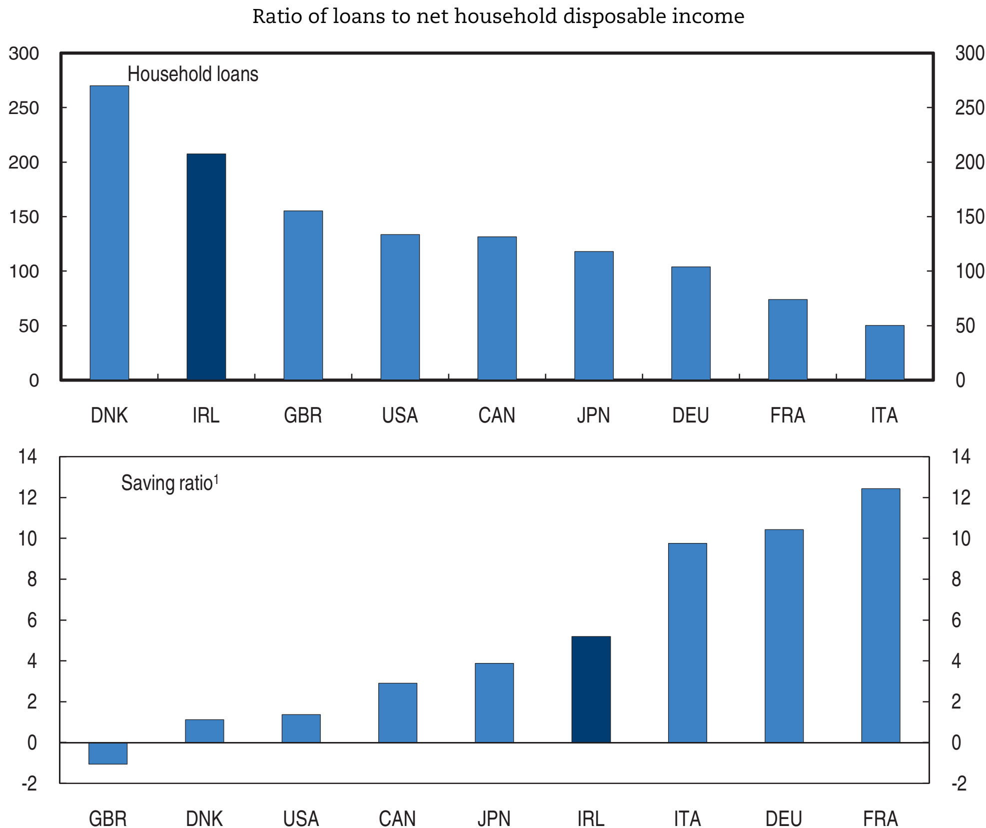


Source: *OECD Financial Accounts Statistics*; Department of Environment, Heritage and Local Government; and *OECD Economic Outlook 85 Database*.

StatLink http://dx.doi.org/10.1787/732054865235

Figure 1.5. **Household saving and indebtedness (average 2005 to 2007)**

Ratio of loans to net household disposable income



1. Net saving ratio including changes in net equity of households in pension fund reserves, except for Canada, France and the United States where these are excluded.

Source: OECD Economic Outlook 85 Database and *OECD Financial Accounts Statistics*.

StatLink http://dx.doi.org/10.1787/732142128583

As well as sharp retrenchment by the household sector, other factors will also weigh on demand (Table 1.2). Domestically, discretionary tightening of fiscal policy will have a strong contractionary effect, although this could be mitigated by positive Ricardian-type effects on confidence. Internationally, the world has experienced a sharp collapse in trade, although the fall in Irish exports has not been particularly large compared with some other OECD countries because of its specialisation in less cyclical activities such as pharmaceuticals. Weak imports have nevertheless led to positive contributions to GDP from net trade in recent quarters and the current account is moving towards surplus. Although a large part of Irish production is traded across the world, the more price-sensitive relatively basic industries are heavily reliant on trade with the United Kingdom and so have been exposed to the depreciation in sterling, both through weaker exports and greater competition from imports.

Ireland has experienced tough economic circumstances before. There was a long period of stagnation in the 1980s but this was followed by a recovery in the 1990s and subsequent growth that were unusually strong. There are several factors that make such a robust recovery less likely in this episode. *Firstly*, Ireland is a more mature economy and therefore lacks the same latent potential for "catch up" growth. *Secondly*, as argued in Chapter 2, there is an overriding need for fiscal consolidation. While fiscal policy also tightened in the early 1990s, the scale of the required tightening is very much larger now.

Table 1.2. **Key macroeconomic developments**

	Current prices € billion	Percentage changes, volume (2006 prices)				
	2005	2006	2007	2008	2009	2010
GDP at market prices	162	5.7	6.0	–3.0	–7.5	–2.4
GNP				–2.8	–10.5	–2.8
Private consumption	74	7.0	6.0	–0.7	–7.5	–2.2
Government consumption	25	5.3	6.8	1.5	–2.6	–2.9
Gross fixed capital formation	43	4.0	1.0	–15.6	–28.9	–16.4
Final domestic demand	142	5.8	4.6	–4.6	–11.7	–5.0
Stockbuilding[1]	1	0.3	–0.8	0.1	–1.0	0.7
Total domestic demand	143	6.1	3.6	–4.5	–12.7	–4.2
Exports of goods and services	132	5.7	6.8	–1.0	–2.2	0.9
Imports of goods and services	113	6.4	4.1	–2.0	–7.7	–0.6
Net exports[1]	20	0.3	2.6	0.6	3.8	1.3
Memorandum items						
Harmonised index of consumer prices	. .	2.7	2.9	3.1	–1.5	–0.3
Private consumption deflator	. .	2.2	3.0	2.7	–3.6	–1.0
GDP deflator	. .	3.4	1.4	–1.2	–3.9	–1.4
Unemployment rate	. .	4.4	4.6	6.0	11.9	14.0
General government financial balance[2, 3]	. .	3.0	0.2	–7.2	–12.2	–11.3
Current account balance[2]	. .	–3.5	–5.4	–5.4	–2.2	–0.8

1. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
2. As a percentage of GDP.
3. The balance includes additional fiscal measures outlined by the authorities for 2010 in the April 2009 Supplementary Budget.

Source: *OECD Economic Outlook Database* and provisional update to June 2009 *Economic Outlook 85 projections*.

Thirdly, as argued in Chapter 3, high unemployment benefit replacement rates combined with weak activation policies create the risk of persistent unemployment during any recovery. *Fourthly*, the financial crisis may make it difficult for firms to borrow as the economy recovers. *Fifthly*, the international economic climate is much less favourable than at the time of the previous recovery when Ireland's export markets continued to grow, albeit sluggishly. By contrast, these are estimated to have contracted by around 15% from the peak and are anticipated to pick up sluggishly over the next year.

This is also the first major correction Ireland has experienced since EMU. This implies that adjustment will have to take place in a different way from the past, where the nominal exchange rate could be adjusted. Ireland has actually been in fixed exchange rate regimes since independence, but it followed a very similar macroeconomic path to the United Kingdom when the currency was pegged to sterling and there was a number of realignments during Irish membership of the European Exchange Rate Mechanism (ERM), including a 10 per cent devaluation in 1993. Facing idiosyncratic shocks within a large monetary union, policy rates are unlikely to be set at the same level as they would if Ireland had an independent monetary policy, although the ECB policy rate is now close to zero.

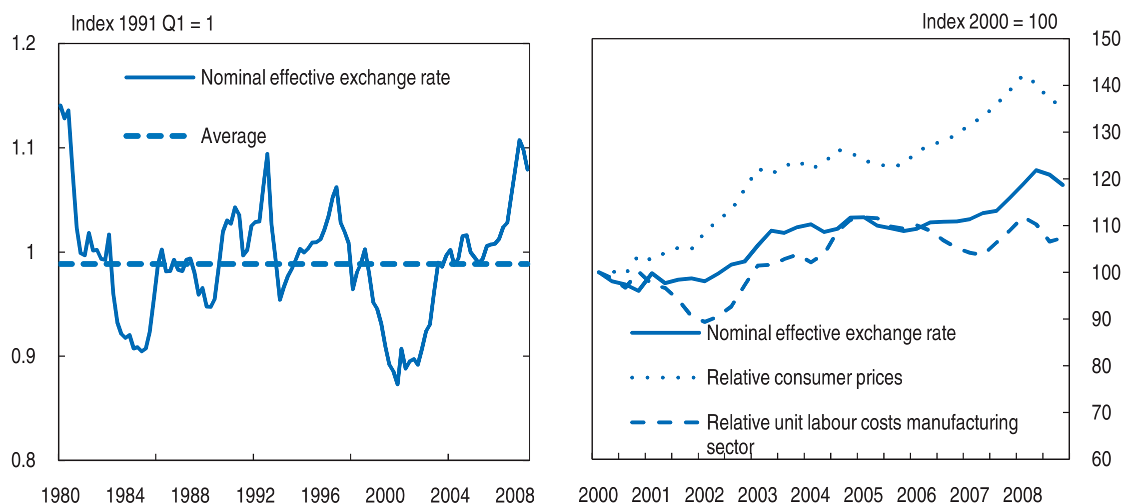
The adjustment to rebalance the Irish economy in response to the fall in demand will involve a reduction in prices, as well as changes in relative prices between different activities and sectors. A key factor in the rebalancing of demand and supply, leading to recovery, is the level of potential output. As discussed below, the sustainable level of output is falling and is likely to be lower than previously estimated. With both supply contracting and demand falling, it is unclear whether prices in the domestic economy should be higher or lower to

achieve balance. OECD estimates, however, suggest that there is considerable slack in the economy even if this weakness in demand only accounts for part of the overall fall in output since the peak (OECD, 2009). Within a monetary union and given the overriding need for fiscal consolidation, there is little that policy can do to boost domestic demand from its current level. A fall in price levels should boost demand for goods and services by raising purchasing power. For a small open economy such as Ireland, much of the economic adjustment occurs through boosting external competitiveness. Lower prices will make non-tradeable goods more attractive for consumers and encourage production to switch to tradeables. This adjustment in prices has significant implications for nominal wages. To maintain real wages, lower nominal wages are needed if the price level falls. In addition, to restore competitiveness, unit labour costs need to be lower to reduce the costs of producing tradeable goods, which would in turn lower the real wage defined in terms of the price of consumption. As part of the return to economic balance at a lower and more sustainable level of output, real wages and average costs are likely to be lower than in the recent past.

Considerable adjustment in wages and prices already appears to be taking place. Inflation has decelerated at a fast pace and the general price level is falling: year-on-year headline CPI inflation has dropped to –5.9% in August 2009, compared with positive inflation of 4.3% inflation a year earlier. Falling mortgage costs explain a large part of this decline, together with the unwinding of the steep increase in global food and energy prices. Core HICP inflation, defined as excluding food and energy and with no housing cost element, has also dropped and turned negative, standing at –1.5% in August 2009. OECD forecasts suggest that Ireland will experience a period of mild deflation, a fall in the general price level, in both headline and underlying terms. As discussed in Chapter 3, wages also appear to be falling at a fast pace: OECD forecasts suggest that average nominal wages will decline by around 5% from their peak (OECD, 2009b). This adjustment is without precedent in recent times among industrialised countries.

A key question is how far prices and wages will need to fall to restore macroeconomic balance and competitiveness. In part, this will depend on developments elsewhere. However, the scale of falls in prices and wages in Ireland appears exceptional compared with most of the OECD countries and it is therefore contributing effectively to improving its relative position. While the falls have been relatively large, wages and prices remain high in Ireland by international comparison. The overall level of competitiveness is particularly difficult to assess in the Irish context because it depends on productivity and how the value of additional production compares with the cost. This is hard to measure for Ireland due to the importance in overall production of some activities with very high measured value-added but with relatively low labour-intensity. Estimates based on more sophisticated models suggest that the real exchange rate may be overvalued by up to 20% (IMF, 2009). Irrespective of the level, it is clearer that competitiveness eroded over the period 2002 to 2007 (Figure 1.6). Compared with the past, Irish exports are likely to be much less price-sensitive as there is a large share of more sophisticated products for which there are few substitutes and because of the importance of intra-firm trade. A simple exercise suggests that wages may be well above productivity levels, proxied by national income, but this simple comparison depends crucially on the true level of labour productivity (Figure 1.7). Although the export sector is exposed to strong international competition, the domestic sheltered sectors do not face strong competitive pressures in many respects, as discussed in Chapter 4. Price adjustment therefore could be more modest in these sectors, which implies that greater adjustment will

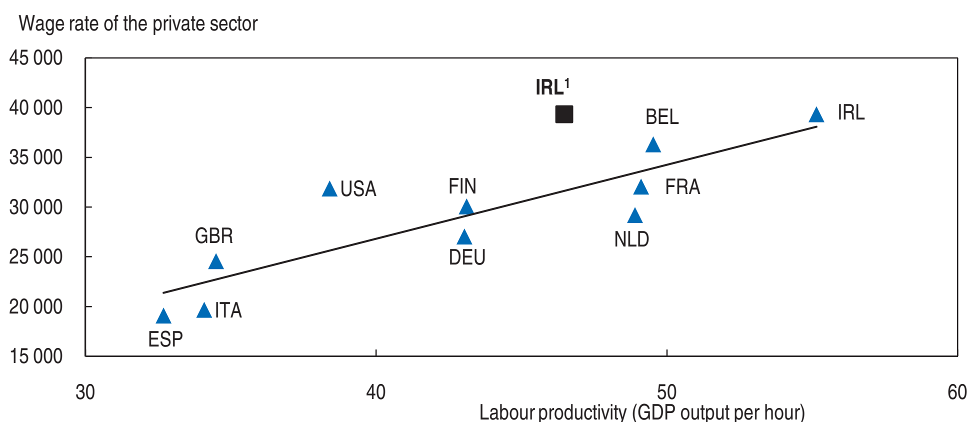
Figure 1.6. **Competitiveness indicators**



Source: *Economic Outlook 85 Database.*

StatLink http://dx.doi.org/10.1787/732144431776

Figure 1.7. **Wages and productivity (2008)**



1. Labour productivity for Ireland is calculated using GNP instead of GDP.

Source: *Economic Outlook 85 Database.*

StatLink http://dx.doi.org/10.1787/732160503075

be needed externally. Policies to increase competitive pressures in those sectors would be helpful, both to reduce domestic costs and increase price flexibility.

There are risks associated with deflation as a means to restoring competitiveness and few precedents in recent history available as a guide. One significant risk is debt deflation: the value of debt is in general specified in nominal terms at origination, so that a fall in prices increases the real value of debt outstanding. This is particularly problematic if the fall in prices is unexpected. With floating interest-rate debt such as most Irish mortgages, this problem may be attenuated because the nominal interest rate would adjust downwards in line with weaker inflation expectations. However, Irish borrowers face interest rates that depend on expectations of euro area, not Irish, inflation and hence will not benefit fully from this effect. The aggregate impact of debt deflation is less than the impact on debtor households because lenders gain from the increase in the real value of loans.

Deflation also has other implications. Firstly, with nominal interest rates set at a level appropriate for the euro area, the real interest rate in Ireland could be relatively high and, if prices are expected to fall further, there is a strong incentive for households to postpone consumption. Secondly, inflation is not neutral in a number of respects. In particular, social benefits and elements of the tax system are not indexed to either wages or prices, although they have typically been up-rated in the past to reflect the rising cost of living. It will be important to make the necessary adjustments to reflect changes in the cost of living, both to maintain the appropriate value in real terms and to avoid putting further pressure on the public finances.

Within monetary union, the Irish authorities have relatively few instruments to support demand. Furthermore, the budgetary situation requires substantial fiscal consolidation. This will inevitably have a depressing impact on demand, although the pace of consolidation should not be frontloaded more than necessary to avoid undue negative effects on activity and this effect may partly be mitigated by Ricardian-type responses to the consolidation. It is also necessary to resolve the banking crisis. Adjustment in the private sector through prices and wages appears to be quite rapid so far and Ireland may eventually fare better than other countries such as Portugal and Germany that have taken many years of weak economic performance to deal with the aftermath of construction booms and to restore competitiveness within the monetary union. Structural policy settings, with some important exceptions, are also relatively favourable to the effective reallocation of resources.

Resolving the banking crisis

Normalising financial conditions, including returning the banking sector to health, is a precondition for economic recovery. Uncertainty and the weight of prospective losses on past lending have led to significant restrictions in the normal functioning of the financial system in Ireland and internationally. The European Central Bank (ECB) Bank Lending Survey shows a considerable tightening in credit standards up to July 2009, more so in Ireland than in the euro area as a whole (although the small number of banks in Ireland makes this indicator difficult to interpret), and this tightening appears to have continued at a high rate up to the most recent observation. Business surveys also point towards tighter conditions in bank lending. In addition, interest-rate spreads on bank lending have increased. Although surveys suggest that loan demand has also weakened significantly, higher lending spreads and tighter non-price conditions have depressed credit. A significant reduction in the availability of bank credit has resulted from the pulling back of foreign banks' activities. Overall private-sector credit fell by 3.0% year-on-year in August, a sharp slowdown from growth of 12.8% a year previously. Credit outstanding peaked in late 2008 and is now somewhat below that level. These figures are net of provisions, which have sharply increased. The growth rate of mortgage lending has slowed sharply and there has been a strong flow of repayments of outstanding debts.

Although reduced confidence in Irish banks during the financial turmoil initially constrained their ability to borrow, this was reflective of underlying weaknesses. During the period before the financial crisis, Irish banks were very heavily dependent on short-term funding in the international interbank markets (Table 1.3). Retail clearing institutions in aggregate drew on interbank deposits for around 40% of their funds in 2007. When problems in the US sub-prime market emerged in mid-2007 banks became reluctant to lend to each other given the uncertainty about the scale and distribution of losses, Irish

Table 1.3. **Aggregated balance sheet of retail clearing credit institutions**

	December 2002		December 2007	
	€ billion	% of total assets	€ billion	% of total assets
Total assets/liabilities	128		441	
Debt securities	8	6.6	70	15.8
Interbank deposits	42	32.5	183	41.6
of which: Foreign	*36*	*27.9*	*117*	*26.6*
Capital and reserves	9	7.3	22	5.0
Central bank deposits	2	1.8	5	1.2
Other deposits	64	50.1	131	29.7
Residential mortgages	16	12.3	51	11.6
Other loans	53	41.6	168	38.1
Other assets	59	46.2	222	50.3
Leverage (ratio[1])	13.8		19.9	
Funding gap[2]	44	34.2	288	65.3
GNP	106		161	

1. Simple leverage ratio measure defined as ratio of total assets to capital and reserves.
2. Simple funding gap measure defined as total liabilities less other deposits, capital and reserves.

Source: Central Bank and Financial Services Authority of Ireland.

banks were therefore particularly severely affected. This occurred despite public information that they had no substantial exposure to sub-prime lending, in part provided by a survey published by the CBFSAI. As a result of the difficulties faced by the Irish banks, there was a sharp increase in their credit-default swap spreads and a steep fall in their share prices: while overall euro area equity prices are around 60% of their January 2007 levels, financial stocks have fallen more sharply with Irish financial institutions particularly severely affected. From the peak in values of February 2007 to the trough of March 2009, share prices in the two main banks fell over 98%, although there has since been a significant recovery in the share prices. Currently their shares are worth less than a quarter of their peak value, despite the benefits of extensive government support.

The underlying problem, however, is that the Irish banking system undertook enormous borrowing to fund a huge extension of credit, heavily concentrated in property-related lending. The total assets of the core banks in Ireland (retail clearing and other institutions with primarily domestic business) are around five times annual GDP, far higher than appears the case in most other industrial countries (Box 1.1).[3] Much of the lending by this group of institutions was to Irish residents. Total lending to Irish residents from all sources is about two and a quarter times GDP. These Irish banks also lent extensively abroad, but this was often biased towards property-related assets and to markets highly correlated to Ireland, with Irish banks having been very active in providing mortgages in the United Kingdom at the height of the housing boom there. Risk diversification was therefore limited. Over 60% loans in 2007 were property-related (CBFSAI, 2007). There was heavy lending to residential development and commercial real estate, as well as for residential mortgages. The buy-to-let sector accounted for 23% of outstanding mortgages in 2007. The expansion in credit is striking: over the five years from 2002, total assets increased by a factor of almost 3.5. This led to large increases in property prices. As a result, the value of collateral increased and further lending became possible. However, this increased the vulnerability of banks if the cycle reversed. In addition, the absolute and relative dependence on short-term financing increased the

Box 1.1. **How big is the Irish banking sector?**

Comparing the "size" of banks across countries should be a useful indicator of the state of financial systems and the risks they pose to their national economies. Unfortunately, internationally comparable data in this area are scarce and cannot be interpreted straightforwardly.

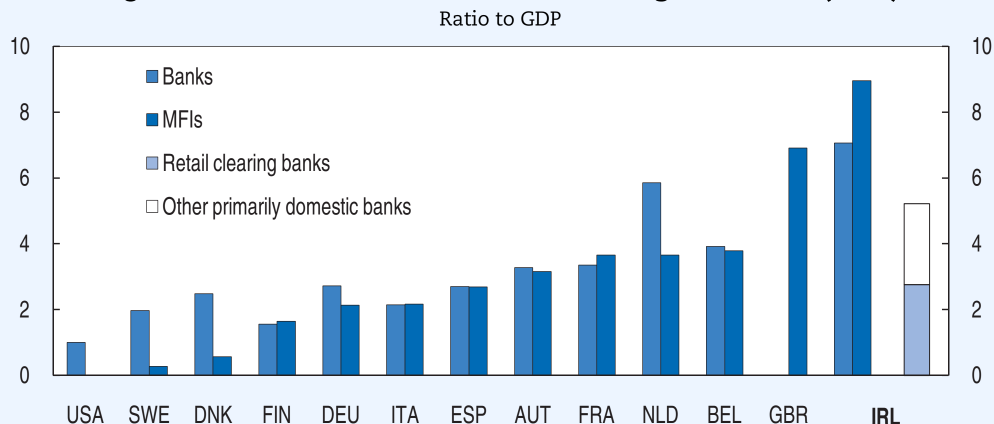
A key difficulty is that banking and finance are very international activities. What exactly is an "Irish" bank? Most national accounts and other financial statistical sources define nationality in terms of residency: banks resident in Ireland include Irish banks' activities carried out through domestic companies, subsidiaries of foreign banks that are incorporated and regulated in Ireland, and the branches of foreign banks that are regulated by their home authorities. It excludes the foreign subsidiaries of Irish banks and branches of Irish banks abroad.

But, "residency" is not the relevant economic concept in many cases. Irish resident banks are not necessarily Irish-owned as this includes foreign-owned branches and subsidiaries, and it excludes the foreign activities of Irish head-quartered banks. Of course, even banking groups headquartered in Ireland have foreign shareholders. Furthermore, credit to the Irish economy does not necessarily come from resident banks. Equally, banks resident in Ireland may not have close links to the domestic economic and financial system. Regulatory responsibility, including any need for public support, does not apply to resident financial institutions only. These problems with "residency" as a proxy for other aspects of the banking system are a particular issue for Ireland, where the International Financial Services Centre (IFSC) houses activities of a wide range of international banking institutions which often have few links to the Irish economy.

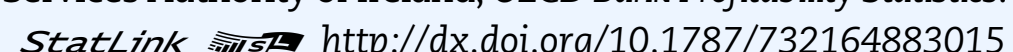
Estimates of the size of the Irish banking system in terms of total assets vary considerably depending on the statistical measure used (Figure 1.8). The highest estimates shown cover monetary and financial institutions (MFIs) resident in Ireland: this includes money market mutual funds, around one fifth of the total, many of whose assets and liabilities are foreign. Estimates of the size of the resident *banks* alone lead to a substantially lower estimate for Ireland. Data that relate more closely to domestically-owned and active banks is available from the Irish central bank. These identify "retail clearing" banks, those with the closest links to domestic activity and which are primarily Irish-owned, and other banks with "primarily" domestic business. These definitions are quite broadly drawn and one large institution in fact has quite limited domestic business in Ireland. 5 foreign-owned banks have a retail presence in Ireland. Nevertheless, the size of the banks in Ireland with strong domestic links appears to be large relative to GDP compared with many other OECD countries, although it is difficult to draw exact international comparisons as comparable data do not exist across countries using these definitions.

Figure 1.8. **Alternative measures of banking sector size (2008)**

Ratio to GDP



Source: European Central Bank, Central Bank and Financial Services Authority of Ireland, *OECD Bank Profitability Statistics*.


StatLink http://dx.doi.org/10.1787/732164883015

maturity mismatch of banks' balance sheets and raised the vulnerability to shortages of liquidity. Furthermore, although tier-1 risk-weighted capital ratios were broadly maintained, leverage measured by the value of assets for each unit of equity capital increased substantially. Increased risk-taking raised the vulnerability of Irish banks to reversals and led to a huge expansion of credit that was inherently unsustainable.

Banks are likely to face very large losses on their assets. The ultimate scale of losses, however, is essentially unknown at present. It depends both on the exact nature of the lending that banks undertook, whether specific projects will yield the expected return, and the overall state of the economy and availability of credit. In particular, property development-related loans are a large part of banks' overall balance sheets and are largely dependent on the future performance of the economy with, in extremis, a floor set by future land values. Standard and Poor's, for example, estimates the cost of bank rescues in Ireland as between € 20 and € 25 billion. Provisions at Anglo Irish Bank for the six months to March 2009 were € 4.1 billion. These sums are very large relative to the amount of equity capital and the immediate ability to generate profits of Irish banks.

Securing bank funding

A guarantee scheme was introduced on 30 September 2008 in the wake of the collapse of Lehman Brothers to address the lack of market confidence in systemically important institutions created by fears about the viability of the Irish banking system, in addition to reinforcing deposit insurance. The guarantee scheme covers almost all bank liabilities (both retail deposits and market finance) for two years from 30 September 2008, with reviews every six months. It covers banks with significant domestic business in Ireland and is voluntary. Banks must accept additional controls on their activities to participate, which has given the supervisory authorities much greater involvement in the banking system and access to additional information. The scale of guarantees is substantial: initial covered liabilities at September 2008 stood at € 365 billion. Covered liabilities have fallen significantly since then and, for the second quarter of 2009, averaged € 275 billion. This is around 1.5 times annual GDP. The banks pay a charge for the guarantee based on initial estimates of the additional cost of government borrowing due to the scheme. This was in the range of 10-15 basis points and was intended to raise € 1 billion over the lifetime of the guarantee scheme. Although this arrangement has been approved under the EU state aid regime, the fees should be priced as an insurance premium and not solely on the basis of the estimated impact on government funding costs. The price of the guarantee appears very low compared with both the increase in government funding costs over the past year and credit default swap rates for Irish banks, however other factors notably the government deficit have also impacted on government costs. There is therefore a large element of transfer to the banking system implied by this regime. It would be appropriate to address this imbalance at the earliest opportunity to lower the transfer and to bring the cost to institutions more into line with that faced by European peers.

Overall, the initial guarantee was more comprehensive than similar arrangements put in place in many other countries, although this reflects the earlier emergence of liquidity pressures in Ireland. The Irish authorities were faced with an urgent need to act and could not wait for a common approach to be established across other countries. In addition, market funding was very large in Ireland so efforts to secure deposits alone would have had a more limited impact than elsewhere. Although there was little choice in the short run, there are a number of problems with issuing such guarantees. The most immediate is finding an

exit-strategy by which the banks return to borrowing without public support. A new Eligible Liabilities Guarantee (ELG) scheme has been proposed to supersede the existing guarantee: this envisages guaranteed debt (including deposits) being issued by participating institutions up to 29 September 2010 with a maximum maturity of five years for the debt/deposit with the guarantee fee set according to ECB guidelines. Provided it is approved, this would allow banks to raise debt using the guarantee at longer horizons but also defines when this arrangement will end. Guarantees on the scale that has occurred in Ireland have a large bearing on how banking problems are resolved and can further complicate shifting any of the burden of losses onto private debt holders. In the long run, guarantees in Ireland and elsewhere have increased moral hazard as banks may expect that they will again be protected when they are in trouble, which increases the need for vigorous regulation and supervision.

Before the guarantee scheme was put in place, a change had been made to the Deposit Guarantee Scheme (DGS) in September 2008 to raise the limit from € 20 000 to € 100 000 per depositor per institution and remove the previous coinsurance element so that the entire deposit is safeguarded up to the ceiling, initially through the DGS and then through a direct government guarantee. The current minimum ceiling for coverage in the EU is € 50 000, which will rise to € 100 000 by end 2010. Following the adoption of a new Directive in March 2009 amending the 1995 EU Deposit Guarantee Schemes Directive, new legislation was introduced in June 2009 in Ireland. This reduces the maximum pay out time from three months to twenty working days, extends the scheme to credit unions and makes a number of institutional changes. This pay out delay, although in line with the new EU directive, is relatively long compared with some other OECD countries (such as the United States) and could provide insufficient reassurance to savers. Consideration should therefore be given to reducing it further, say to no more than seven working days as the United Kingdom is adopting as a target pay out period from 2010, and the appropriate operational measures taken to ensure that the scheme is credible. The DGS has been simplified by removing the netting arrangements across different accounts held by the same depositor, making it simpler to administer. Over time, banks' contributions to the fund should be raised from the current level of 0.2% of eligible deposits to reflect the increase in the guarantee provided as well as any revisions to the likelihood of payout, both for individual institutions and for several institutions at the same time. Consideration should be given to making the contributions risk-based.

Although the risk spread on the lending of Irish banks remains higher than prior to the financial crisis, the system of guarantees has allowed the banks to continue to access international markets. As conditions in interbank markets have improved in recent months, Irish banks have benefitted from this reduction in funding costs. The two main banks have issued paper to mature beyond the guarantee date of September 2010. The expansion of the ECB's balance sheet since August 2007 has also provided considerable support to the Irish banking system: retail clearing banks' central bank deposits rose from under € 1.64 billion before the crisis to close to € 46 billion by June 2009, a much faster increase than for the Eurosystem's balance sheet as a whole and representing around 8% of all Irish retail bank liabilities. In addition, the volume of outstanding mortgages that has been securitised has also increased substantially. This may be because securitising such assets makes them eligible for repo at the ECB and therefore a source of liquidity funding.

Restoring the banking system to good health

Given the large accumulated and prospective losses, it is necessary to ensure that the banking system is returned to good health and able to function normally. This requires that

banks are well-capitalised and not burdened by uncertainty about future losses. In common with most other countries, the Irish authorities have provided capital to the major banks. However, Ireland is unusual in having taken the further step of creating the National Asset Management Agency (NAMA) to deal with problem assets (OECD, 2009c).[4]

The government announced its intention to recapitalise the banks in December 2008 with the aim of increasing the stability of the financial system and restoring confidence in Irish banks. Following the initial plan to inject € 5.5 billion into the three largest banks, a package was announced on 11 February 2009 for Allied Irish Bank (AIB) and Bank of Ireland (BOI), after the nationalisation of Anglo Irish Bank in January 2009. Under the scheme, the government has provided € 3.5 billion of Core Tier I capital each to AIB and BOI in the form of preference shares with a dividend of 8% payable in either cash or common equity at the banks' discretion. The banks have the option to repurchase these preference shares at face value for the first five years and then at 25% premium thereafter. Warrants give the state the option to purchase up to 25% of the ordinary share capital of each institution at strike prices that place a very low valuation on the banks' equity, prices that were subsequently reached but are below the current level. Although the 8% yield on preference shares gives banks a strong incentive to repay the government's investment, it also acts as an additional drain on the banks' cash resources. The use of preference shares removes any upside gains to the taxpayer as the performance of the banks has improved. A number of additional conditions were imposed. The Minister has the power to appoint 25% of directors in each bank and has 25% voting rights for appointments, and the banks need permission for further changes to their capital structures. The banks also accepted to reduce compensation for senior executives. Each committed to raise lending capacity to first-time buyers by 30%, increasing credit availability to small and medium enterprises by 10%, to participate in a "clearing group" to resolve problems of lack of credit for viable projects, and to make contributions to funds for venture capital and "green" innovation. AIB committed to generating a further € 1.5 billion of capital in April, based on needs identified by independent auditors as part of the due-diligence for the initial capital provision. All banks must abide by new codes of conduct on business lending and mortgage arrears. In May 2009, following the publication of Anglo Irish Bank's half-year results, the Government committed to providing up to € 4 billion in capital for Anglo, with an initial € 3 billion provided in June 2009. Anglo increased capital by a further € 1.6 billion through a debt buy-back exercise completed in August 2009.

The recapitalisation of the banks and the creation of NAMA are important steps in resolving the banking crisis in an effective way. Although Ireland has not explicitly used public "stress tests" along the lines of the United States, the authorities were able to get a good picture of the state of the banking system through the analysis associated with the guarantee scheme and due diligence exercises associate with state recapitalisations, in part carried out by independent consultants, and to act accordingly. This allowed the requirements to return the institutions to good health to be identified and for Anglo Irish Bank to be treated in a different way from the other institutions. This kind of "triage" is extremely important in getting to grips with underlying problems in a timely way; although there is limited evidence of what works and each crisis is different, evidence from cross-country experience suggests that allowing impaired institutions to continue to operate for extended periods of time can significantly increase the fiscal costs associated with resolving banking crises (OECD, 2002).

The establishment of the NAMA was proposed in April 2009 to purchase property development-related loans (Box 1.2). Creating NAMA to deal with troubled loans may improve the chances of minimising the losses on these loans by allowing greater

Box 1.2. **The National Asset Management Agency**

The National Asset Management Agency (NAMA) was proposed in April 2009 to take property-development related loans off banks' balance sheets. Combined with additional capital injections as required, this would leave the banks in a stronger position to undertake new lending by reducing the uncertainty about future losses on these loans and improving their capital position. Draft legislation was published in July and the proposal submitted to the parliament in September 2009. It is currently pending parliamentary approval and therefore the details of the scheme remain to be confirmed. The NAMA will be a semi-state entity under the National Treasury Management Agency (NTMA). The main features of this scheme are:

- **Participation** in the scheme by banks is voluntary. It is anticipated that five of the institutions covered by the guarantee scheme will seek to participate, including Anglo Irish Bank which has been nationalised.
- The **assets covered** are land for development loans and certain associated loans. In applying to participate, banks would have to agree to sell to NAMA all eligible loans identified by it for transfer. The current book value of the assets projected to be transferred to NAMA from these institutions is around € 77 billion, of which € 49 billion are land and development loans and the rest is associated lending. € 9 billion is estimated to be rolled-up interest. The projected portfolio amounts to around 21 500 loans from almost 2 000 customers, primarily in Ireland but also internationally. The average loan to value ratio is estimated to be approximately 77%. It is estimated that € 28 billion of the loans were originated by Anglo Irish Bank, while € 24 billion and € 16 billion come from Allied Irish Bank and Bank of Ireland respectively.
- **Asset valuation** by NAMA is based on the current market value of the underlying collateral, adjusted to reflect longer-term economic value. The valuation methodology will comply with EU guidelines. In practice, it is assumed on an illustrative basis that there has been a 47% average decline in the value of underlying property collateral since origination of the loans but that the long-term economic value of the assets is around 15% than the estimated current market value. This suggests that NAMA would pay € 54 billion for the loans, a 30% discount on their current book value.
- There is a **risk-sharing mechanism** whereby 5% of the government securities or guaranteed-debt used to purchase the assets from the banks is in the form of subordinated debt, which will not be repaid in the event that the NAMA makes a loss on those loans. It is estimated that this margin, together with a 10% recovery in asset prices (rather than 15% assumed above), would avoid any loss to the tax payer.
- The government intends to use a **levy** to recoup any losses if the NAMA makes a loss over its lifetime.

specialisation in the working out of bad assets and by ensuring that this is the management's main focus. Given the amount of loans to property development in Ireland, the NAMA may be able to play an important role in ensuring that loans made by different banks are dealt with in a way that preserves the most value by internalising some of the externalities that can arise between different real estate projects. For the NAMA to fulfil these roles, it is essential that it has the necessary resources and expertise, that appropriate incentives exist for those working with the NAMA to achieve its objectives, and that its independence from political and industry pressures is ensured. It is also important that the NAMA scheme is not too narrow in scope: as discussed below, Ireland has little experience of losses on household

mortgages but the pressures may be stronger in this episode than in the past and lead to losses in this segment as well. The draft legislation envisages that the NAMA could be extended to other classes of assets, increasing the scope and scale of the agency, although the government has stated that it has no intention at the present time to do so.

The creation of the NAMA should in principle help to resolve uncertainty about future losses on banks' balance sheets and enable future lending on a sound footing, in combination with the guarantee and government recapitalisation. The key issue with the NAMA is at what price it purchases the troubled loans and how risks are shared between the banks and taxpayers: a low price tends to reduce the risks of large fiscal costs but imposes greater losses on banks, requiring additional recapitalisation and greater public ownership of some banks. It is inherently difficult to establish such a price given the state of financial markets and the idiosyncratic nature of property-development loans. This also makes it unfeasible to use market or auction-based mechanisms. In terms of the overall portfolio, the valuation scheme for the assets that is being used is based on explicit assumptions about falls in the value of the underlying collateral but builds in an expectation that prices will return to a higher level as a result of economic fundamentals in the medium term. To avoid undue risk to the tax payer if this price were to higher than the ultimate value that is recovered from the assets, there is an explicit risk-sharing mechanism covering the first 5% through subordinated debt. Any profit made by the NAMA would be retained by the state. In addition, the government is making provision for a levy which will be applied after 10 years or on the winding up of NAMA. It would be important to act on this if these circumstances were to arise. In addition, introducing such risk sharing is somewhat at odds with the original intention of insulating the banks from losses on their portfolios, although the NAMA approach may make the initial losses more explicit than if they remained on banks' balance sheets, and in an accounting sense these residual losses would not have to be recognised as quickly. Public ownership of bank equity also brings in an element of risk sharing: the largest source of assets in the NAMA is Anglo Irish Bank, which is nationalised and so the price paid for its assets is in essence a transfer within the government balance sheet, and the government has a significant stake in most of the other institutions concerned.

Bank recapitalisation has also increased the role of the state in the banking system. Although the government has been keen to maintain private-sector discipline and market listing for private banks, this is difficult when they are so heavily reliant on public support and there is such close interaction with the authorities. This raises a difficult dilemma. Private ownership of banks is likely to be the best solution in the long run but, the greater the private stake, the more likely are private individuals to profit from state support. Given the high level of public involvement already, the lines are somewhat blurred between different forms of ownership. It is clear that banks, irrespective of their ownership, should be run on as close as possible to a profit-making basis without being used to support other social objectives. Temporary nationalisation would have a number of drawbacks, but it should not be ruled out altogether provided that appropriate safeguards are in place. Exit from public ownership will ultimately be required and should aim to maximise the return to the tax payer.

Overall, the combination of different instruments amounts to maintaining the existing level of liabilities and then trying to provide sufficient capital to absorb the losses. As a result, substantial banking losses are ultimately likely to be met by the taxpayer. Although this solution has only been adopted in a few cases during the crisis and may be especially difficult to implement for a small country within the global financial system, an alternative would have been to impose some losses on unsecured creditors. This would

have reduced the size of banks' balance sheets and compensated for the losses on the asset side. By swapping bad assets for relatively high yielding government debt and with sizeable margins between government-supported funding costs and lending rates, banks' profits before credit losses will be high in coming years and this will to a great extent contribute to restoring them to good health. In addition, the government debt that will be taken by banks to replace their NAMA assets can be used for market funding or as collateral at the ECB and therefore also contributes to liquidity. The authorities may have had a wider range of options and been able to act more quickly if Ireland had a special bankruptcy procedure for banks, allowing banks to be restructured rapidly and in an orderly way. The Special Resolution Regime in the United Kingdom, introduced following the financial crisis, provides a basic framework where banks can be sold, wound down or taken into public ownership. Consideration by the government of options for the introduction of a legislative regime to deal in a systematic way with distressed financial institution is underway and proposals are anticipated next year. An exit strategy is required to move from the current situation towards the long-run sustainable situation of a privately-owned banking system run without public support and this is currently being examined. Support should be withdrawn gradually so as not to jeopardise progress that has been made (OECD, 2009c).

Financial regulation and supervision

The financial and banking crisis has revealed a number of weaknesses in the regulatory and supervisory framework, both in Ireland and internationally. While the Irish approach in these areas takes place within a framework of European regulations (OECD, 2009d) and international practices, there is substantial national discretion to impose tighter regulations and the way supervision is applied is largely a national matter. The European and international regulatory contexts may change substantially as a consequence of the financial crisis, but there is nevertheless important scope for Ireland to strengthen its own arrangements.

The main supervisory issues were two-fold. Firstly, there have been serious and well-documented issues in Irish banks recently. These related mainly to Anglo Irish Bank and are currently under official investigation. Although there may be an idiosyncratic element to these breaches and Anglo was in serious financial difficulties at the time, these transactions suggest that the threat of enforcement was too weak. The regulator should be better informed about what banks are doing and enforce the rules more strictly.

Secondly and more fundamentally, Irish banks took enormous risks by such heavy reliance on market funding and the scale of exposure to housing and other real estate lending. As a result, asset prices ballooned and borrowing in the Irish economy reached high levels by international standards. This has resulted in large losses to the banking sector and a high cost to the economy. This reflects a number of regulatory and supervisory shortcomings. At the level of individual institutions, excessive lending growth was tolerated. For example, the total assets of Anglo Irish Bank increased at an average annual rate of 38% over the five years to 2007 (PWC, 2009). Very high asset growth is a well-established predictor of banking difficulties; other states have taken action to reduce the possibility of this problem from arising in the future without a regulatory response, for example as with the US Prompt Corrective Action regime. More generally, there was a failure to recognise the full impact of the decisions being taken by each institution. However, the regulator did take some measures: the risk-weighting in calculating capital requirement for high loan-to-value residential mortgages was increased, while a 150%

risk-weighting was applied to speculative real estate lending, well-above the international norm. In addition, with the implementation of the Basel II system, the three banks that adopted the Internal Ratings-Based (IRB) approach were required to hold 95% of the capital held under Basel I, more than required by international standards, and the transition to this level was made very slow. In addition, a new Consumer Protection Code came into effect in 2007 and the CBFSAI's remit was widened to halt the nascent sub-prime mortgage market. New forward-looking liquidity requirements were introduced.

As the result of recent experience with greater supervisory activity related to the guarantees, substantial changes are underway in financial supervision. There is a move away from principles-based regulation to a more intrusive model. To support this, approval has been given to hire 40 additional staff and the organisation will have these positions filled at the earliest possible date. Examination teams have been strengthened by the addition of a credit specialist who is able to bring cross-cutting experience from different supervised institutions to benchmark banks. Information systems are being enhanced beyond the standard EU requirements to better reflect the key risks for Irish banks. On-site supervisors have been introduced and banks are required to make monthly reports to the regulator. Supervisors now attend a sample of internal bank meetings, up to Board level, rather than relying on minutes. The regulator has a particular focus on how institutions can improve their risk management procedures. Supervisory attention is being increased for institutions in the IFSC.

Taken together, these new procedures represent a major shift in the model of supervision. It will be important to ensure that these measures, which have grown out of the immediate crises and government support, continue to be developed in a systematic and effective way. As financial conditions normalise, it will be crucial to define the boundaries between more intrusive supervision and banks' management of their own affairs. While the regulator should have detailed information about what banks are doing, it should also maintain an independent judgment and sufficient distance from the regulated institutions. A system of numerical triggers should be adopted for certain supervisory actions in line with practice in some other countries. This could include loan growth and the size of funding gaps, as well as the size of exposure to particular types of lending. Where these need to be supplemented by judgment, the regulator should be as transparent as possible. Over time, banks should be required to hold more capital overall in line with developments in international regulations.

The governance of the Financial Regulator is also being enhanced. While currently the Financial Regulator is legally an autonomous entity within the Central Bank and Financial Services Authority of Ireland (CBFSAI) with responsibility for the supervision of banks and a wide range of other financial institutions, the new institutional framework for financial regulation, currently being put into practical effect in anticipation of future legislation, will move responsibility for financial regulation to the central bank, while certain responsibilities related to consumer protection which currently lie with the Financial Regulator, such as consumer information and education and financial inclusion, will be given to a separate agency. The Head of Financial Regulation will sit on the new Central Bank of Ireland Board, which replaces the current board structure. Currently, in order to facilitate joint Central Bank Board and Regulatory Authority consideration of financial stability and prudential supervisory issues, the two meet in joint session monthly and central banking and financial regulatory working arrangements are more closely linked.

Macroeconomic stability and macro-prudential policy

The downturn raises the question of what can be done to reduce the cyclicality of the economy and avoid a similar unsustainable run up of credit and asset prices in the future. Although the debate about macroeconomic and macro-prudential stability is much wider, the issues are particularly important in Ireland given its small open economy and large financial sector. While participation in monetary union has many benefits and has had a stabilising influence during the crisis, it implies that monetary policy in Ireland may deviate from the optimal from an Irish perspective for very long periods, which can encourage large deviations in credit from what economic fundamentals might suggest, in addition to the standard workings of the credit channel. Many of the feedback mechanisms that might have helped to balance the economy appeared to act very weakly during the past cycle.

A number of different policies were used in Ireland during the boom to "lean against the wind" of growing asset-price and credit imbalances:

- A number of changes to housing taxation were made over the period 1998-2001, including higher stamp duties and reductions in tax relief. These changes managed to slow the housing market considerably, particularly during the period 2001-02, but were largely reversed in 2002.[5]
- Special Saving Incentive Accounts (SSIAs) were introduced in May 2001 to try to increase saving temporarily and reduce consumer spending.[6] There could have been a problem as these matured during 2006 and 2007, injecting funds of around 15-20% of household disposable income at a time when demand was already especially strong, but this effect ultimately appears to have been fairly limited.
- The National Pension Reserve Fund was established in April 2001 to prepare to meet future costs related to social welfare and public service pensions from 2025. Although this is not a countercyclical measure *per se* and was instituted before the most recent phase of economic expansion, it did have the effect of increasing the national saving rate relative to what it would otherwise have been during the years of strong growth, and it provided a pool of funds that have been available to deal with the financial crisis.
- Financial regulations were tightened, as discussed above, in recognition of growing risk associated with some property-related activities, the need to protect the consumer and ensure that the liquidity regime was sufficient.
- The government budget was mostly in surplus over a long period including the most recent expansion, peaking at close to 3% of GDP in 2006 and with a cyclically-adjusted underlying surplus of around 2%, although this was boosted by very buoyant property-related receipts.

Although these restrictive measures went in the right direction, their scale was clearly insufficient to counter the growing domestic imbalances and forces, both Irish and international, adding to the housing and credit cycles. Some measures were limited in scope or time and might have been more effective if introduced a great deal earlier, before the credit cycle became self-sustaining. Such policies should be further developed and applied more aggressively in the future. While annual Financial Stability Reports provided a good indication of some of the emerging difficulties, they did not translate into sufficient action. These reports have not been published since 2007 and their publication should be reinstated as they give an important overview of developments related to financial stability. Bringing the Financial Services Authority within the Central Bank should increase the ability to put macro- and micro-prudential information together and to vary

regulations in an appropriate way. Changes in European and international regulations may also help but, given that the credit cycle will not always be the same across all euro area countries, it is important to have some local variation in the regulatory stance. Consideration should be given to the use of an overall leverage ratio, covering all assets, to put a limit on the amplitude of the cycle, while either dynamic provisioning or counter-cyclical capital requirements could contribute to dampening the cycle. A rules-based numerical framework may be helpful in ensuring that these policies are applied consistently: this could limit forbearance by regulators, and make counter-cyclical measures easier to apply in an environment where the financial sector might appear to be thriving and different measures could be in force at the same time in other jurisdictions. However, there is little experience internationally of effectively applying such counter-cyclical regulations. More effective regulation and supervision may therefore play an important role in achieving stability: making each institution as a whole more stable contributes to overall stability even if it is not sufficient in itself. In particular, competition from fast-growing institutions put significant commercial pressure on other banks to reduce their lending standards during the credit expansion. By avoiding such regulatory failures related to some institutions, these pressures are less likely to exist elsewhere. Furthermore, reforms to the housing market and a strengthening of fiscal institutions to achieve a more counter-cyclical outcome would contribute greatly to financial and broader economic stability.

The housing market needs to be reformed

The current situation in the housing market creates immediate challenges. With rising unemployment and falling incomes, the high burden of debt is likely to become a more serious constraint. Low policy interest rates in the short run are attenuating these effects, but there will be more pressure to meet mortgage interest payments as the ECB raises interest rates in the future. Furthermore, negative equity has become more common. As people are paying mortgages that are greater than the value of their homes, there is a strong incentive not to pay but mortgages in Ireland are with recourse so it is difficult for homeowners to distance themselves from this situation. Historically, home repossessions have been extremely rare and there is little evidence of a substantial pick up in repossession orders at present, by contrast with the United Kingdom that has a somewhat similar legal framework but much greater experience of repossessions both in the past and in the current slowdown. The very limited increase in the number of Irish repossessions to date largely relates to the small amount of "sub-prime" lending that took place. What will happen to repossessions in the coming years is a major uncertainty: the level of indebtedness is much greater than in the past and negative equity is a far greater problem, because house prices are now falling in nominal terms even as deflation is raising the value of debt outstanding. In addition, the increased maturity of mortgages reduces the scope to reduce the burden of mortgage payments by extending the term further.

The government has introduced a new Mortgage Arrears Code in the context of recapitalising the banks, but this only sets out procedures for dealing with mortgage arrears. In addition, a Mortgage Interest Supplement is available to households without work to assist with their mortgage interest payments, subject to various conditions. A ceiling and time limit should be applied to this payment. Although the number of people claiming this benefit over the past year has doubled, it remains a very small fraction of the total number of unemployed. The government introduced a temporary Home Choice Loans scheme for first-time buyers to help them buy newly-built houses if rejected by

commercial banks. It is unclear what such a scheme can achieve and, by targeting newly-built houses only, the main effect would be to support the price of such homes, which transfers the support to developers. Take up of this scheme appears to have been extremely limited. One problem with negative equity is that it can be difficult to move house, as this would require a new loan with a very high loan-to-value ratio. Home owners can therefore be stuck in their existing properties, which can be harmful both to labour mobility and for the smooth functioning of the housing market. Banks should be encouraged to allow existing loans to be transferred to new homes.

For the longer term, the housing market needs to be reformed as it played a key role in the build up of imbalances, with poorly-designed policies contributing to the extent of the over-heating. Ireland's tax system is biased towards housing, homeownership and property, as argued in the previous *Survey* (OECD, 2008). It is the only country in the OECD to give mortgage interest tax relief without having a tax on primary residences. This distortion makes housing more expensive and adds to the volatility of the housing market: there is a strong positive association between the volatility of house prices and the generosity of the tax system towards housing (van den Noord, 2004). Policy towards housing and property should ensure that it is treated in a consistent way with other assets to avoid any bias in how consumption or investment is allocated, while channelling housing support for those with low incomes in the most efficient way. In addition to these reliefs, a number of other tax inducements were given towards property more generally (often through so-called "Section 23" reliefs). Although many have now been abolished, their effects continued to influence the property market throughout the boom, and others remain in place. Such schemes distort the allocation of resources towards property, and are likely primarily to result in higher prices and gains to existing landowners. All such inducements should be removed. Limited progress is already being made in this direction with the introduction of an annual € 200 levy on second homes, although the recommendations of the Commission on Taxation and government statements indicate that this is likely to be the beginning of a wider reform (see Chapter 2).

In the Supplementary Budget in April 2009, mortgage interest relief for owner-occupiers was restricted to the first seven years of a mortgage. The government announced that this would be kept under review with a view to eventual abolition over successive budgets. As set out in the previous *Survey*, there are a number of options for achieving a phasing out of the distortion caused by mortgage interest tax relief.[7] The most recent change is limited in the sense that it only covers some mortgage holders and continues a trend to limit the upper limit of relief for this group. Concern about placing additional financial pressure on households who have purchased houses in the past seven years, whose value has since fallen, may limit further reductions in interest deductibility for this group in the short run, but this should be addressed in the future. More fundamental and immediate changes should be targeted at future home buyers, including reducing the ceiling for relief and the number of years over which it can be claimed. This can begin now. The main constraint is to ensure that the discrepancy between the terms on new and existing mortgages is not too great, to avoid trapping existing mortgage holders with their current loans. This would provide a clear signal to future home buyers about the nature of taxes around housing in the future. While this may depress house prices in the short run as the present discounted value of property taxes is frequently capitalised in property values, this effect is part of a necessary adjustment. The need to reduce reliefs would be less if a local property tax were introduced, which could have the advantage of

being used to pay for local services and internalising some of the gains to homeowners form public infrastructure investment. The current economic difficulties created by the housing market, as well as low interest rates, ease some of the political economy constraints on reforming mortgage interest relief.

Public support for housing should be provided in more efficient ways. While the government is increasing the supply of public housing, this is a costly way of providing support and the number of families who can be helped in this way is necessarily limited. Although home ownership can have benefits, the Affordable Housing Scheme and tenant purchase scheme, which has been extended to include flats, are both inherently costly because they involve selling public housing at below the market value. Assistance for housing should be switched into more effective channels, such as the Rental Accommodation Scheme (RAS), which makes use of good standard private rental accommodation to meet long-term needs. The current state of the housing market may create opportunities to use private housing to meet public housing needs, although these schemes should be judged on their own merits and not targeted at supporting the private housing market. As argued in Chapter 3, the Rent Supplement should be redesigned to remove the joblessness traps created by the high taper rate.

Potential output is crucial for the outlook

The prospects for potential output are central to the medium-term outlook. The path of long-run sustainable growth determines how living standards will evolve in the future and what kind of country Ireland will be. The amount of resources and the rate at which this increases is extremely important for how much income there will be available in the future to repay the burden of accumulated debts, both for the private sector and for the government. Low growth would imply that the debt-to-GDP ratio would tend to remain high for longer. Potential output is also critical to judging the underlying structural fiscal position. More immediately, the sustainable level of demand depends on the supply that is available. Financial crises are typically associated with large permanent falls in the level of economic activity (Reinhart and Rogoff, 2009). As a result, estimated potential output is now likely to be lower than previously thought. In addition, the booming conditions in the run up to the crisis are likely to have presented too positive a picture of the underlying state of the economy.

It is inherently difficult to judge the potential level of output as it is unobserved. For Ireland, these difficulties are compounded by its being a small and highly open economy, so that inputs such as labour can vary greatly in response to changes in demand. In addition, Ireland recently experienced a period of extremely rapid "catch up" from 1995 onwards so it is difficult to assess what the "normal" steady-state of the economy might look like. The most relevant concept of potential output corresponds to the level of output where production evolves along an efficient growth path, which should be smooth given that rapid adjustment is costly. This concept is neither a necessary nor a sufficient condition for inflation to be at its "neutral" level. Although Irish inflation was slightly above the euro area average in recent years, this understated the true excess of demand over sustainable supply because resources were drawn in from abroad in an unsustainable way. Equally, money demand increases with wealth so that the asset-price cycle would have depressed price pressures relative to changes in the money supply (Boone *et al.*, 2004).

OECD estimates of potential output for Ireland have been revised very substantially, both over past history and over the forecast horizon (Box 1.4). With outward migration, rising long-term unemployment and a contracting capital stock, the level of potential falls

Box 1.3. **Re-estimating potential output for Ireland**

The estimated level of potential output for 2009 for Ireland was revised down over 7% in the most recent OECD *Economic Outlook* compared with the previous forecast (OECD, 2009b). In addition, the long-term growth rate was revised down to a little below 3% per year. While forecasts for other countries were also revised down in light of the international financial crisis, the revisions for Ireland were particularly large. Potential output in other countries heavily affected by the turning of the credit and housing cycles, such as Spain, were among those also revised down substantially.

OECD estimates of potential output published in the *Economic Outlook* are based on a whole economy aggregate production function (Beffy *et al*, 2006). This approach relates potential supply to the available capital services and potential labour inputs through a production function that allows for trend changes in total factor productivity (TFP). This approach was modified in the most recent estimates so that capital is based on actual rather than smoothed capital, tracking the evolution of capital more closely (OECD, 2009b).

Long-term potential growth in 2017 is estimated to be around 2.8%. Growth is mostly driven by rising employment resulting from expansion of the working-age population and technical progress. Capital deepening continues to contribute to growth. This is somewhat lower than the estimates for 2015 to 2020 produced by the ESRI in their *Medium-Term Review* (Fitzgerald, 2008), in large part due to differences in population growth assumptions. Long-term growth is assumed to be well above the euro area average of 1.4% principally because of stronger assumed growth in the working-age population in Ireland compared with the more rapidly ageing European average.

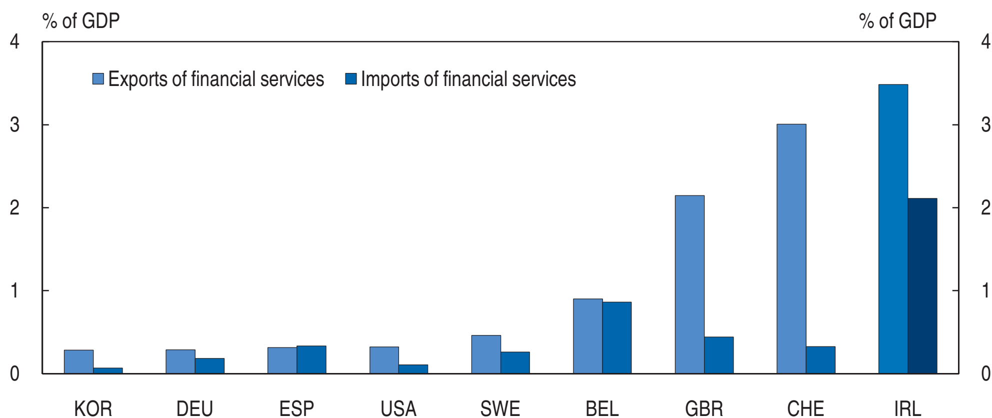
There is massive uncertainty around any estimates of this nature. Key judgments for Ireland include future population growth and the sensitivity of net migration flows to the state of the economy. Historically, Ireland has the most cyclically sensitive flow of net migration of any OECD country. In addition, it is assumed that three-quarters of the increase in long-term unemployment feeds into a higher NAIRU as for all euro area countries based on Laudes (2005). This could overestimate the degree of stickiness in Irish labour markets and so understate the level of potential. It is assumed that the scrapping rate of capital will increase as a result of the slowdown and financial crisis. Trend total factor productivity is derived using an econometric filter, taking into account forecasts for the coming years. These techniques are sensitive to the assumptions about developments at the end point but would fail to estimate the trend properly if there were an abrupt change or if the credit cycle had significantly distorted the picture of the underlying path of the economy in recent years. The risk of abrupt changes is real: the change in estimated potential between 1995 and 2000 made in 1998 in *OECD Economic Outlook* 64 is around 4 percentage points lower than the current estimates of the change over the same period, as the view at the time did not pick up on the sharp "catch up" growth that was achieved.

over the short run and takes some time to reach its trend growth rate through the sluggish recovery. The financial crisis and short-run economic weakness will reduce potential output through a number of channels. Although policy interest rates are low, the credit-spread and the availability of loans have deteriorated. This will limit capital formation, as reflected in the sharp fall in investment. Some of this effect may be temporary as firms hold off on investment until economic uncertainty has cleared, but the required rate of return on projects is likely to be permanently higher than during the early years of the decade when international financial conditions were exceptionally loose.

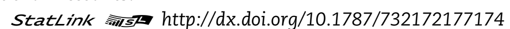
During recessions, the scrapping rate often increases as parts of installed capital are written-off, either because there is no longer demand for them or because capital is scrapped as firms are liquidated or production is halted.

Ireland developed a relatively large financial sector during the global credit cycle (Figure 1.9). A permanent downsizing of the financial sector would lower average labour productivity because value-added per worker in finance is significantly higher than in the economy as a whole, a gap which grew in most OECD countries since the 1990s. This could occur if employment in the financial sector were permanently reduced and workers move to less productive activity in the non-financial sector. The value-added of the financial-sector workers may also fall, either because productivity falls or because past productivity may have been overstated by the credit cycle.

Figure 1.9. **Trade in financial services (2006)**



Source: OECD Statistics on *International Trade in Services* and *National Accounts*.


StatLink http://dx.doi.org/10.1787/732172177174

The massive fall in construction activity, particularly house-building, could have several effects on potential output. Construction is a labour-intensive activity: output per employee in building is at least one-fifth lower than average productivity in the economy as a whole. If the number of construction employees returns to its 1998 level and all workers are reallocated to jobs with average non-construction productivity, this would suggest a gain in the level of productivity of around 1.5 to 2.5%, although this could be towards the upper-limit of the possible effect as some construction workers may be re-employed in activities with below average productivity, particularly those who are young and not well-educated. The stock of non-residential buildings and structures increased by over one-third in the five years to 2006 (the latest year for which data are available). This boom in non-housing construction accounts for around one-quarter of the overall increase in capital services over that period. Of the countries for which data are available over this period, the contribution of non-housing structures to the increase in overall capital services was the highest in Ireland, just ahead of Spain. Given that the credit cycle may have distorted the allocation of construction investment, this poses the risk that productivity of these investments will be low and may even lead to higher scrapping in the coming years.

There will be a substantial impact on potential output from high unemployment in the short run. As discussed in Chapter 3, the size of this effect depends on how rapidly the economy adjusts and on structural policies. While the wage and price flexibility to date

suggest that adjustment could be swift, high unemployment replacement rates and weak activation could allow short-term unemployment to translate into a high permanent level of the non-accelerating inflation rate of unemployment (NAIRU), implying a lower effective supply of workers. There is clear evidence that net migration has begun to reverse, both because migrants are taking decisions to leave Ireland and because the inflow of new migrants has fallen too low to replace the outflow of migrants that would have occurred in any case. In addition, the incentive for Irish nationals to work abroad has increased. The scale of these outflows is difficult to assess. In addition to problems of measuring flows accurately, the inward migration in recent years was unprecedented in Ireland's history and so it is difficult to know how sensitive migrants will be to the deterioration of economic conditions in Ireland. Based on historical relationships since the 1960s, net outward migration could be in the range of 200 000 to 300 000 people (OECD, 2008). These econometric relationships, however, seriously under-predicted the scale of inward migration since 2002. If the stock of foreign nationals working in Ireland were to fall from its peak to its 2001 level, this would imply net outward migration of around 375 000.

The revision to estimates of potential output over the past is partly driven by changes in the trend as more recent data are taken into account. In addition, the degree to which the credit cycle and related activity were unsustainable is now becoming clearer. Based on OECD forecasts, if the period 2002 to 2010 is a cycle, growth from trough to trough will have averaged an annual rate of just 1.65% compared with a rate of growth of over 5% over the expansion alone. Although there is no requirement that the output gap averages zero over the cycle, this indicates the scope for potential to have been overestimated. In particular, estimates of trend growth may have been excessively backward-looking and therefore projected forward part of the "catch up" growth of the late 1990s that was not be repeated. Such a failure in identifying turning points in the underlying position of the economy is a common problem that has led to policy errors in other settings, such as monetary policy. The revisions in Ireland have important implications, suggesting for example that the underlying fiscal position was less strong.

The impact of policy on potential output

The level of potential output is determined in part by policy. Well-designed market-oriented structural policies can contribute to encouraging long-term growth, while restrictive policies can constrain the level of output and impair growth prospects. An important channel for these effects is the flexibility of the labour and product markets and hence their ability to transfer economic resources from redundant to emerging activities. Compared with the OECD average, indicators suggest that Ireland has considerable flexibility and relatively favourable structural policy settings as a whole even if there are some significant remaining weaknesses. As discussed in Chapter 4, there is a range of measures that would make the sheltered services sector more competitive and reduce costs and prices, as well as further investment and improvements in research and development, education and infrastructure.

Structural policy changes that are already underway as the result of the economic downturn and the fiscal consolidation, which are necessary in themselves, will tend to lower potential growth. An increase in the tax wedge of one percentage point is on average in OECD countries associated with a 0.2 percentage point increase in the NAIRU (Gianella *et al.*, 2008). This suggests that the measures taken through the Income and Health levies might raise the NAIRU by around 0.5 percentage points in the long-run. An increase in the average unemployment benefit replacement rate of the same size raises the NAIRU marginally as well.

Box 1.4. Summary recommendations to restore macroeconomic stability

Resolving the banking crisis

- The National Asset Management Agency (NAMA) should be swiftly established and the assets identified as eligible under the scheme transferred to the NAMA at the appropriate price with risk-sharing mechanisms to protect the taxpayer. Appropriate resources and expertise should be available to get the most value out of the assets.
- The government should remain ready to provide additional capital to the banks as required in the form of common equity shares, even if this requires greater public ownership. While it cannot be ruled out, nationalisation would carry significant costs and risks, and should only be undertaken with the utmost reluctance. Any form of public ownership of banks should be temporary and transparent.

Financial regulation and supervision

The main policy actions to strengthen financial regulation need to be taken at European and international level through the implementation of such initiatives as the ECOFIN Financial Turmoil and Financial Stability Roadmaps. In addition, some measures can be taken at national level:

- Introduce a special resolution and bankruptcy mechanism for banks so that the authorities have the legal powers to implement the full range of options in dealing with failing financial institutions if this were to become necessary. Explicit quantitative thresholds, such as high loan growth or exposure to particularly sectors, should feed into the triggering of this procedure in line with practice in some other countries.
- Banks should be more tightly regulated and supervised, together with other financial institutions. Banking supervision should be made more effective by increasing the resources and capacity to monitor major institutions, and developing an enhanced understanding of overall developments in the credit market and comparative performance of different institutions. The quality of financial and macroprudential analysis should be enhanced. The emphasis should be increased on a rules-based approach, including quantitative limits on overall bank leverage and balance sheet growth.
- Banks should be required to hold more capital against risks in line with developments in international financial regulation.
- The regulation of funding should be kept under review in the light of market developments and evolution in international best practice.
- The Deposit Guarantee Scheme should be strengthened further by reducing the payout time, both in law and operationally. After a transitional period, the fee should be raised in line with the increase in protection and any revision to the risk of claims. Consideration should be given to making funding risk-based.

Macroprudential policy

- The Central Bank should be given a more explicit macroprudential mandate. The Financial Stability Report should continue to be published annually.
- The development of more effective macroprudential instruments should be considered. These could include an overall leverage ratio, covering all assets, and either dynamic provisioning or counter-cyclical capital requirements. A rules-based numerical framework may be helpful in avoiding forbearance.

Box 1.4. **Summary recommendations to restore macroeconomic stability** *(cont.)*

Housing

- Reduce the bias towards home ownership in the tax system, by continuing to phase out mortgage-interest tax relief, and by introducing a property or capital gains tax on owner-occupied housing. Tax relief could be limited immediately for new buyers. A property tax could help to fund local infrastructure and services.
- Social housing policy should become less reliant on direct provision of publicly-owned housing. Assistance should provided to a greater extent through schemes such as the Rental Accommodation Scheme (RAS), which make use of good standard private rental housing to meet long-term housing assistance needs.

Notes

1. See Department of the Environment, Heritage and Local Government Housing Statistics, online.
2. See Box: "Measuring House Prices in Ireland" (Barrett *et al.*, 2009) for further details about house price measures in Ireland.
3. The analysis in this section largely relates to this set of retail clearing banks and other institutions with primarily domestic business. The data on these institutions includes intra-group lending, It also includes the assets of some foreign-owned banks, including one very large international institution with limited domestic business. This group does not include the building societies.
4. The approach of other countries in this regard is reviewed in Box 1.6: "Dealing with impaired assets across the OECD" of *OECD Economic Outlook 86* (OECD, 2009b). This helps to put the NAMA scheme in context, although solutions are likely to vary across countries according to the situation.
5. See Box 7.1: "Tax breaks for housing and policy flip-flops" (OECD, 2006).
6. Each adult was allowed to contribute up € 3 048 over the following year with the government topping this amount up by 25% and the accounts being closed after 5 years.
7. See Box 2.1: "Reforming taxation of housing" (OECD, 2008).

Bibliography

Ahrend, R., B. Cournède and R. Price (2008), "Monetary Policy, Market Excesses and Financial Turmoil", *OECD Economics Department Working Papers*, No. 597, OECD, Paris.

Barrett *et al.*, (2009), *ESRI Quarterly Economic Commentary*, Spring 2009, The Economic and Social Research Institute, Dublin.

Beffy, P.O., P. Olivaud, P. Richardson and F. Sedillot (2006), "New OECD Methods for Supply-Side and Medium-Term Assessments: A Capital Services Approach", OECD Economics Department Working Papers, No. 482, OECD, Paris.

Bernanke, B. and S. Gilchrist (1995), "Inside the Black Box: The Credit Channel of Monetary Policy Transmission", *Journal of Economic Perspectives*, Vol. 9 (Fall), pp. 27-48.

Boone, L., F. Mikol and P. van den Noord (2004), "Wealth Effects on Money Demand in the Euro Area", *OECD Economics Department Working Papers*, No. 411.

Catte, P. *et al.* (2004), "Housing Markets, Wealth and the Business Cycle", *OECD Economics Department Working Papers, No.* 394, OECD, Paris.

Central Bank and Financial Services Authority of Ireland (CBFSAI) (2007), *Financial Stability Report 2007*, Dublin.

Gianella, C., I. Koske, E. Rusticelli and O. Chatal (2008), "What Drives the NAIRU? Evidence from a Panel of OECD Countries", *OECD Economics Department Working Papers, No.* 649.

Duffy, D. (2009), "Negative Equity in the Irish Housing Market", *ESRI Working Paper, No.* 391, October.

Guichard, S., D. Haugh and D. Turner (2009), “Quantifying the Effect of Financial Conditions in the Euro Area, Japan, United Kingdom and the United States”, *OECD Economics Department Working Papers*, No. 677, OECD, Paris.

Fitz Gerald, *J. et al.* (2008), *ESRI Medium Term Review 2008-15*, The Economic and Social Research Institute, Dublin.

Haugh, D., P. Ollivaud and D. Turner (2009), “The Macroeconomic Consequences of Banking Crises in OECD Countries”, *OECD Economics Department Working Papers*, No. 683.

Hayashi, F. and E. Prescott (2002). “The 1990s in Japan: A Lost Decade”, *Review of Economic Dynamics*, Vol. 5(1), pp. 206-235, January.

IMF (2009), *Staff Report for the Article IV Consultation: Ireland*, May, Washington.

Laudes, R. (2005), “The Phillips Curve and Long-Term Unemployment”, *ECB Working Paper*, No. 441, February.

OECD (2002), *Financial Market Trends*, No. 82, June 2002, OECD, Paris.

OECD (2006), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2009a), *Pensions at a Glance*, OECD, Paris.

OECD (2009b), *OECD Economic Outlook*, No. 85, OECD, Paris.

OECD (2009c), *Finance, Competition and Governance: Strategies to Phase Out Emergency Measures*, OECD, Paris.

OECD (2009d), *OECD Economic Surveys: Euro Area*, OECD, Paris.

PWC (2009), *Project Atlas – Anglo Irish Bank Corporation plc: Summary Report Extracts*, PriceWaterhouseCoopers, 20 February.

Reinhart, C. and K. Rogoff (2009), “The Aftermath of Financial Crises”, *NBER Working Paper No. 14656*.

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

© OECD 2009

Chapter 2

Rebuilding the public finances

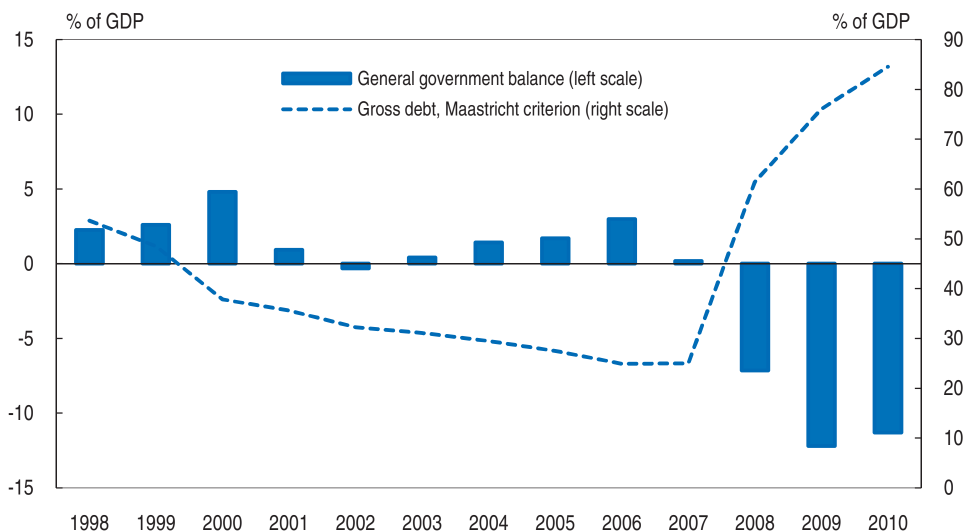
The fiscal consolidation challenge for Ireland is severe, the underlying budget balance having moved abruptly from surplus to a large deficit. Consolidation has already begun to repair the deterioration in the public finances via a series of emergency budget interventions amounting to close to 5% of GDP in 2009, but the adjustment process will last several years. Debt levels have risen very substantially from initially low levels. Restoring the budget to a sustainable path will require both increases in revenues and cuts in public expenditure. On the tax side, this involves correcting structural deficiencies that built up as revenues became over-dependent on buoyant house prices and construction, which have collapsed, while the revenue-raising capacity of the income tax base became severely impaired. The Commission on Taxation has recently reported on proposals for tax reform. On the expenditure side, many public programmes over-expanded in the boom and have to be brought into balance with reduced resources. An independent report commissioned by the government has identified a wide range of cuts in expenditure and staffing. Cushioning the effect of public spending cuts on service provision will require greatly enhanced efficiency. Since weaknesses in the budget process have been partly to blame for the current crisis, the consolidation process will also require the establishment of stronger budgetary planning and control mechanisms, which identify and pursue long-run fiscal objectives in a consistent and sustainable way.

Fiscal conditions have deteriorated abruptly

Soaring deficits have led to emergency consolidation measures

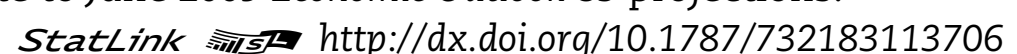
The fiscal position has deteriorated abruptly (Figure 2.1): from near budget balance in 2007, the deficit reached 7.3% of GDP in 2008 and the OECD projects a further increase to 12.2% of GDP in 2009. Spending has surged while revenues have collapsed (Figure 2.2). In value terms, government expenditure will have risen significantly between 2007 and 2009, of which higher unemployment-related transfer payments account for around half. The expenditure/GDP ratio will rise by around 9 percentage points. Meanwhile, the ratio of receipts to GDP will fall sharply, despite a series of tax increases.

Figure 2.1. **The fiscal position has deteriorated sharply**[1]



1. The balance includes additional fiscal measures outlined by the authorities for 2010 in the April 2009 Supplementary Budget.

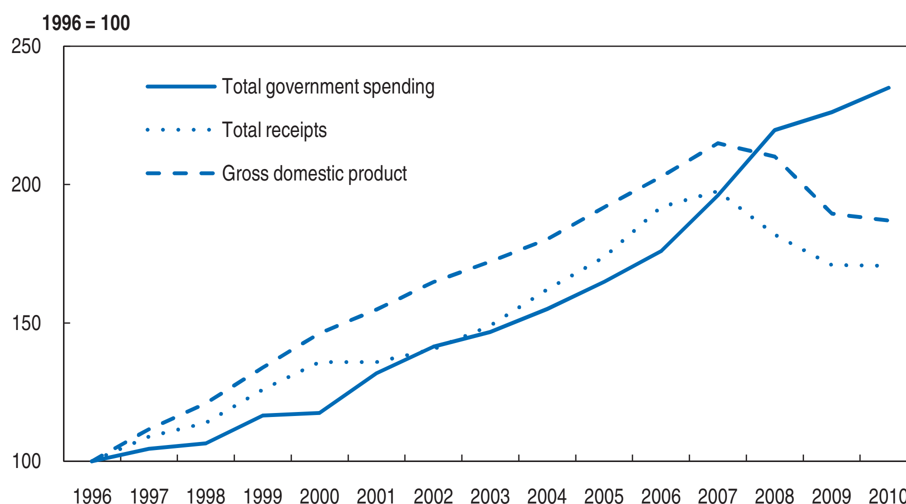
Source: *OECD Economic Outlook Database* and provisional update to June 2009 *Economic Outlook* 85 projections.

 http://dx.doi.org/10.1787/732183113706

Additional policy measures were taken in July 2008 to reduce spending. The Budget for 2009 was then brought forward to October 2008 to raise almost € 2 billion in a full year (1% of GDP) in additional taxation. An income levy was introduced and new taxes imposed on items such as second homes, airline passengers and car parking.[1] The VAT rate was increased by 0.5 percentage points. As the scale of the revenue collapse emerged, further rounds of austerity measures were introduced:

- In February 2009, budget savings of € 2 billion in a full year were announced, including the introduction of the Pension Levy, a pension-related pay deduction averaging 7% for public servants. Postponing the next rounds of the national pay agreement secured savings of up to € 1 billion relative to the 2010 baseline.

Figure 2.2. **Revenue and spending have become misaligned**



Source: OECD (2009), *Economic Outlook 85 Database.*

StatLink http://dx.doi.org/10.1787/732233446762

- The Supplementary Budget in early April 2009 introduced measures to claw back a further € 5 billion (3% of GDP) full-year slippage in the budget deficit compared to that projected in January. Additional revenues focused on changes in the Income Levy, the Health Levy and Pay-Related Social Insurance (PRSI) contribution arrangements, supplemented with current and capital expenditure cuts.

These actions steadied the fiscal position in the face of a rapid economic deterioration: the April 2009 budget deficit projection for the current year was virtually the same as the January baseline (Table 2.1).

Table 2.1. **Budget deterioration and discretionary action**

General government balance, %GDP

	2007	2008	2009	2010	2011	2012	2013
2009 Budget projection (October 2008)	0.2	–5.5	–6.5	–4.7	–2.9		
January 2009 baseline projection		–6.3	–10.8	–12.5	–12.3	–12.3	–11.3
Discretionary cuts, February 2009			1.0	1.0	1.0	1.0	1.0
April 2009 baseline projection		–7.1	–12.7	–16.2	–16.6	–13.8	–11.3
April supplementary budget cuts			1.9	3.0	3.0	3.0	3.0
Supplementary budget projection (April 2009) with only legislated measures	0.2	–7.1	–10.7	–13.2	–13.6	–10.8	–8.3
Future planned adjustments							
2010 adjustment				2.4	2.7	2.8	2.8
2011 adjustment					2.3	2.5	2.5
2012 adjustment						2.2	2.2
2013 adjustment							1.5
Supplementary budget projection (April 2009) with all planned adjustments	0.2	–7.3	–10.7	–10.8	–8.6	–5.6	–3.0

Source: Ireland – Stability Programme Update, October 2008; Addendum to the Irish Stability Programme Update, January 2009; and *Macroeconomic and Financial Framework*, April 2009.

The underlying budget deficit has increased markedly

The deterioration in the budget deficit has been largely structural. The underlying fiscal balance is anticipated to have undergone a shift of close to 10 percentage points between 2006 and 2010 using the standard OECD methodology, although this may overstate the scale of the structural decline as the cyclical fall in revenues has been particularly sharp. Nevertheless, underlying revenues have deteriorated despite tax raising measures already put in place and expenditure has increased, even allowing for higher unemployment-related costs and debt-servicing.

Budget cuts have left some counter-cyclical stimulus in place…

The discretionary action already taken so far amounts to a cumulative budget consolidation of around 5% of GDP by 2010. This stands out internationally as a response to the recession as most other OECD countries have undertaken discretionary fiscal stimulus packages, albeit on a small scale in many cases (Figure 2.3). However, the discretionary fiscal tightening is smaller than the overall increase in the budget deficit, which means that the government sector is contributing to cushioning the impact of the economic slowdown on activity: less spending power is being taken out of the economy than is being put in. It is necessary that a balance be struck in this way between the imperative to consolidate the budgetary position and not exerting an excessively negative impact on economic activity in the short run.

… but further major consolidation is unavoidable

Consolidation measures of close to € 5 billion have been set out for each year of 2010 and 2011, equivalent to nearly 3% of annual GDP. Together with an assumed relatively strong economic recovery and additional measures in later years, official projections from the 2009 Supplementary Budget show the fiscal deficit falling to 3% of GDP by 2013. The overall amount of consolidation that is envisaged stands out in OECD experience and is almost unprecedented: most fiscal consolidation episodes are quite short and smaller.[2] The consolidation of the late 1980s in Ireland may be most instructive about the feasibility of the effort involved. Between 1986 and 1990, the structural deficit was reduced by 8 percentage points of GDP, a pace of consolidation which exceeded initial plans.[3] But, while the early stages of deficit reduction were mainly due to a substantial discretionary tightening through restraint on current spending, it was ultimately greatly assisted by rapid economic growth and falling interest rates. These developments created favourable debt dynamics but are unlikely to be repeated in the current situation. For consolidation to be durable and transparent, it is important to avoid relying on fiscal one-offs and other changes primarily of an accounting nature (Koen and Van den Noord, 2005). The Irish authorities have largely avoided this to date. While the state has assumed the assets of the pension funds of certain semi-state bodies, the impact on the fiscal balance was ultimately small and the state needed in any event to clarify its position with regard to how these funds would be organised, managed and funded in the future.

Debt dynamics are unsustainable without further budget adjustment

Ireland appeared to be in an internationally favourable position with a gross debt-to-GDP ratio of 25% in 2007 (Figure 2.4),[4] which might have given some fiscal flexibility. Modest primary surpluses with budget deficits averaging 1% of GDP were sufficient to keep the gross debt ratio on a gradual downward trend over the 2003 to 2007 period because of low

Figure 2.3. **Discretionary, cyclical and underlying influences on fiscal stance**

Decomposition of cumulative changes in government balance, 2009-10[1]

% of 2008 GDP

Cyclical | Fiscal package | Other[2] | Cumulative change in deficit

ISL HUN ITA CHE POL CZE PRT FRA BEL IRL AUT DEU USA JPN ESP CAN LUX AUS FIN SWE NLD DNK NZL GBR

Decomposition of the 2010 gross government debt

% of 2008 GDP

2008 debt | Cumulative deficit | Additional factors affecting debt[3]

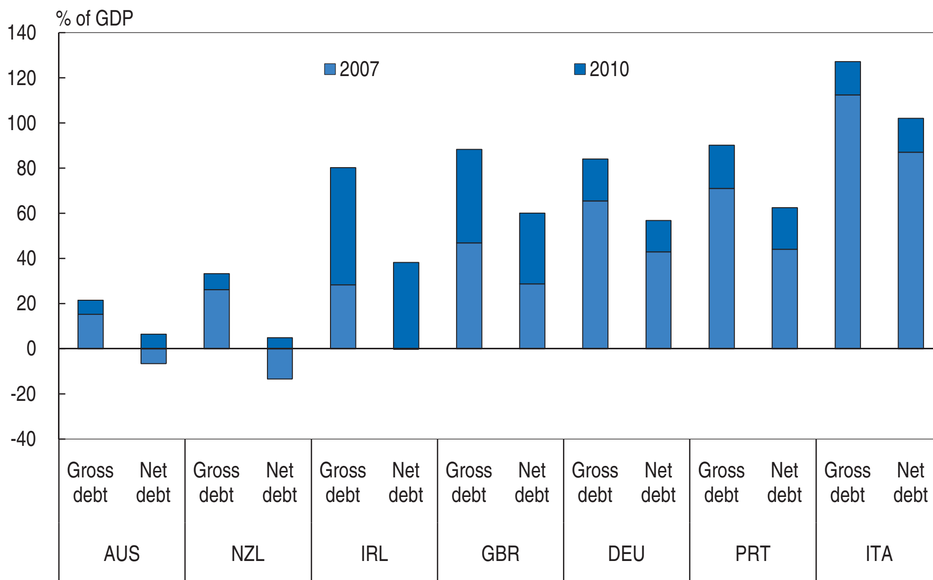
LUX AUS NZL CZE CHE FIN DNK SWE ESP POL IRL NLD AUT DEU CAN HUN PRT GBR FRA USA BEL ISL ITA JPN

1. Sum of 2009 and 2010 deviations from 2008 levels of government balances.
2. Cumulative changes in deficit *minus* the sum of the fiscal package and the cyclical components. This captures effects such as discretionary fiscal policy measures other than those in response to the crisis and the disappearance of exceptional revenue buoyancy.
3. 2010 debt *minus* the sum of 2008 debt and the cumulative deficit for 2009-10. This includes debt-increasing equity participations in companies.

Source: OECD (2009), *Economic Outlook 85 Database*.

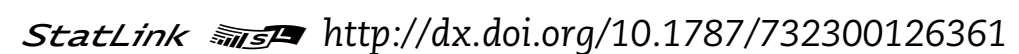
interest rates and strong growth. But, this position has since deteriorated rapidly. By 2008, the ratio had soared to 43% of GDP and will increase substantially further at a fast pace relative to other OECD countries and historical experience. OECD projections, based on legislated policies and incorporating future consolidation plans, show the gross debt ratio rising to over 75% of GDP by the end of 2010. This surge in debt has been the result of a dramatic deterioration in the primary budget balance, lower growth and higher interest rates. The fiscal consolidation actions already taken have contributed to containing the increase in debt and bringing the public finances under control. A further substantial step increase in gross debt is likely as a result of the financing of the National Asset Management Agency (NAMA), which is excluded from these projections, although there would be no impact in principle on net debt as the NAMA will be purchasing assets.

Figure 2.4. **Gross and net government debt**[1]



1. Gross debt based on OECD system of national accounts (SNA) definitions.

Source: *OECD Economic Outlook 85 Database.*


StatLink http://dx.doi.org/10.1787/732300126361

Government debt dynamics remain unstable and debt will increase while the primary balance is deeply in deficit. The gross debt ratio will continue to rise until 2012 under the Supplementary Budget projections, under the assumption that future fiscal plans are implemented, and would peak at 79% (excluding any future NAMA-related increases). This forecast and scheduled consolidation aims for the budget balance to reach 3% of GDP in 2013, implying a positive primary balance at that point. However, failure to deliver the schedule fiscal consolidation would lead to debt continuing to rise relative to income (Table 2.2). If little of the planned consolidation were to take place, the debt ratio would rise at a considerable pace.

Table 2.2. **Dealing with adverse debt dynamics**

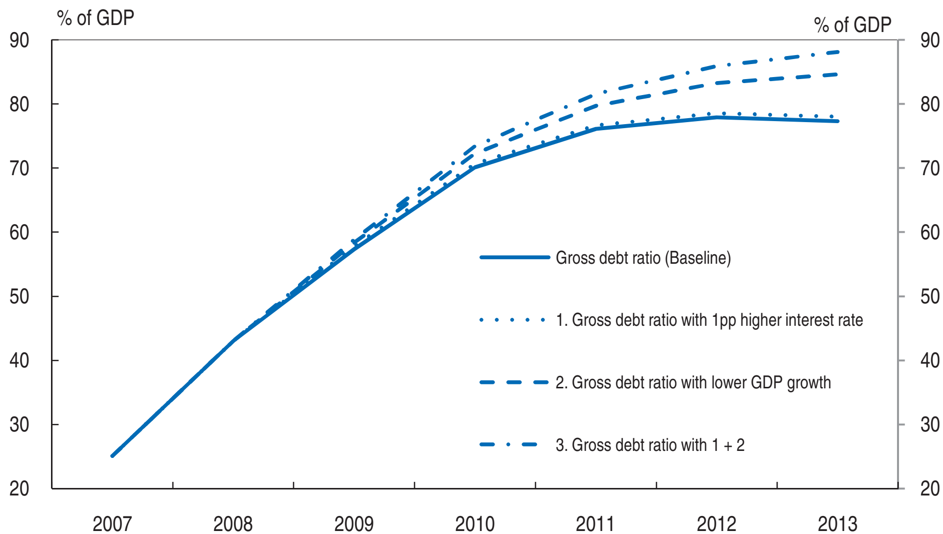
% of GDP

	2008	2009	2010	2011	2012	2013
Gross debt trajectory without further consolidation	43	59	72	85	98	112
Gross debt trajectory with full implementation of consolidation plans	43	59	73	78	79	77

Source: Department of Finance, *Macroeconomic and Fiscal Framework*, April 2009, and OECD calculations.

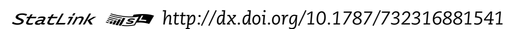
This level of debt, contingent on the envisaged severe fiscal consolidation, would be manageable, comparing with the euro area aggregate ratio which is projected to rise to over 80% of GDP by 2010. However, Ireland's long-term fiscal position will have been transformed compared with recent years and, as a small economy, the vulnerability to adverse interest rate movements would be fairly high with such a level of debt. Furthermore, this projection is sensitive to a number of key assumptions: simulations with a somewhat less benign scenario, where growth falls by 1 percentage point and the average interest paid on debt increases by the same amount, would push up the debt ratio and require a substantial additional budgetary correction beyond current plans (Figure 2.5). Moreover, such simulations are static in nature and failure to stabilise debt might in itself

Figure 2.5. **Debt sensitivity to growth, interest rate and primary balance assumptions**



1. Stylised model of debt dynamics for Ireland to illustrate risks around a debt path. These projections should not be interpreted as forecasts.

Source: OECD calculations.


StatLink http://dx.doi.org/10.1787/732316881541

raise interest rates. Since market confidence depends on the credibility of future consolidation, it is important that the measures by which the structural deficits will be reduced have been articulated for 2010 and 2011 with some detail and that further guidance is provided in due course about plans further into the future.

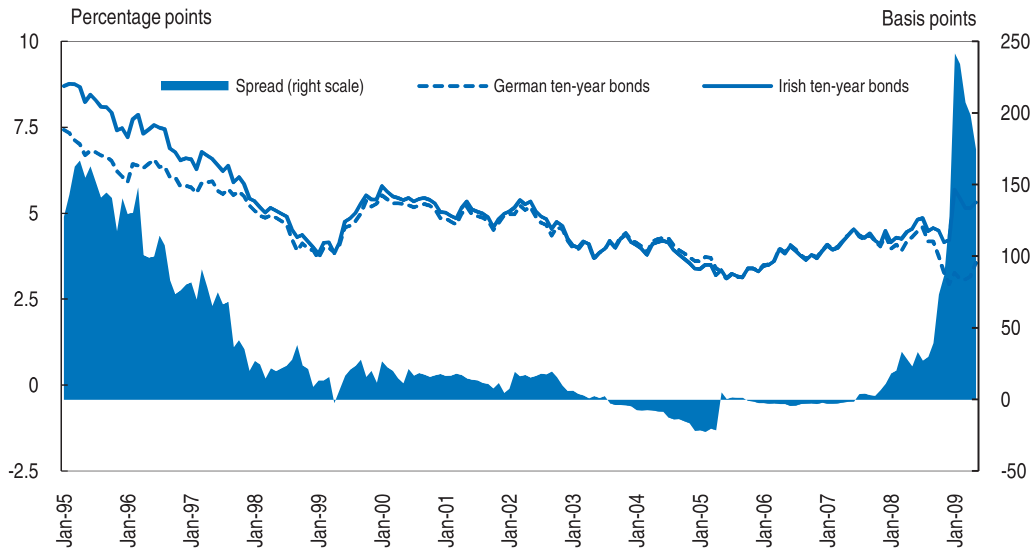
Spreads on Irish government bonds, relative to German yields, have risen. Having increased to over 250 basis points earlier in the year, the spread is around 140 basis points, giving a bond yield of close to 4.6% (Figure 2.6). The increase in spreads *vis-à-vis* German bonds was a euro area-wide phenomenon due to a flight to quality, increased concerns about liquidity and a reassessment of risks that led to renewed differentiation between sovereign debt of euro area countries. However, the deteriorating fiscal position and the risks associated with supporting the bank system contributed to further raising spreads in Ireland. Econometric evidence based on the experience of different countries suggests that the debt-service ratio has a non-linear effect on spreads and is amplified by the general degree of risk-aversion, although Ireland's good fiscal performance in the past would help to mitigate this effect (OECD, 2009a). High expected future deficits are an important part in explaining the increase in spreads for Ireland, although the banking crisis has played a significant role and changes in spreads have often occurred at the same time as events relating to the banking system, such as the nationalisation of Anglo Irish Bank or the announcement of the creation of the NAMA.

Supporting the banking system increases the size of the government balance sheet

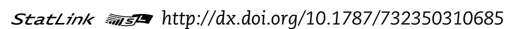
Support for the banking system, described in Chapter 1, has a number of effects on the public finances; the precise impact on public debt and government liabilities is currently unclear and is not included in the above analysis of the future path of debt. The very large guarantees given to the banking system are off-balance sheet items, although they are likely to be reflected already in higher interest-rate spreads. The nationalised Anglo Irish

Figure 2.6. **Ten-year government bond spreads compared to Germany**

Last observation September 2009



Source: Datastream.


StatLink http://dx.doi.org/10.1787/732350310685

Bank is not part of the general government balance sheet as it is currently classified as a commercial semi-state company. However, its balance sheet is large and of comparable size to the outstanding stock of public debt. There could be an impact on the general government finances if it is judged that the state should pay the equity holders for some of their capital stake. The recapitalisation of Allied Irish Banks and Bank of Ireland plc was financed through the National Pension Reserve Fund (NPRF) with the government bringing forward payments from future years to assist this and changing the NPRF's investment rules. While this has no immediate impact on the public finances, as these payments were due to be made in any case, it may change the asset side depending on the return on these investments. The National Asset Management Agency (NAMA) will have a large direct impact on gross public debt, depending on exactly how to the price paid to purchase assets from the banks. Estimates suggest that the price paid is anticipated to be around € 54 billion, just over 30% of GDP. The impact on net debt should in principle be limited as the funds are being raised to purchase assets and, as discussed in Chapter 1, there are elements of risk-sharing to protect the tax payer. As the assets are being purchased using public debt, these bonds will necessarily find buyers, although there may be a broader impact on the debt market. The government should publish clear and regular statements of both on- and off-balance sheet assets and liabilities related to the financial crisis in line with the best practice from other countries.

Pre-funding age-related spending has become more difficult

Despite the very large consolidation planned up to 2013, debt levels will remain at a high level and an on-going primary surplus greater than 1% of GDP will be needed to get gross debt below 60%, even before taking account of NAMA-related increases in debt. Restoring flexibility in the face of future possible shocks requires a relatively low debt target and a more substantial primary surplus. Moreover, the longer-run consolidation path will begin to be affected by increasing spending pressures related to ageing. Prior to

the crisis, Ireland's very low net debt position gave some room for manoeuvre in the face of such long-term challenges but this is no longer the case.

Through the National Pension Reserve Fund (NPRF), the government has substantial assets built up against future ageing pressures and it continues to pay 1% of GNP into the fund each year. Some resources have been used for bank recapitalisation: in March and May 2009, the NPRF invested a total of € 7 billion to recapitalise Bank of Ireland and Allied Irish Banks, which was funded by € 4 billion from the Fund's existing resources and by € 3 billion from a frontloading of the Exchequer contributions for 2009 and 2010. As a long-term fund, the NPRF has significant investments in equities and other real assets with three quarters invested in such assets at end 2007, relatively high share by international standards. As a result of declining market valuations, the NPRF experienced an investment return of –30% in 2008, reducing its annualised return since inception in 2001 to 0.5% compared with 6.1% at end 2007 (NPRF, 2008). The NPRF is currently valued at over € 20 billion. There may be a case for temporarily suspending payments into the fund after 2011 because of the need to reduce gross debt. However, the underlying ageing problems remain and are even more binding given the overall increase in debt. The NPRF has been a successful institution in increasing government saving to meet future needs, above what it is likely to have been otherwise the case, and it is important that it is retained. It was originally envisaged that the NPRF would cover around one-third of the projected increase in pension costs over the period 2025 to 2050. Public spending on pensions is now set to rise by about 6 percentage points of GDP by 2060, largely as a result of an ageing population (Table 2.3). Some pre-funding is desirable from an inter-generational equity and tax-smoothing viewpoint. However, the strategy of using public sector leverage, relying on high-return equities and other risky assets to meet ageing costs, now appears more difficult to achieve in the light of falls in equity values. Measures to reform the pension system discussed in the previous *Survey* will need to play a larger and more urgent role in addressing long-term pressures (OECD, 2008).

Table 2.3. **Long-term public pension projections**

% GDP

	Share 2007	Change in share					Share 2060
		2007-20	2020-30	2030-40	2040-50	2007-60	
Ireland	5.2	1.4	1.2	1.2	1.7	6.1	11.3
United Kingdom	6.6	0.3	0.0	1.2	1.2	2.7	9.3
EU15	10.2	0.4	0.9	0.2	0.1	2.4	12.5
Of which: Public service occupational pensions for Ireland							
	1.2	0.8	0.4	0.2	0.1	1.5	2.7

Source: Commission services, EPC (2009).

Revenues need to be raised and the tax system reformed

The collapse in revenues since late 2007 in part reflects fundamental weaknesses in the tax structure, including an excessive reliance on revenues related to the value of property transactions. Such revenues fell dramatically and will only partly be restored as the economy recovers. Other more conventional tax revenues also fell as the economic activity contracted. Although these revenues can be expected to recover as the recovery takes hold, the revenue-raising capacity of some of these more stable traditional tax bases had also become inadequate in recent years. Since the Budget for 2008, a number of substantial revenue

raising measures has already been implemented, principally in the form of levies rather than changes in existing taxes. Such levies are effective. But there is a need to consider these levies in the context of more lasting adjustments to the tax system. Some of the measures undertaken, including limiting tax relief on mortgages and changes to capital gains tax, go in this direction of rebuilding the tax base in a durable way.[5] The impact of higher taxes on potential growth and competitiveness is an important constraint. International evidence shows that some taxes are less damaging to growth than taxes on more mobile or sensitive bases such as capital and labour income (OECD, 2008); residential property taxes being perhaps the most effective. Equally, the tax system itself can be further reformed to remove growth-limiting distortions, where the tax system departs from principles of neutrality and efficiency because of poorly-designed exemptions and incentives. The issues have been considered recently in Ireland by the Commission on Taxation (Box 2.1).

Box 2.1. **The Commission on Taxation**

The report of the Commission on Taxation was published on 7 September 2009. This provides a wide-ranging agenda for reforms to the tax system to provide the appropriate system for the medium-term. The main recommendations are (Commission on Taxation, 2009):

- Personal income tax: there should be a single system to collect tax on income, a three-rate income tax structure has merit but this needs to have regard to keeping taxation on labour low and marginal rates competitive. The general aim should be to continue to exempt the minimum wage from income tax.
- PRSI (Pay Related Social Insurance) contributions: there should be a separate comprehensive review of the system and these should be better integrated with the income tax system. The Health and Income Levies should be integrated into the income tax system.
- A residential property should be introduced as soon as is feasible based on an assessment of actual property values.
- 245 tax relieving measures were considered: 115 were identified as tax expenditures and each was evaluated. 25 were recommended for abolition, approximately 40 to be retained unchanged with the remainder to be reviewed or otherwise modified. Social welfare payments should be taxed in many cases (such as Child Benefit) but not all. Mortgage interest relief should continue for first-time buyers only. Some other property-related reliefs should be eliminated. Health-related reliefs should be reduced overall.
- A carbon tax should be introduced at a rate set in line with price of carbon in the ETS for sources outside the trading scheme.
- Tax relief for private pensions should be replaced with matching contributions in the medium term and a “soft mandatory” approach considered.

The tax base has been over-reliant on housing-related revenues

Revenues from capital taxes and the overall proportion that they represented of overall taxation yields rose over the 2000-06 period (Table 2.4). The rise in property prices, together with the high level of activity in the property market, was responsible for a large increase in the share of stamp duties in tax revenues and capital gains tax receipts also increased significantly.[6] The net impact was to push the elasticity of tax receipts with respect to GDP from a more normal 1.1 into a range of 1.5 to 2.[7]

Table 2.4. **Breakdown of tax revenues**

Share of tax revenue, per cent

	2000	2006	2010
Income tax	33.5	27.2	36.1
Corporation Tax	14.3	14.7	11.4
Taxes on capital	7.6	15.6	5.6
Of which: Stamp duty	4.0	8.0	2.9
VAT	27.5	29.5	32.9
Excises and other	17.1	13.0	14.0
Total taxes as share of GDP	26.4	25.9	22.4
Income tax as share of GDP	8.9	7.0	7.7

Source: 2000 and 2006 Revenue Commissioners, *Statistical Reports*; Department of Finance, *Macroeconomic and Fiscal Framework*, 2009-13 (April 2009); and OECD calculations.

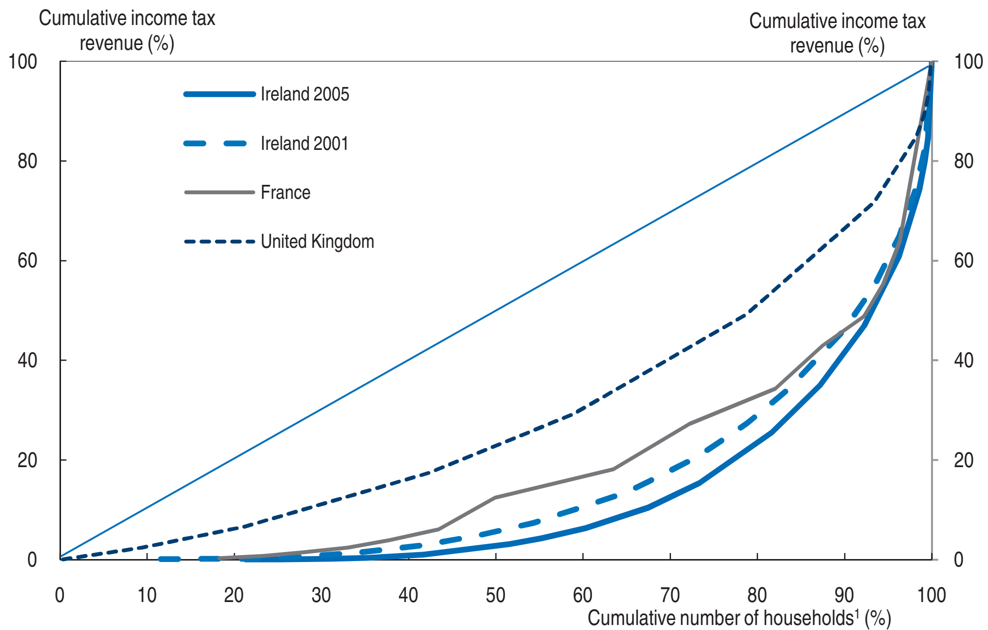
The collapse in revenues from these previously buoyant tax bases is the major factor behind the precipitous decline in the aggregate tax/GDP ratio. The largest proportional falls have been for capital taxes, with receipts from capital gains tax and stamp duties particularly affected. Corporation tax receipts have also fallen significantly. Boosted by the introduction of the Income Levy in the 2009 Budget, income taxes have risen substantially as a proportion of total tax revenue. They have also risen somewhat as a proportion of GDP, but remain over a percentage point lower than in 2000.

The income tax base should be broadened if tax rates are not to rise further

The buoyancy of capital taxes during the first half of the decade helped to create the conditions where income tax was cut. Fundamental changes were made to the income tax system, including the introduction of tax credits and partial individualisation. Personal allowances were increased much more rapidly than inflation, reducing the number of people in the tax net: two out of five of workers paid no income tax in 2008 and a family with two children on the average industrial wage was a net beneficiary of the state when child benefit is counted. Policy was designed so that workers on the minimum wage would not pay income tax. The result is that just under half of all income tax in 2008 was paid by the top 7% of income earners, those with earnings above € 100 000 a year (Figure 2.7). The introduction of the Income Levy, which has a simpler structure that applies to all labour income and applies from a minimum threshold of € 15 028 per year (well below half average wages), begins to address this problem.

The cost of tax allowances, reliefs and exemptions is high: the cost of tax expenditures grew to be larger than income tax receipts (Table 2.5). Tax expenditures in the income tax system are far higher in Ireland than the EU average (CTPA, 2009). These cover *inter alia* medical premiums, pension contributions, interest payments, numerous social schemes, and saving and investment. The Commission on Taxation has now carried out an evaluation of whether these reliefs are effective at achieving sensible economic objectives, building on a narrower review undertaken in 2006 of property-based and area-based tax schemes, together with certain other schemes (Department of Finance, 2006). The 2006 review led to the elimination of a number of tax expenditures. In addition, a restriction on the use of a range of tax reliefs was introduced from the 2007 tax year, which aimed to achieve a minimum average effective rate of tax of 20% for taxpayers with adjusted income from € 500 000 and able to claim significant amounts of tax relief, with these restrictions applying

Figure 2.7. **Distribution of income tax payment by income**



1. Ranked from lowest to highest income brackets.

Source: National statistical offices.

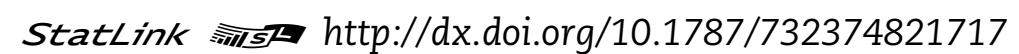
StatLink  http://dx.doi.org/10.1787/732374821717

Table 2.5. **Costs of tax credits, allowances and reliefs against personal income tax**

Type of allowance	2000/01[1]		2005		% change 2000-05	2009 € billion	% change 2005-09
	€ billion	% of total	€ billion	% of total			
Personal allowances/credits	3.17	47.1	6.57	53.8	107	9.18	40
Age credit and exemption	0.04		0.08	0.7	103	0.10	16
Medical insurance premiums and health expenses	0.13	1.9	0.37	3.0	180		
Pension contributions	2.62	38.4	2.46	20.1	*Nc*[1]		
Interest relief	0.23	3.4	0.35	2.9	51		
Of which: On principal residence	0.20	2.8	0.28	2.3	40	0.54	95
Social schemes	0.56	8.2	0.98	8.0	74		
Of which: Rent in paid private tenancies	0.02	0.3	0.05	0.4			
Third level education fees	0.00	0.1	0.01	0.1			
Exemption of child benefit	0.15	2.1	0.37	3.0			
Trade union subscriptions	0.00	0.0	0.01	0.1			
Saving and investment schemes	0.06	0.9	0.69	5.6	963		963
Total income-tax expenditures	6.81		11.49		69		69
Income tax receipts	9.12		11.34		24		
Tax expenditures as % of GDP	6.62		7.17				
Income Tax as % of GDP	8.87		7.07				
International comparison: ***Tax expenditures excluding personal credits as % of total tax revenues***							
Ireland				**18.3**			
EU[2]				**5.6**			

1. Non-comparable as classification of type of allowance is different.
2. Average of 22 countries reporting excluding Ireland.

Source: Revenue Statistics and Tax Expenditures and base broadening, CTPA/CFA/WP2(2009)5, 11 May 2009.

to an increasing degree for those with adjusted income from € 250 000. However, tax expenditures remain a target for reforms aimed at raising revenue and enhancing the efficiency of the tax system. While personal allowances take the lowest earners out of the income tax system, the distributional nature of the other reliefs goes against progressivity as they only affect those who pay tax and benefit the highest earners the most. Fiscal consolidation should include a rationalisation and reduction of tax expenditures to restore the income tax to full functionality. Where it remains, deductibility should generally be limited to the standard rather than the marginal rate and the overall amount of relief available should be capped. In addition to the vast array of allowances and exemptions, the definition of gross income for tax purposes leaves several sources of income out of the tax net altogether, including state benefits. A broadening of the income tax base, via lower tax thresholds and the removal of often ineffective and distorting reliefs, offers the opportunity for revenue gains, greater neutrality in respect of incentives and resource allocation and enhanced equity. Base broadening is essential if tax rates are not to be pushed up substantially further. The Supplementary Budget took a number of steps in this direction and the governmental signalled its intention to do more.

Tax relief given against private pension contributions is a very significant tax expenditure. As noted in the 2008 *Survey*, many pensions are unlikely to be fully taxed at any point in the life cycle.[8] But the current system of tax incentives does not provide an effective way of achieving adequate private provision, despite the generous level of support. They tend to act to divert funds from other investment, rather than to increase overall pension saving, as they are poorly targeted at marginal savers. The system performs badly in terms of equality since 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 than for those paying the standard rate. The overall level of tax subsidy for pension savings is projected to rise very sharply as the population ages and people build up retirement savings. Indeed, Ireland is projected to have the largest share of income committed to these schemes in 2050 of any OECD country. 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, favourable taxation for the old redistributes between the old and young, which will become more costly as the dependency ratio rises.

The bias in taxation favouring property and especially home ownership has been a significant problem. As argued in Chapter 1, mortgage interest relief without any form of property tax has distorted the housing market and contributed to the amplitude of the housing cycle, as well as making houses more expensive. The least distortionary system for taxing housing and 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. Under such a system, mortgage and other costs relating to a house should be tax deductible. However, no OECD country applies this system. Removing the tax deductibility of mortgage interest is a more feasible option, but it has to be done gradually. A more comprehensive and consistent approach would include introducing a property tax, which would also make the tax system more neutral and make the tax base more stable. The Commission on Tax proposes a recurrent, annual, property tax (without proposing a specific rate) to be introduced as soon as is feasible (Commission on Taxation, 2009); illustrative calculations suggest that rates of 0.25% to 0.30% could raise

€ 1 billion to € 1.2 billion per year (once waivers to low-income households are taken into account). A key practical difficulty is assessing the value of properties but many countries overcome this, even if the market value of homes cannot always be tracked exactly.

Income levies by-pass the impaired revenue-raising capacity of the income tax as they cover almost all income earners and tax credits and reliefs do not apply.[9] A new Income Levy came into effect on 1 January 2009, payable on gross income, at a progressive rate of 1% to 3%. Income levies formed the centrepiece of the April Supplementary Budget with a doubling of the rates and a significant reduction of the thresholds. The Health Levy has doubled, the lower rate rising from 2% to 4% and the higher rate from 2.5% to 5%, and the PRSI contribution ceiling has been raised significantly. This growing reliance on levies is an important short-term expedient but cannot be the cornerstone of a rational system of taxation. Income levies should eventually be integrated into the income tax system as the tax base is broadened by bringing in more people into the income tax net. It would be appropriate at that point to consider the rate structure and a broader tax base could allow a lower standard rate of income tax.

The mobility of the corporation tax base limits its revenue-raising capacity

A low rate of corporation tax has been an important part of Ireland's ability to attract foreign investment. Since 2003, the standard rate of corporation tax has been 12.5%, which is the lowest headline rate in the OECD (Jones, 2008). The 10% rate on certain activities, including manufacturing, will cease to apply from 2010. The tax expenditures in this area are gradually being reduced in most areas (Table 2.6). The advantage enjoyed by Irish companies has been susceptible to erosion because of tax competition: the average statutory corporate tax rate has come down considerably in the rest of the European Union in recent years and several countries have announced further cuts. Since a low rate of corporation tax has played a special role in Ireland's economic development, preserving that advantage has been a major driver of tax policy and the government has announced that the corporation tax rate will be maintained at 12.5%, despite the steep fall in revenues which has occurred with the recession. This is a realistic approach, since the tax base is highly mobile across borders and tax revenues might decline if attempts were made to increase the rate, but this should be assessed carefully.[10]

Table 2.6. **Costs of tax allowances and reliefs against corporation tax**

Type of allowance[1]	2000/01		2005		% change 2000-05
	€ billion	% of total	€ billion	% of total	
Capital allowances	1.7	36.3	1.9	54.3	10
Effective rate of 10% on manufacturing	2.4	51.8	0.39	11.5	–84
Research and development		0.0	0.1	1.9	
Other reliefs	0.6	11.8	1.1	32.3	200
Total	4.7		3.5		–26
Corporation-tax expenditures as % of GDP	4.6		2.2		
Corporation tax receipts as % of GDP	3.8		3.4		
Tax expenditures as % of total tax revenues					
Ireland			**8.7**		
EU average[2]			1.2		

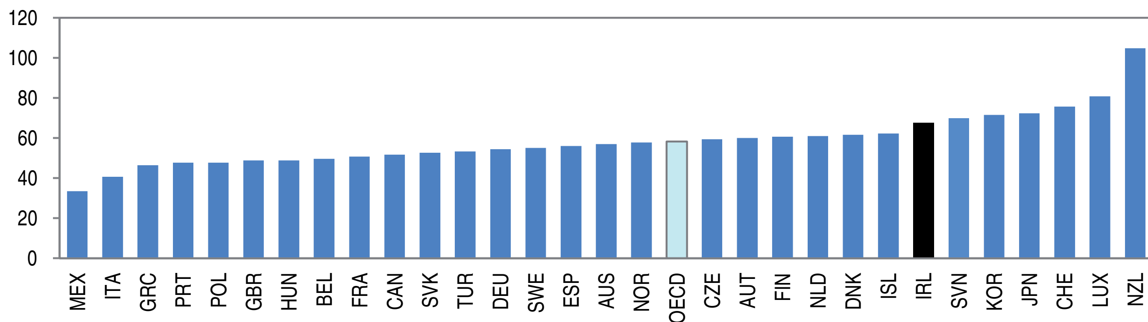
1. Categorisation is informal.
2. Average of countries reporting.

Source: Revenue Statistics and Tax Expenditures and base broadening, CTPA/CFA/WP2(2009)5, 11 May 2009.

The Value Added Tax rate is relatively high

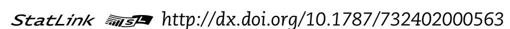
The VAT rate, increased to 21.5%, is relatively high by international comparison. The VAT base has few exemptions and rate variations: Ireland comes out relatively well, except by comparison with New Zealand, in terms of a measure of revenue efficiency based on the ratio of value of the effective VAT rate to the statutory rate (Figure 2.8). The opportunities for base-broadening are thus limited. The standard rate has been raised by 0.5 percentage points but the common border with the UK, which has temporarily reduced the VAT rate to 15%, offers the opportunity for consumers to make purchases outside the Republic. There is no strong case for general reform to the indirect tax system. Although there is a case in many countries to shift the burden to taxation towards consumption, these taxes are already high in Ireland and distributional concerns are important.

Figure 2.8. **Effectiveness of value added taxes as measured by the VAT Revenue Ratio,[1] 2005**



1. The VAT Revenue Ratio (VRR) is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. The calculation for Canada is for federal VAT only and the OECD aggregate is an unweighted average of data for the countries shown.

Source: OECD (2008), *Consumption Tax Trends* and Ministry of Finance.


StatLink http://dx.doi.org/10.1787/732402000563

Environmental taxes should be extended

Taxes on pollution and other negative externalities can raise economic efficiency, as well as revenues. Ireland is broadly in line with other OECD countries in reliance on environmental taxes, which account on average for about 6.5% of overall revenues. In Ireland, around 90% of this is aimed at motor vehicles and fuels. The Budget for 2008 contained measures to reduce pollution by linking carbon-dioxide emissions to Vehicle Registration Tax and capital allowances and expenses for business cars, in addition to linking motor tax rates to the level of emissions. The government is committed to introducing a carbon tax and the Commission on Taxation has proposed a carbon tax on fossil fuels. This tax would apply to sources outside the EU Emission Trading System (ETS) with the tax rate set in broad terms to approximate the ETS carbon price (Commission on Taxation, 2009). The expected potential tax revenue from a proposal of this type would be of the order of € 500 million per year (Tol *et al.*, 2008), while taxing other types of emission could raise additional income and have further environmental benefits although these would need to be considered in the light of international initiatives and assessed for their impact on competitiveness. Introduction of a carbon tax would reduce the pressure to raise other taxes, such as those on labour, which would be supportive of growth.

Reducing public spending and increasing efficiency

Resources and costs need to be cut

The structural shift in the budget deficit can be traced in major part to the strong and continuing rise in public spending. Spending cuts therefore need to bear a major part of consolidation. Decisions on what to cut should be made according to the marginal benefits of programmes. Those which over-expanded during the boom are obvious potential targets, although in practice redeploying resources once they are in place can be disruptive and resources that had little impact on output when they were added may be missed if taken away. A Special Group on Public Service Numbers and Expenditure Programmes, consisting mainly of outsiders but with a strong input from the Department of Finance, was set up to identify scope for spending cuts and reported in July 2009 (Box 2.2). This has identified and a wide range of measures, both specific spending cuts and more general improvements in public sector processes and efficiency. The need to make savings while maintaining the level of public services as far as possible, will require a greater focus on efficiency gains.

Box 2.2. **Report of the Special Group on Public Service Numbers and Expenditure Programmes**

The report of the Special Group on Public Service Numbers and Expenditure Programmes, known colloquially as "*An Bord Snip Nua*", was published in July 2009. The report identifies € 5.1 billion (in a full year) of proposed savings in current expenditure, many of which could be achieved very rapidly. This amounts to around an 8.2% overall reduction in gross spending and a total reduction in full-time equivalent staff of 17 000 (around 6% of the current number). The cuts proposed are greater than the € 3 billion of overall current expenditure reductions set out in the Supplementary Budget for 2010 and 2011 but less than one-third of the overall fiscal consolidation intended by 2013.

A large number of cuts are recommended within the programmes and costs of all government departments. These often relatively small measures combined together amount to a large total. The main savings identified are:

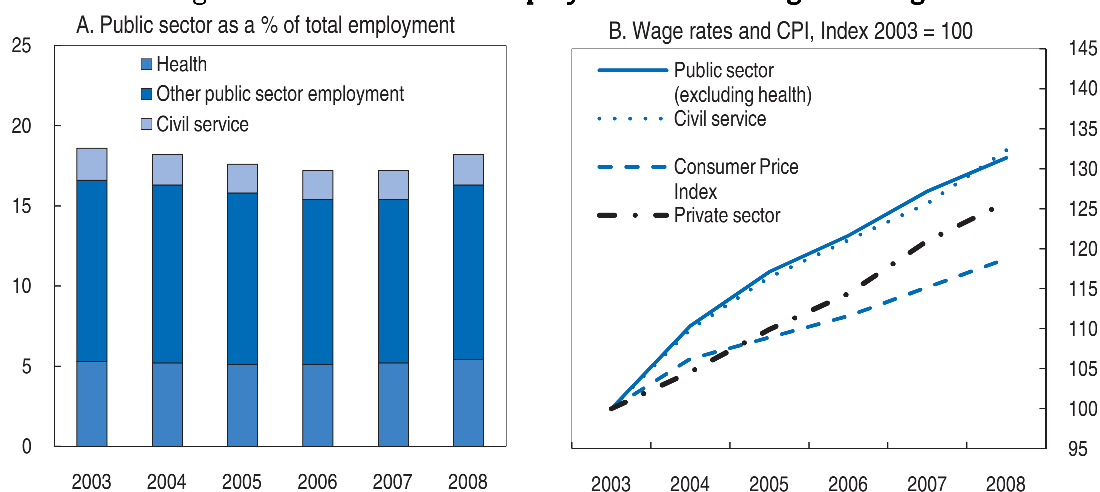
- A 5% reduction in all welfare rates (€ 850 million) and changes in benefits, including the reduction and standardisation of the Child Benefit rate, saving € 1.85 billion in the social welfare sector (–8.7%).
- Staff cuts of 6 930 across education sector and other cuts in services, saving € 736 million (–8.5%).
- Staff reductions of 6 168 across health sector and other service cuts saving € 1.2 billion (–7.9%), primarily through staff cuts, open competition to provide services in general medical services in primary care and tighter conditions on providing free medical care to the unemployed.

In addition, it argues that further savings are required in public service pay costs and that further reductions in rates of pay and allowances should be considered. Furthermore, the report places a strong emphasis on raising public sector efficiency and improving expenditure management, in line with 2008 OECD Review *Towards an Integrated Public Service* (OECD, 2008b).

The public sector has over-expanded and needs to be cut back

In earlier years, the government in Ireland was relatively small: in 2006, the Irish public expenditure-to-GDP ratio was only 34%, significantly below the euro area of 47% of GDP (ECB, 2009). This situation, however, is changing rapidly as the result of substantial discretionary real spending increases in 2007 and 2008, rising social and interest costs, and falling GDP. From that perspective, Ireland has had the advantage of having a relatively small government sector. The share of government education spending in GDP was close to the EU average. However, health spending had already expanded its GDP share to above the EU and euro area averages in 2006 and this has since increased further. The public sector suffers from two structural weaknesses which tend to push spending up. The first is the inability of the government sector to expand *via* productivity gains, which is common to many OECD countries. Output gains have relied on expanding payroll numbers, which grew by 15.5% in the seven years to 2008. This maintained the government share of employment at just over 18% during a period when private employment was expanding rapidly (Figure 2.9).

Figure 2.9. **Public sector employment and average earnings**



Source: Central Statistics Office.

StatLink http://dx.doi.org/10.1787/732426610481

The second common difficulty is that the lack of effective productivity benchmarking can result in periodic and unwarranted expansions of public sector pay. In Ireland, real earnings in the government sector increased rapidly, particularly in 2004 and 2005. Benchmarking exercises have been of dubious value. The first Public Service Benchmarking Body (PSBB) report in 2002 was instrumental in pushing up public service pay costs, resulting in a sharp relative increase in public sector wages. The second Benchmarking Report in 2008, based on a wide-ranging and transparent analysis of how public sector wages compared with the private sector, found that public service salaries in general "compared well" with the private sector. Particular attention was given to the value of public service pensions, which were estimated to be worth 12% of salary more than the private sector equivalent.

Public service pay costs and pensions should have a role as part of the overall package of reductions.[11] Reduced wage costs have been an important part of consolidation to date on the expenditure side. In February 2009, the government introduced the public-sector

Pension Levy, which resulted in an average deduction of 7.5% from the salaries of public servants. It is also necessary to control public sector numbers. A combination of major reforms is necessary, which should include ending the pay-parity link for public sector pensions, where public servants are guaranteed pensions based on the ongoing salary of the job they held. Public service pension liabilities should be systematically taken into account in decisions regarding staff costs. The Finance Accounts from 2008 will for the first time include an estimate of overall accrued pension liabilities and these are now included in the annual accounts of almost all semi-state commercial bodies. A fundamental repositioning of the public service pension for new entrants should be considered, moving away from defined benefit provision to a defined contribution with a state guarantee of certain minimum investment returns. A permanent reduction in the public payroll is an essential element of any fiscal consolidation plan. So far, a key element has been a ban on recruitment and promotion, with certain exceptions, although the Report of the Special Group (see Box 2.2 above) calls for a new numbers policy to bring about major structural reductions in the staffing levels across the civil and public service.

The need to improve efficiency

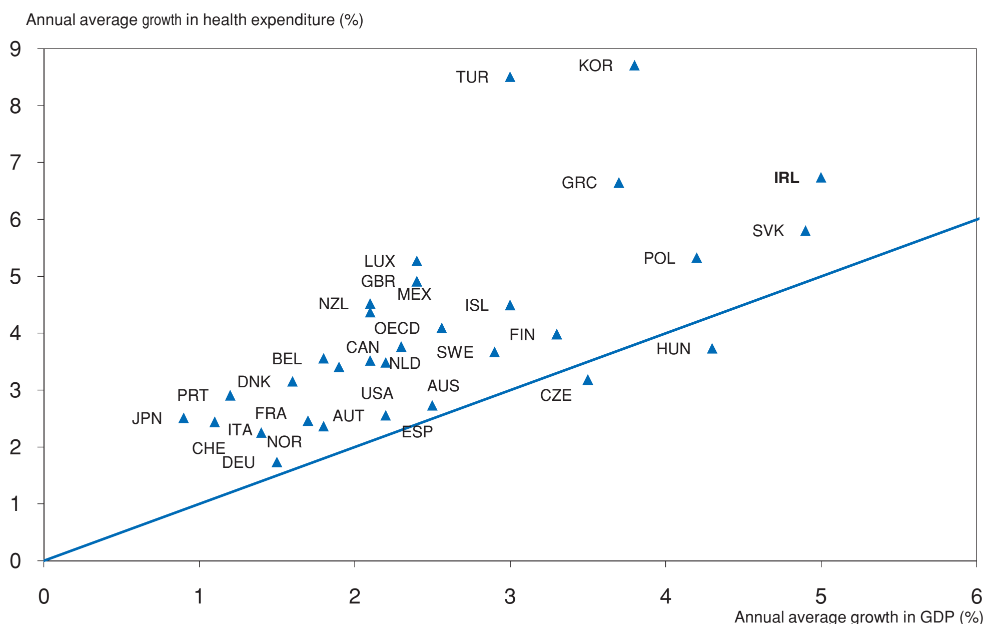
In principle, public sector pay increases have been tied to the elimination of inefficient working practices, such as the system of linking pay in different parts of the public sector. But in practice, progress towards more efficient working practice is hard to evaluate: although reports have been published that show compliance with the agreed changes in working practices, no evidence has been made available to demonstrate that better outcomes have really been achieved. The boom in tax revenues over the last decade may actually have slowed the pace of structural reform in the delivery of public services, since it has been possible to respond to public dissatisfaction with health and education services by increasing the level of public expenditure without tackling inefficiencies. The constraints imposed by a tighter budgetary situation should prompt a reassessment of the gains in efficiency that have been made and lead to a more ambitious approach to public sector reform, based on improvements in the quality of public spending. Achieving value for money will become increasingly important if high standards of service are to be delivered.

Health spending

Achieving value for money in the health sector is difficult. Public spending on healthcare in Ireland rose significantly faster than the OECD average in the decade up to 2005 (Figure 2.10). This was partly a catching up after a period of retrenchment, but health spending by 2006 was a significantly higher proportion of GDP than the EU average. Ireland is now entering an extended period when demographics will place increasing pressure on the core system from the demand side, with a further average increase of around 2 percentage points of GDP projected over the next five decades (EC, 2009a). Demographically-driven increases in long-term care would add a further demand on resources equal to 1.5% of GDP.

The number of hospital staff increased by around one third in the first half of the decade. While Ireland still has a relatively low number of physicians per capita, it has a very high number of practising nurses. This points towards some resource allocation problems, particularly as the number of specialised nurses is also low and there difficulties in recruiting into some areas and hospitals. Managerial accountability, incentives and flexibility should be improved to help bring the necessary changes about. A strengthened

Figure 2.10. **Annual average growth in real per capita expenditure on health and GDP, 1997 to 2007**



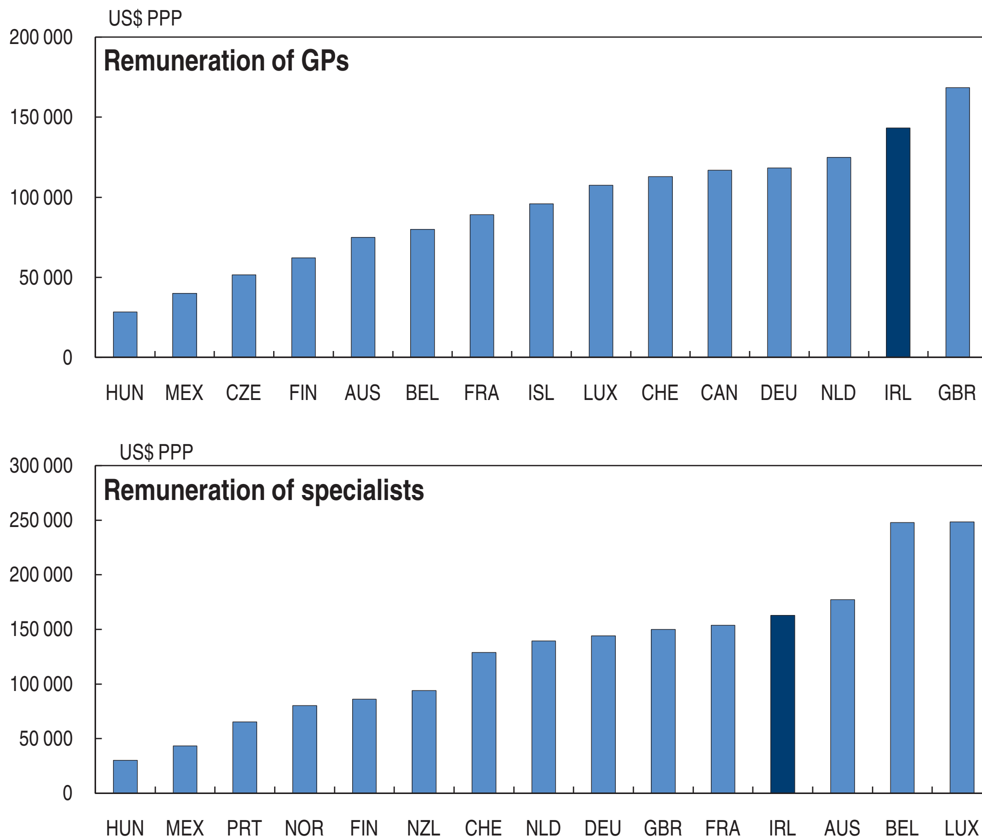
Source: *OECD Health Database*, 2009.

StatLink http://dx.doi.org/10.1787/732430515658

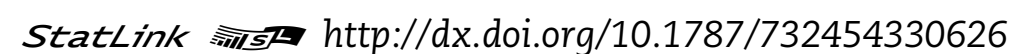
employment control framework was put in place in 2008, which included an end-year ceiling and a two-year reconfiguration target for the redeployment of some 1 800 staff from the hospital sector to less well-provisioned areas. At the same time, the remuneration of doctors has increased substantially, to the point where Irish healthcare professionals are among the most highly paid in the OECD (Figure 2.11). Furthermore, the structure and staffing of the Health Service Executive creates a significant burden of overheads with spending going into administration rather than on front line services or reforming how services are delivered. Improving the primary health care by establishing primary care teams across the country is a key challenge and would both improve services and reduce costs, in part by reducing unnecessary pressure on the hospital system (OECD, 2008b). Progress on this is advancing slowly and is partly held back by administrative problems.

It is difficult to assess health service productivity gains as the measurement of outputs is complicated by the requirement to aggregate very disparate interventions and operations. In Ireland, the number of hospital beds per capita has fallen over time with shorter stays, which is encouraging (Figure 2.12), but the number of procedures per physician seems to have declined. Health outcomes are improving as judged by mortality/longevity indicators and life expectancy is nearly one year above the OECD average. Controlling for environmental factors, there is cross-sectional evidence that health care spending plays an important role in explaining health status changes over time and between countries but it does not yield the same value for money across countries (Joumard *et al.*, 2008). This evidence based on the early part of the decade does not point to marked relative inefficiencies in the provision of medical services in Ireland but it does tentatively suggest that there is scope for cutting resources, while maintaining the same quality of outcomes. Given the number of health practitioners and controlling for other factors, Ireland has a weaker outcome in terms of health status than would be expected. It

Figure 2.11. **Remuneration of healthcare professionals, 2007**



Source: *OECD Health Data 2009.*

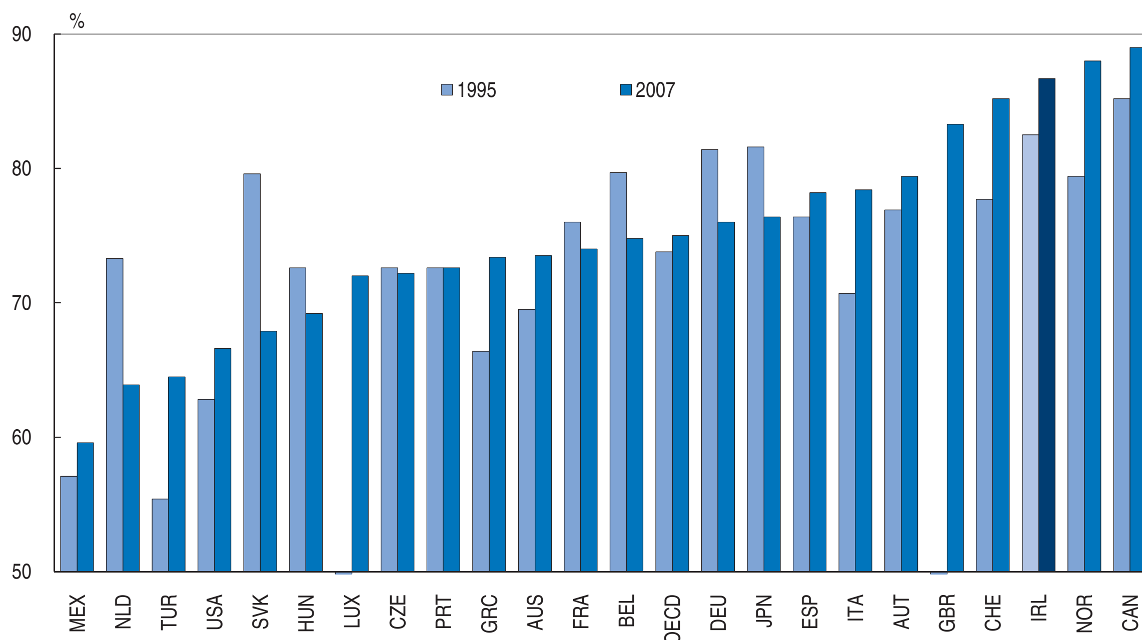

StatLink http://dx.doi.org/10.1787/732454330626

is hard to draw firm conclusions about health efficiency but, in the current environment, the emphasis should be primarily on reducing costs.

In the 2009 Budget, the health sector will have to implement savings measures totalling around € 800 million this year. Since in the short term reducing wage costs is difficult, there is a danger that a search for economies could affect adversely services. Moreover, the Budget also contained a cutback in terms of the capital allocation for hospital building. While it is natural that capital spending should be contained, there is a danger that cuts will focus on what is most expedient to cut, rather than on reducing the high overall costs of medical service provision.

The nature of the Irish health system as a part-private part publicly-provided system offers the possibility of increasing user charges in the private sector. Half of the population have private health insurance and such payments are partly subsidised through tax reliefs, which may themselves need to be restricted. The effectiveness of the medical card scheme should be reconsidered: this is available to approximately one-third of the population, those wholly reliant on social welfares or whose income lies below a certain threshold, as well as most of those over 70 years of age.[12] This entitles them to free medical services at the point of delivery. A doctor visit card confers free GP services to some others. All other citizens must pay for all GP services and for prescription drugs up to a maximum. Fees are charged for hospitalisation and a levy may be charged for attendance at a hospital Accident

Figure 2.12. **Occupancy rate[1] of acute care hospital beds, 1995 and 2007**



1. In the Netherlands and Luxembourg, occupancy rates are slightly under-estimated, as the number of beddays in hospital only include inpatients while the number of acute care beds (the denominator) also includes beds available for day care.

Source: *OECD Health Data 2009.*

StatLink http://dx.doi.org/10.1787/732462380548

and Emergency (A&E) department. This system is complex and does not exploit the possibilities of co-payments in an equitable way. Reform is necessary and a group has been established to review the scheme's operation and report later this year.

Education spending

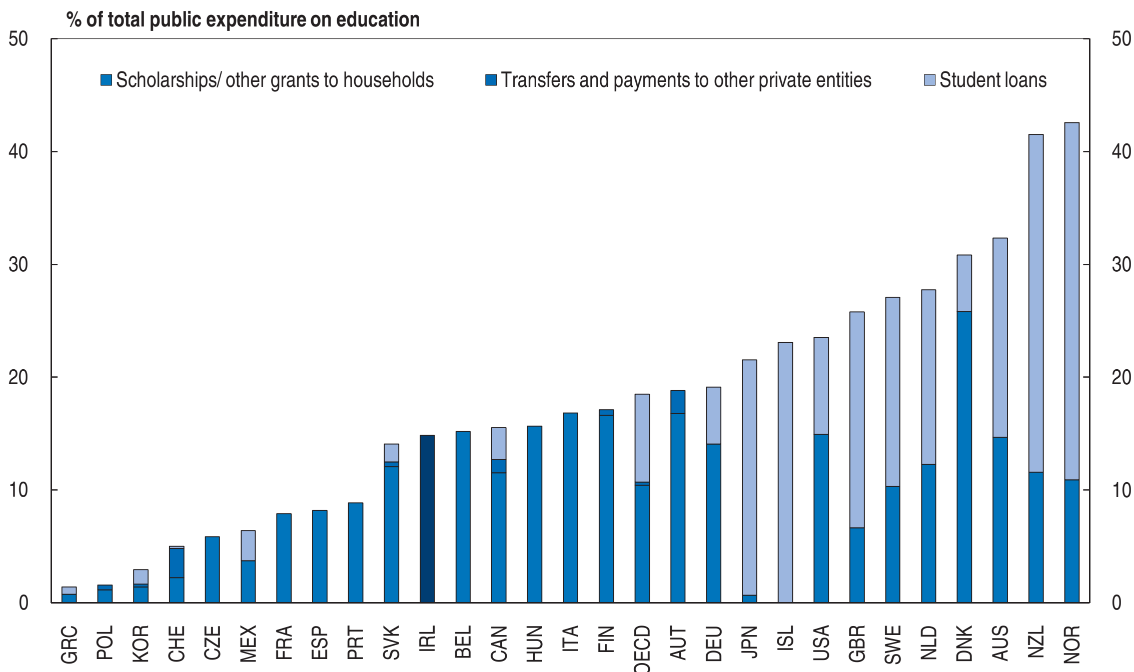
Public expenditure on education amounted to only 4.2% of GDP in Ireland in 2006, compared with the EU average of 5.2%, but it is close to the EU average amount *per student* (Sutherland *et al.*, 2007). Student/teacher ratios are now among the lowest in the EU at the secondary level, though closer to the norm at primary and tertiary levels (ECB, 2009b). At the same time, compensation costs per unit of output have risen and the proportion of current spending devoted to teacher salaries at primary, secondary and post-secondary non-tertiary levels is well above the OECD average, at 75% of total current expenditure.

Looking at educational outcomes as measured by student attainment at age 15 in the OECD *Programme for International Student Assessment* (PISA), Ireland is close to international norms in terms of educational attainment for the resources committed (Sutherland and Price, 2008). However, econometric analysis suggests that higher spending and especially lower class size do not translate into greater efficiency in Ireland or across OECD countries. Furthermore, there are potential efficiency gains in the education sector. Compared with international best practice, analysis suggests that Ireland could have saved around 12-18% of the real resources devoted to education in 2003 and have still achieved the same educational outcomes. There would be further gains from bringing the least efficient schools up to the standards of the best. These efficiency gains in education could be achieved by reducing teacher inputs and making institutional reforms. In particular,

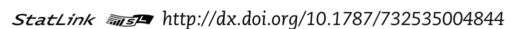
greater decision-making autonomy at the school level tends to be associated with higher levels of efficiency, while small school sizes is associated with inefficiency.

The level of state support to tertiary education is significantly lower than the OECD average (Figure 2.13). Overall resources are further reduced by the absence of tuition fees, which is regressive because students are more likely to come from wealthier backgrounds and move into well-paid occupations. A more equitable system and less costly system would be to introduce upfront tuition fees for higher education financed by income-contingent loans to make institutions more responsive to students' needs (OECD, 2008). The government has signalled the likelihood that third-level fees will be introduced from 2010 and is considering a number of options, including income-contingent loans.

Figure 2.13. **Public subsidies for tertiary education, 2005**



Source: OECD, *Education at a Glance*, 2008.


StatLink http://dx.doi.org/10.1787/732535004844

Social welfare spending needs to be better targeted

While the amount of resources spent on social protection has been comparatively small in Ireland in the past, there has been a significant increase in the generosity of welfare over the last decade. Child Benefit has increased by a factor of almost four to € 166 per month since 1997; the state contributory pension has doubled to around € 230 per week since 1999; and the weekly rate of long-term job seekers allowance was also doubled since 2001 to € 204. These benefit payments are high by international comparison, particularly with respect to the United Kingdom. With welfare spending accounting for one-third of all government spending and with the generosity of benefits having been based on more favourable economic conditions, the rates of welfare payment will need to be adjusted to reflect the new realities.

This will be difficult, as inflation cannot be used to achieve the real adjustment as in the past. Indeed, falling prices have made the situation more difficult. In the 2009 Budget,

welfare payments were increased by around 3% and it was decided not to reduce welfare rates in the Supplementary Budget notwithstanding an expected fall in consumer prices of close to 4%.[13] Welfare payments should be reduced at least in line with prices. Major changes are being made in eligibility to certain benefits, such as payments under the Rent Supplement scheme, which will be reduced in line with fallings rents. More substantial changes, however, are required. Welfare spending needs to target the available resources on those most in need and for that reason, the intention is that Child Benefit will be means-tested or taxed in the 2010 Budget. More generally, benefits where entitlement does not depend on household resources retain an important role in social welfare policy and this approach should be re-considered. Increased use of means-testing will be hard to avoid if the generosity of benefits for low-income households is not to be severely reduced, and this should be carefully co-coordinated with any other changes in the tax and benefit system.

Adjusting capital spending to the new fiscal realities

High levels of public investment can be growth enhancing but the budgetary situation justifies a cautious approach in the near term. The government has already made very significant adjustments to its capital investment plans as part of its consolidation effort: for 2009, the Exchequer capital allocation is more than 5% of projected GNP and maintains most of what was in the National Development Plan (NDP). Thereafter, spending will fall to an average of 4.2% of projected GNP over the period to 2013, although this maintains a relatively high level by international comparison. Significant reductions in tender prices are expected to help to deliver a large part of the NDP programme within the envisaged timescale, helping to offset the impact of reduced spending in cash terms. More limited resources will require greater prioritisation to be given to projects that make the greatest contribution to economic recovery.

Public-Private Partnerships (PPP) arrangements have played a role in delivering improved public services and infrastructure, particularly in road building and accommodation projects such as schools. € 8.6 billion of the € 36.3 billion capital envelope for the years 2005 to 2009 will be funded by PPP investments. Having encountered similar challenges to other countries when this type of procurement was initially used, the recent experience of PPPs for road construction has subsequently been good, delivering many projects on budget and ahead of schedule. Other projects, such as the National Conference Centre and the Criminal Courts Complex, also demonstrate the value of PPPs in delivering public infrastructure. Given pressures on public finances, PPP options should be considered seriously but only be used when there is a genuine efficiency gain or cost-effective risk transfer, and not be used as a device simply to keep government borrowing off-balance sheet for national accounting purposes.

Strengthening fiscal rules and institutions

The precipitous deterioration in the public finances results from a number of factors, but partly reflects weaknesses in the budgetary institutions during the economic expansion. Forecast errors have inevitably played a part, but more fundamentally the system made it difficult not to spend incoming revenues or to impose a level of structural surplus consistent with longer term stability and short-term flexibility, despite achieving surpluses over most of the past decade. More effective budget planning and management is crucial to delivering a better public service from existing and additional resources. This will require building on recent innovations in budget processes, as well the creation of new rules and institutions which embed safeguards against a recurrence of the budget weaknesses of the past.

Towards a more efficient government sector

Enhancing budget efficiency via *output budgeting*

Efficient budget processes can help achieve increased cost-efficiency by linking resources more closely to objectives. This requires greater clarity in terms of outputs. The Annual Output Statements (AOS) introduced in 2007 are designed to make explicit the public service outputs expected to be delivered with the allocated funds. The AOS framework has since been further developed to align resources more closely to strategic objectives. It is formally integrated into the procedures of parliamentary scrutiny. OECD analysis into education-sector efficiency shows that countries registering higher scores for quality in budget management tend to be more efficient at restraining input use for a given level of attainment. Budget efficiency in this case means implementing an outcome-focused approach at a decentralised level, comprising clear targets, the existence of a credible reward and sanction system, and performance assessments (Sutherland and Price, 2007). Consistent with this and in the longer run, output statements should serve as a reference for the Performance Verification Process in the determination of public sector wages, together with links to other processes such as the cascading of performance objectives and employee evaluation. Some of the existing processes have contributed usefully to identifying the scope for cuts in the work of the Special Group on Public Service Numbers and Expenditure Programmes.

The 2008 OECD Review *Towards an Integrated Public Service* (OECD, 2008b) identified the need to give more emphasis to the public service as an integrated system, with greater focus on the needs and user satisfaction of citizens as guides to whether public service outputs are meeting their aims. In earlier years, the public service had already put in place initiatives such as the Quality Customer Service and Citizen Charters to better measure user satisfaction and improve customer focus. Public sector management and procedures were strengthened, value-for-money reviews undertaken in all government departments, as well as the rolling out across government of the Management Information Framework (MIF). Substantial inefficiencies result from the multiplicity of bodies and agencies; in approaching the task of rationalising them, the government has been following the recommendations of the *OECD Review* that reforms should be reinforcing and aim at an integrated public service system. In response to the *OECD Review* more widely, the government created a high-level Task Force to prepare a comprehensive framework for renewal of the public service, drawing together the OECD analysis and on-going initiatives to improve the quality and efficiency of service delivery. The Report of the Task Force and a government statement on "Transforming Public Services" were published in November 2008. These set out a three-year framework for radical transformation of the public service: this includes a new round of Value-For-Money reviews, an organisational review programme extending across government, and the creation of a National Public Procurement Unit. The Special Group on Public Services Numbers and Expenditure Programmes, discussed above, was set up at the same time. The whole process is overseen by a Cabinet committee and steering group of Secretaries General. Annual reports will be published on the implementation of these reforms. In the short term, the need to reduce expenditure is likely to shape developments within the public sector and will help to reduce costs. Some improvements in government processes also require initial investments that may be delayed. However, it will be important in later years that implementation of the transformation of the public service successfully leads to a more responsive and service-oriented public administration.

Efficiency reviews help apportion budget cuts

The progress being made in the direction of greater allocative and cost efficiency should show up principally in longer-run value for money, but it has also assisted the process of apportioning budget cuts. An Efficiency Review of public expenditure was launched in the 2008 Budget, which resulted in a range of expenditure saving measures in July 2008 and fed through to further action in the 2009 Budget. Various efficiency measures have been taken, leading to cost savings on consultancy, advertising, public relations and procurement. A review of capital projects has helped in allocating capital spending cuts. As discussed above, more savings have since been proposed. Efficiency gains can be easier to identify where the public and private sectors interface or where there is some contestability. But, outsourcing is relatively limited in Ireland and a lack of information makes it hard for the public service to evaluate the cost of providing services itself. Consideration should be given to how outsourcing, appropriately used, could contribute to raising efficiency in the provision of services to the public. 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.

However, while efficiency reviews should play an increasingly important role, it is not apparent that these processes are contributing to an improved ability to frame strategic decisions about longer-run programme growth or to prioritising the major shifts in resources which are now needed. The previous long-standing approach, whereby the existing level of service' (ELS), was taken as the starting point for budget allocations, did not encourage departments to prioritise among activities or to allow inter-departmental reallocation of resources. A more effective starting point for negotiations with departments is a top-down publicly-stated, rather than internal, target for actual overall spending. This constraint is tighter on departments and encourages greater efficiency; similar measures have been found to be helpful in countries such as Australia and Sweden. Movement in this direction began in Ireland with the 2008 Budget, which abandoned the ELS approach by using the 2008 level of expenditure (adjusted downward by spending cuts made in July 2008) as the baseline. In the April 2009 Supplementary Budget, the government signalled a further move towards a more top-down approach by setting out in advance the overall level of current and capital expenditure savings for 2010 and 2011: these targets are intended to form the basis of the expenditure negotiation process for the 2010 Budget. For this approach to be effective, the binding nature of the future-year expenditure targets should be clarified within the existing budgetary processes and these innovations, that have been introduced in the context of fiscal consolidation, should become a permanent feature of the budgetary framework in line with the Special Group Report's call for formal multi-year expenditure envelopes.

Improving the fiscal planning framework

Once the economy gets back onto a sustainable growth path, it will be necessary to create a budget framework which does not allow future instabilities to occur. There are two dimensions to this: budget rules and institutions. Ireland's domestic budgetary framework has relied heavily on the set of rules imposed under the EU Stability and Growth Pact (SGP): while these are important in terms of maintaining fiscal discipline at a European level, these fiscal institutions have not provided sufficient as the main basis for domestic fiscal policy setting for Ireland and a stronger national framework is required in Ireland within the wider context of the SGP. One problem is that is difficult in general to assess the cyclical

and structural/underlying components of the fiscal balance because of the asset cycle effect and uncertainties about the output gap. A reassessment is needed of the methods by which underlying budgets and net debt are calculated, seeking to minimise the overestimation of potential growth and allowing for the build-up of stabilization funds in times of revenue buoyancy. The principal requirement is a cautionary approach to the inclusion of volatile revenue sources. This means that any abnormal cyclical revenue gains should be saved, which requires a greater emphasis on net debt and the government asset position. In terms of political economy, an institutional means needs to be found whereby revenue overshoots are saved rather than spent, which could involve the creation of some sort of stabilization fund where payments vary on the state of the economic cycle.

The need for new budget institutions

A medium-term, input-oriented focus needs institutions which reduces the risk that short-term political pressures diverting the fiscal stance from a sustainable path. An enduring strength of Ireland's system is local participatory politics, which ensures the political system avoids the kind of disconnection with voters that many other mature democracies suffer. But it is also a budgetary weakness, since political decisions can be made on a short-term and partial basis. Deciding on the level of taxation and spending would need to remain part of the political process, but an independent expert institution such as a fiscal council with sufficient access to information could produce recommendations on the appropriate overall fiscal stance and related matters.

Such institutions exist in some other European countries in a variety of different forms (European Commission, 2009b).[14] In Germany, there is a council of economic advisers (the so-called "wise men") and in the Netherlands the Central Planning Bureau has some of these functions. One of the most notable recent examples is the creation of a Fiscal Policy Council in Sweden (operational since August 2007) to assess whether fiscal policy objectives are met, including long-run sustainability, the budget target, the expenditure ceiling and consistency with the cycle. Three main functions could be involved if Ireland were to follow such a route. The first is an assessment and recommendations about the overall fiscal stance. The second is the evaluation of spending programmes before implementation, which would reinforce the increasing internal assessments described above. Ireland lags far behind the European norm in this regard. Subjecting spending proposals to scrutiny is needed to ensure that the objective is being achieved at the lowest cost to present and future taxpayers. The third is the auditing of spending after it has taken place. The Comptroller and Auditor General in Ireland already does this, but the office is less resourced and has fewer statutory powers than in many other jurisdictions. It should be given additional powers. Real checks and balances are needed to prevent repeating the errors of the past.

Box 2.3. **Summary of recommendations of fiscal policy**

Substantial and prolonged further fiscal consolidation is necessary to close the underlying gap between tax revenues and expenditure, although the pace should not unduly weigh on the recovery in the near term. Consolidation, which has already begun, will need to continue in the longer term to reduce debt and prepare for population ageing.

Restructuring the tax system

The tax system should be strengthened to raise revenues, increase efficiency and improve equity:

- The income tax base should be broadened. All tax reliefs have been reviewed by the Commission on Taxation. These should now be re-assessed on a regular basis. Many tax reliefs should be eliminated. In other cases, deductibility should be at the standard rather than the marginal rate and the overall amount of relief capped. Mortgage interest relief should be phased out and a property tax introduced.
- Recently introduced levies should be integrated into the income tax system and personal allowances reduced only once the income tax base has been repaired.

Reducing and rebalancing public spending

Substantial reductions in public spending are needed. Improving the allocation of resources, reducing costs and modernising the public service (including through improved used of information technologies) would help to reduce the impact on frontline services:

- Investment spending should be reduced in line with current plans so that efforts continue to upgrade the infrastructure, albeit at a slower pace. Projects should continue to be evaluated carefully and in the light of changing economic circumstances. User charges should be extended where possible. Public-Private Partnership (PPP) funding should be used where risks can be transferred to the private sector at reasonable price or efficiency increased.
- Public-sector remuneration should be reviewed independently, taking into account falling private-sector wages and conditions. Public-sector pensions should evolve in line with changing needs and practice in other sectors, the basis for up-rating of pensions in payment reconsidered and earlier reforms phased in more rapidly. Employment in the public sector should be reduced.
- Social welfare spending should be more targeted. Consideration should be given to widening the use of means-testing. Benefits should in general be subject to tax. Benefit payments should reviewed in the light of falling wages.
- In the health sector, spending should be reduced and services improved by reducing costs and redeploying manpower resources. The Medical Card scheme and tax deduction of medical expenditures should be reviewed.
- In education, resources should be redeployed more effectively and secondary-level class sizes could be increased. University tuition fees should be introduced, supported by loans with income-contingent repayments.

Box 2.3. **Summary of recommendations of fiscal policy** *(cont.)*

Reforming the budget process

Strengthening budgetary institutions would enhance the credibility of the fiscal consolidation and help to avoid future underlying fiscal imbalances from developing. This approach should include:

- The multi-annual outline for current expenditure, set out in the 2009 Supplementary Budget, should be made permanent. An overall expenditure ceiling should be introduced in place of the former "existing level of service" expenditure baseline.
- Irish domestic fiscal rules and institutions should be developed beyond the Stability and Growth Pact mechanisms to allow larger surpluses in good times. Consideration should be given to the creation of an expert independent fiscal council that could assess the overall stance of fiscal policy and the evaluate government programmes. Consideration should be given to creating a stabilization fund or cyclical contributions to the NPRF.
- The government should publish a complete balance sheet for the public sector, including details of off-balance sheet liabilities under PPP contracts and items related to support for the banking sector.
- Budget efficiency can be further improved by using output statements as a reference for performance-rated pay and employee evaluation in the context of greater managerial flexibility and enhanced mobility.
- Cost efficiency can be increased by a continuing emphasis on the public service as an integrated system, focusing on reducing the inefficiencies resulting from the multiplicity of bodies and agencies. The gains from efficiency reviews would be enhanced if outsourcing is increased and good practice is better identified.

Notes

1. This further requires a Ministerial Order, which has yet to be introduced.
2. The median duration is two years among those identified by Guichard *et al.* (2007). In 25 cases, the consolidation lasted for at least four years and for three it lasted seven years. 31 episodes involved an improvement of the underlying primary balance by at least 4% of potential GDP, including nine episodes involving an improvement of the underlying primary balance by at least 7%.
3. The 1987 Budget and *Programme for Economic Recovery* adopted a target of reducing the Exchequer Borrowing requirement by 6-8 percentage points of GDP in three years, which was achieved ahead of schedule.
4. The measure of debt used in this chapter is the Maastricht definition of debt, unless otherwise stated. This differs from the definition in the OECD system of national accounts essentially in two respects: the Maastricht definition is somewhat narrower and liabilities are at nominal rather than market or actual value.
5. The rates of Capital Gains Tax, Capital Acquisitions Tax, and Deposit Interest Retention Tax (DIRT) are being increased in two stages from 20% to 25%. The rate of exit taxes on investment funds and life insurance products were also increased by 5 percentage points. The tax free threshold for Capital Acquisitions Tax has been reduced by 20%.
6. While the yields from residential and commercial property transactions undoubtedly played an important role in driving the increase in revenues from this tax head, other sources of CGT such as from the disposal of quoted and unquoted shares and agricultural and development land have also contributed significantly.
7. *Report of the Tax Forecasting Methodology Review Group*, February 2008.
8. This is equivalent to an EEE (exempt-exempt-exempt) model of taxing income that goes towards pensions, at the saving, accrual and payment stages (OECD, 2008).

9. The levy is made on income over € 18 304 a year, with some exceptions (for over-65s and those with medical cards) and exemptions (such as social welfare payments).
10. The danger is rather that the Irish advantage depends on decisions taken elsewhere – what happens to rates in both the US and bigger countries, and in competitor countries like in Eastern Europe. Ireland is likely to continue to benefit from its corporation tax advantage but it should be borne in mind that these revenues partly depend on outside factors and there is a risk that these could change.
11. This was outside the terms of reference of the Special Group on Public Service Numbers and Expenditure Programmes.
12. This universal benefit has been means-tested since January 2009 but a very high level of income.
13. The December bonus, however, has been cancelled this year.
14. In 2005, 13 among the EU15 countries had such institutions, some issuing normative recommendations, others fiscal and economic forecasts, though only 4 member states relied on independent fiscal institutions for the budget preparations and medium-term planning (European Commission, 2009b).

Bibliography

Commission on Taxation (2009), *Report of the Commission on Taxation*, September.

Department of Finance (2006), *Budget 2006 – Review of Tax Schemes*, December.

Department of Finance (2008), *Ireland – Stability Programme Update*, October.

Department of Finance (2009), *Addendum to the Irish Stability Programme* Update, January.

Department of Finance (2009), *Macroeconomic and Financial Framework*, 2009-13.

Department of the Taoiseach (2008), *Transforming Public Services: Report of the Tax Force on the Public Service*, November.

European Central Bank (2009), *The functional composition of government spending in the European Union*, *ECB Monthly Bulletin*, April 2009.

European Central Bank (2009), *Economic and Monetary developments*, *ECB Monthly Bulletin*, March 2009.

European Commission (2009a), *The 2009 Ageing Report*, European Economy 2, 2009.

European Commission (2009b), *Public Finances in EMU.*

Fitz Gerald *et al.* (2008), *Medium-Term Review*.

Guichard, S., M. Kennedy, E. Wurzel and C. André (2007), "What Promotes Fiscal Consolidation: OECD Country Experiences", *Economics Department Working Paper*, No. 553, Paris, OECD.

Joumard, I., C. Andre, C. Nicq and O. Chantal (2008), "Health Status Determinants: Lifestyle, Environment, Healthcare Resources and Efficiency", *Economics Department Working Paper*, No. 627, Paris, OECD.

Koen, V. and P. van den Noord (2005), "Fiscal Gimmickry in Europe: One-Off Measures and Creative Accounting", *Economics Department Working Paper*, No. 417, Paris, OECD.

National Treasury Management Agency (2009), *Press Release, Quarter 1 Update*, 8 April 2009.

OECD (1991), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008b), *Public Management Reviews: Ireland. Towards an Integrated Public Service*, OECD, Paris.

OECD (2009), *Going for Growth*, OECD, Paris.

OECD (2009a), *OECD Economic Outlook* 85, OECD, Paris.

OECD (2009b) *Tax Expenditures and base broadening*, OECD, Paris.

Public Service Benchmarking Body (2007), *Report.*

Office of the Revenue Commissioners (2000 and 2006), *Statistical Reports.*

Special Group on Public Service Numbers and Expenditure Programmes (2009), *Report of the Special Group on Public Service Numbers and Expenditure Programmes*, Volumes I and II, July, Dublin.

Standard and Poor's (2009), *Ratings Direct*, 30 March 2009.

Sutherland, D. and R. Price (2007), "Linkages Between Performance and Institutions in the Primary and Secondary Education Sector", *Economics Department Working Paper*, No. 558, Paris, OECD.

Sutherland, D., R. Price, I. Joumard and C. Nicq (2007), "Performance Indicators for Public Spending Efficiency in Primary and Secondary Education", *Economics Department Working Paper*, No. 546, Paris, OECD.

Tol *et al.* (2008), "A Carbon Tax for Ireland", ESRI.

Taxation Methodology Review Group (2008), *Report*.

© OECD 2009

Chapter 3

The labour market: Getting people into work

The Irish labour market is undergoing a severe adjustment following the sharp fall in output, which has been concentrated on labour-intensive sectors. This has led to a large reduction in employment and high levels of unemployment, despite some outward migration. The labour market in Ireland is flexible in terms of regulation and widespread evidence suggests some reduction in nominal wages is already taking place. But, there is a serious risk that joblessness in the short run will translate into a permanently higher level of unemployment due to the combination of relatively high unemployment benefits for low-skilled workers and, more importantly, weak activation measures. Although some measures have been taken in response to the rise in unemployment, greater encouragement and support should be provided to help the unemployed get back into work and conditionality should be stricter. For the longer run, female participation would be facilitated by removing obstacles in the tax-benefit system; lone parents would be helped by greater support and a stronger requirement to work; and more systematic efforts are required to ensure that disability is not a pathway to inactivity.

Labour market conditions have deteriorated rapidly: employment has fallen by over 7 per cent since the peak and unemployment has risen from an average rate of 4.5% in 2007 to close to 12 per cent.[1] Further labour market deterioration is inevitable in the short term. Getting people into work should be the main priority, because high short-term unemployment may lead to permanently higher joblessness. If this is to be avoided, the level of unemployment-related benefits needs to be reduced to improve work incentives and, more importantly, effective activation policies should be strengthened to help to maintain pressures on pay, as well as preventing the long-term unemployed from becoming detached from the labour market. In the long run, raising participation among groups with weak attachment to the labour market would bring more people into work and boost living standards.

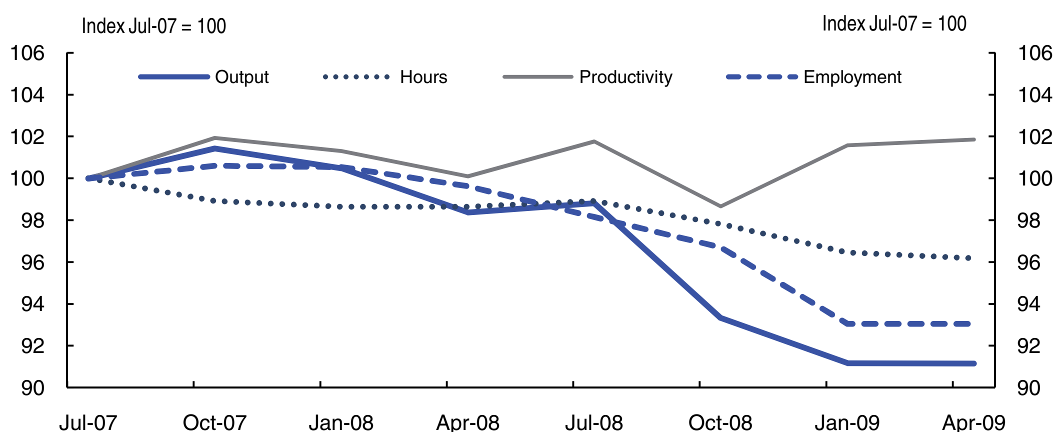
The Irish labour market is relatively flexible and supportive of long-run growth. Prior to the downturn, low unemployment and employment gains were impressive by international standards: the number of people with jobs increased at an average annual rate of 3.2% over the period 2001-07, and the share of the working-age population participating in the labour force rose to 64.1%. The unemployment rate averaged just 4.5%, among the lowest rates in the OECD. There was a substantial and unprecedented net inflow of foreign migrants. Although average hours per worker fell over the period, the offsetting rise in employment rates was sufficient to raise labour utilisation. Labour productivity growth, at an average annual rate of 2.3%, was strong and real wages rose substantially. This nevertheless represented a slowdown since the Celtic Tiger era. Furthermore, real wage growth was less muted in this expansion than in the earlier period and unit labour costs grew more rapidly. Nevertheless, performance was strong by international comparison.

Short-term labour market adjustment

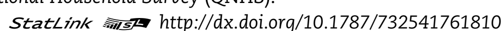
The economic slowdown has hit labour-intensive sectors

The contraction in output since 2007 has sharply reduced the demand for labour: employment declined by 7.4% from the peak to the first quarter of 2009 and average hours worked by those in employment have shortened (Figure 3.1). The reduction in labour utilisation has been less pronounced than the fall in output, so labour productivity per hour worked has also fallen. As labour demand has slumped, the standardised unemployment rate has increased sharply from around 4.5% in late 2007 to reach 12.4% in August 2009.[2] The increase in unemployment has partly been attenuated by a reduction in the labour force, largely due to a fall in the participation rate of around 1.5 percentage points. The inflow of new migrants has slowed very sharply and the number of migrants in the labour force fell by 10% over the year to the second quarter of 2009, partially reversing the inward migration of recent years. Outward migration by those from the new member states of the European Union was particularly significant. The percentage point increase in the unemployment rate since the slowdown began has been the second highest in the

Figure 3.1. **Labour market adjustment in the current downturn**



Source: *OECD Economic Outlook Database* and CSO *Quarterly National Household Survey* (QNHS).


StatLink http://dx.doi.org/10.1787/732541761810

OECD, with other economies that were heavily dependent on construction such as Spain and the United States also severely affected.

Employment began to decline first in the construction and other production sectors with the number of workers peaking in the first half of 2007 (Table 3.1). In early 2008, the contraction of employment spread to other sectors including wholesale distribution, transport and finance. Employment in the construction sector has fallen by around one third since its peak, with reductions in employment of 5-7% to date in manufacturing, distribution services, hotels and restaurants. These reductions largely mirror the sectors most severely affected by the crisis, which are relatively labour-intensive such as construction.[3] These sectors were the main drivers of the rise in employment during the expansion: construction, finance and business services, and distribution and other services each accounted for around one fifth of the overall increase since 2003. The recent falls in industrial employment accelerate an already downwards trend since the peak in 2001. Employment in primarily non-market activities, such as public administration and health, accounted for a substantial part of the growth in employment in recent years and has continued to increase, although this is likely to slow or even reverse as public expenditure is restricted. The labour market situation has deteriorated much more rapidly for men than for women: the fall in employment for males has been more than twice as large and the male unemployment rate is now almost twice as high as for females. This reflects higher shares of male workers in

Table 3.1. **Changes in employment by sector**

	2008 Level (000s)	Change 2003-08 (000s)	Change 2007-08 (000s)
Agriculture, forestry and fishing and other production industries	405	–12	–6
Construction	255	88	–27
Hotels, restaurants, wholesale and retail trade	435	63	0
Transport, storage and communication	122	10	–0
Financial, business and other services	417	81	9
Public administration, defence, education and health	470	80	12
Total employment	2 104	310	–13

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

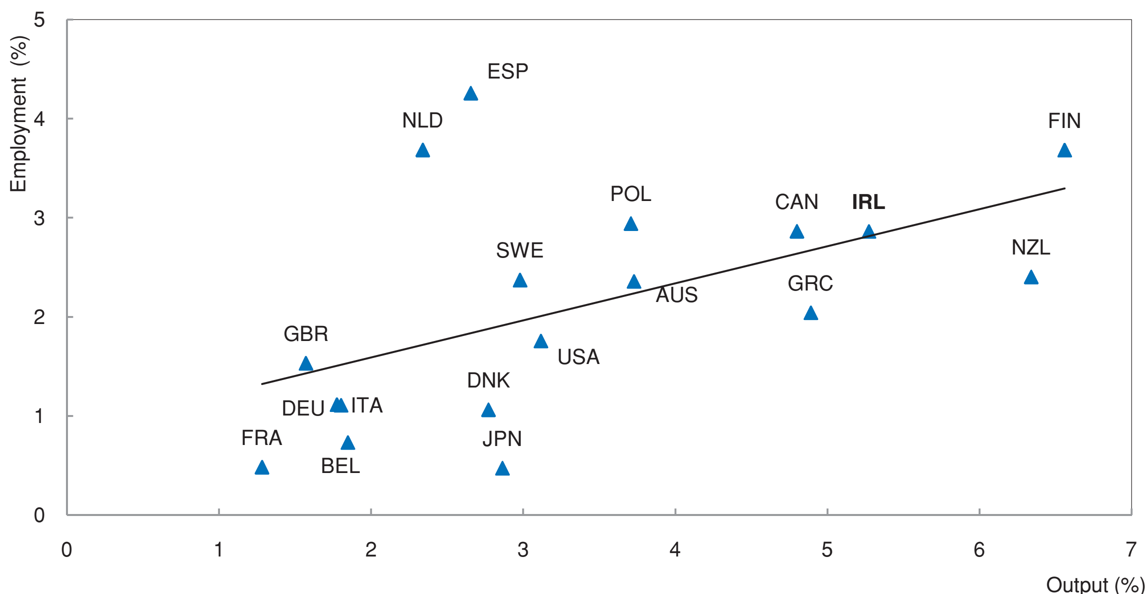
sectors, such as construction, that have been most severely affected by the downturn. The impact on females may worsen, in the short run as reductions in employment spread to other sectors and in the longer run because real wages are falling and female labour supply decisions tend to be more sensitive to pay than for men.

Lessons from past slumps in labour demand

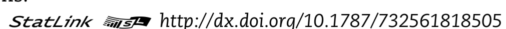
It is too early to say how the labour market will ultimately adjust to the economic downturn. Past episodes provide some guidance, although structural change and the specific features of the current situation necessarily make the comparison inexact. Adjustment can occur either through the extensive margin (number of workers) or the intensive margin (average hours worked). Adjustment on the extensive margin can be more costly because the firm-worker job match is broken and because it leads to unemployment, raising the cost and creating a risk of quasi-permanent exit from the labour market. Over the period 1983 to 2007, adjustment on the extensive margin explains almost all of the variation in labour utilisation in Ireland, a higher share than in a sample of other European countries (OECD, 2009).[4] Most of these adjustments in Irish unemployment can be explained by variation in the employment rate, although labour force participation also varies. Adjustment of average hours has played a modest role and been less important than for the average country in the sample. The overall volatility of the Irish labour market is also high over the cycle in comparison with other OECD countries (Figure 3.2). This reflects the variability of production, which is likely to be higher in small economies which are less diversified in production and more exposed to international shocks. It also reflects policy settings that allow swift adjustment in the labour market. This combination of structural and policy factors is similar to that in Finland and New Zealand.

Figure 3.2. **Cyclical variation of output and employment**

Variance of deviations from potential, 1981 to 2007



Source: OECD (2009b), *Economic Outlook 85 Database* and OECD calculations.


http://dx.doi.org/10.1787/732561818505

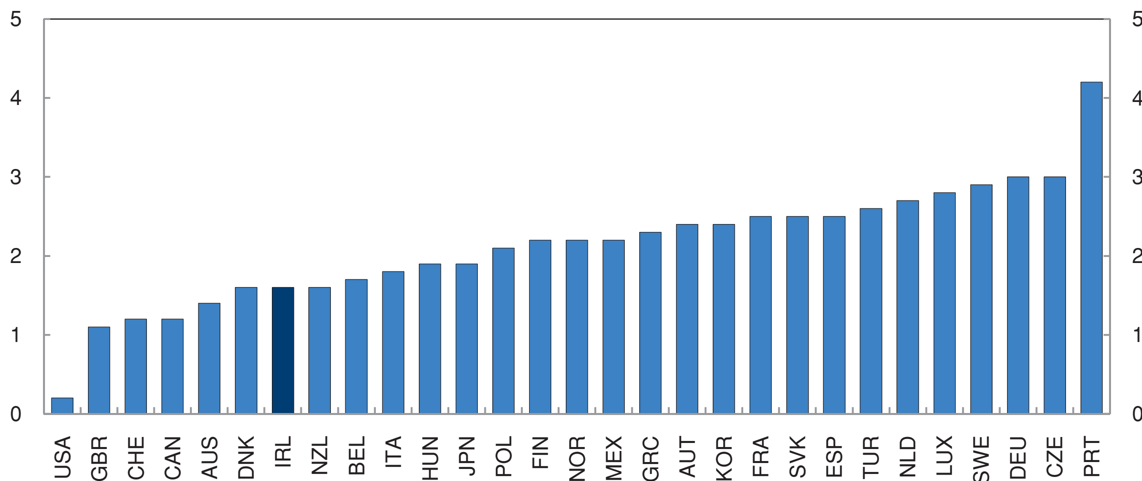
Business-cycle sensitivity varies strongly across different workforce groups. Younger workers are more likely to be affected because of their limited labour market experience and seniority rules. On average across the OECD, older workers are one fifth more sensitive to the business cycle than prime-age workers (OECD, 2009). Turnover costs tend to be higher for more skilled workers and hence demand for low-skilled labour is more sensitive to the cycle. The share of younger workers (those aged under 25) in the labour force is around 15%, similar to that in the early 1990s but around 10 percentage points lower than at the beginning of the 1980s. The cyclical impact of this downturn on overall employment may therefore be less than in the 1980s. Total hours worked in some sectors are more volatile than in others depending on the cyclical variation in output and how much this affects labour demand. Firms that are more dependent on external credit find it harder to hoard labour. Labour utilisation in construction is the most cyclical across OECD countries followed by durable goods manufacturing and business services (OECD, 2009). In 2007, the share of construction workers in Ireland was around twice the OECD average, consistent with the relatively large adjustment in overall employment that has been seen subsequently.

In addition, the flexibility of the Irish labour market may have increased with the rising share of part-time workers, whose hours are easier to vary and who can be less costly to fire. Based on the definition of full-time work as being more than 30 hours in a usual week, 20% of workers in Ireland were in part-time employment in 2008. This share is around double what it was in the early 1990s, above the European average and similar to other English-speaking countries. More than one third of female workers are in part-time employment. Around one tenth of workers in 2007 were on fixed-term contracts, well below the OECD average. The limited use of such contracts is in part because flexible employment protection legislation has avoided the creation of a two-tier labour market seen in some other OECD countries. About 17% of the civilian workforce is self-employed, around the OECD average and with the share having declined by around one quarter compared with 20 years ago. Self-employed workers tend to have a less cyclical labour market position than other groups of workers, in particular because they are often in the relatively stable 25-54 age group (OECD, 2009a). This pattern might be somewhat different in Ireland because self-employment has been common in the construction industry and hence may be more severely affected by the current slowdown.

Flexible employment protection legislation should speed adjustment

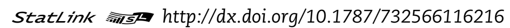
The flexible regulation of the Irish labour market facilitates adjustment in the face of shocks: the OECD's indicator for the strictness of Employment Protection Legislation (EPL) suggests that Ireland is among those economies with relatively less strict EPL, alongside such countries as Australia and Denmark and markedly different from the euro area norm (Figure 3.3). Workers are entitled to redundancy payments of two weeks' pay per year worked up to a level of annual pay of around € 30 000, on which employers receive a rebate of 60% funded by social security contributions and with a fund to pay out in the case of employer insolvency. Many private employers opt to make much higher payments. The legal minimum requirement is broadly twice as generous as the current scheme in the United Kingdom, which no longer provides a government rebate to employers. New legislation adopted in 2007 covering exceptional collective redundancies provides for longer notification periods. In addition, a panel determines whether certain proposed collective redundancies are motivated by replacing existing workers by lower-paid workers, although these provisions do not appear to have had a material impact on the operation of the labour market. In terms of

Figure 3.3. **Labour market regulations encourage flexibility, 2008**[1]



1. Strictness of employment protection on a scale from 0 (least strict regulation) to 6 (strictest regulation).

Source: OECD, *Key Labour Force Statistics.*


StatLink http://dx.doi.org/10.1787/732566116216

adjusting employment following negative shocks, higher flexibility in employment regulation has two effects: the immediate increase in unemployment is likely to be greater because it is easier for firms to make workers redundant, but higher unemployment persists less because firms are not reluctant to hire again as the commitment is less costly. Econometric evidence suggests that less strict Irish EPL has only had a modest effect on joblessness compared with the European average (Duval *et al.*, 2007). Cross-country evidence suggests that the main effect of EPL settings that do not restrict adjustment is to weaken the prospects of younger workers, although it may also leave older workers more exposed to changes in employment (Bassanini and Duval, 2006).

Competitive product markets, which are encouraged by Ireland's relatively unrestrictive product market regulations (PMR), also help labour market adjustment by facilitating more rapid adjustments in activity. For example, low barriers to entry will help new firms to enter the market and begin hiring as soon as demand picks up. Other aspects of the Irish economy may, however, be more restraining of flexibility. In particular, inadequate infrastructure makes it harder to people to move to jobs located in other parts of the country, although recent progress is likely to have made such commuting easier. In addition, high housing costs and a limited private rental market can constrain movement over longer distances. This may be a growing problem to the extent that negative home equity makes it harder to move to a new job and this underlines the importance of banks allowing people to move with their existing mortgages.

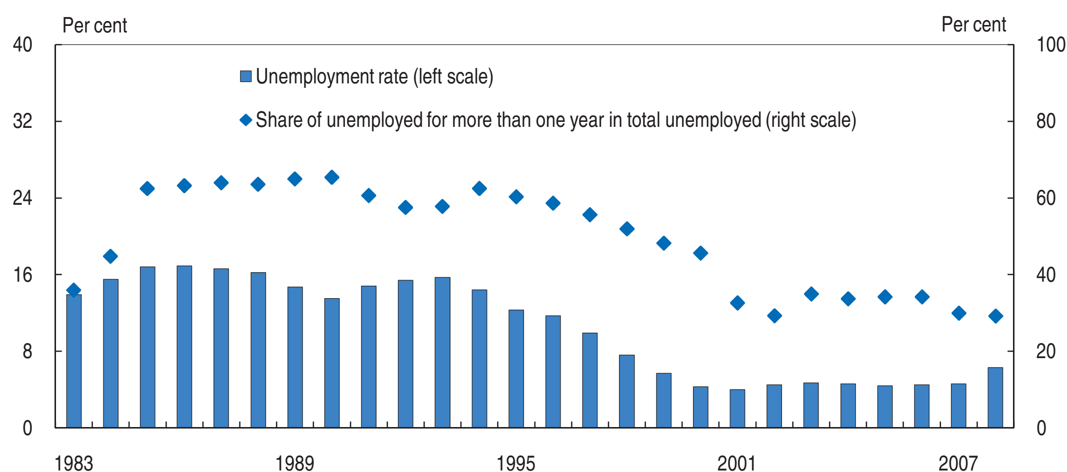
A flexible job market is also helpful in achieving the best job matches throughout the economic cycle. Evidence based on panel data for 1995 to 2001 for workers aged under 30 suggests that job mobility rates are relatively high in Ireland, with close to 16% of workers experiencing a change of job between two years (Davia, 2005), somewhat below the rate in Finland, the United Kingdom and Spain but well above the rate of mobility in many continental European countries. The job mobility rate for the Irish workforce as a whole increased sharply from around 6.5% in 1995 to reach 13.5% by 2000 (Bergin, 2008): around a third of this increase can be explained by changes in the characteristics of the workforce

and it is also likely that strong labour market conditions encouraged people to change jobs by increasing the number of vacancies, widening opportunities to find a better job and reducing the risks of moving jobs. This flexibility will also support economic growth by making it easier to adjust different activities, thereby contributing to creative destruction and the creation of new, more productive, enterprises.

High levels of unemployment will be hard to cut

International evidence suggests that a short-term rise in unemployment typically leads to an increase in long-term joblessness, particularly in European countries, and it can therefore be difficult to reduce unemployment quickly following a recovery. The Irish experience in terms of unemployment has been different following each of the two most recent serious downturns (Figure 3.4). The unemployment rate remained above 10% for about a decade following the recession of the early-1980s, despite a large outflow of workers to other countries. By contrast, unemployment fell very sharply following the early 1990s slowdown: the unemployment rate dropped from a peak of 16% in 1993 and fell fairly consistently at a brisk pace to reach 4% by 2000. Such a large and sustained fall in unemployment is remarkable in the experience of OECD countries. This followed important labour market reforms, such as reducing tax rates and reforming unemployment benefits. These included lowering unemployment benefits relative to wages, introducing conditionality and doing more to monitor and sanction the unemployed. In addition, wage restraint appears to have played a particularly important role (Blanchard, 2000). Although output recovered more strongly from the 1990s slowdown than in the previous cycle, the number of jobs created for each additional unit of output accounts for a much larger part of the difference in employment creation in the two recoveries. The central question now is whether the swift decline of unemployment along the lines of the 1990s can be repeated; this depends on wage developments and effective policies towards the unemployed. These issues are interrelated, as the downward pressure on real wages falls when the unemployed compete less intensely for jobs. The following analysis suggests that wage flexibility will contribute to resolving the high level of unemployment, with evidence that nominal wages

Figure 3.4. **Long-term unemployment is likely to increase**



Source: OECD, *Labour Force Statistics.*

StatLink http://dx.doi.org/10.1787/732618786104

may already be falling, but that policies towards the unemployed need to change in order to avoid persistent joblessness as the economy recovers.

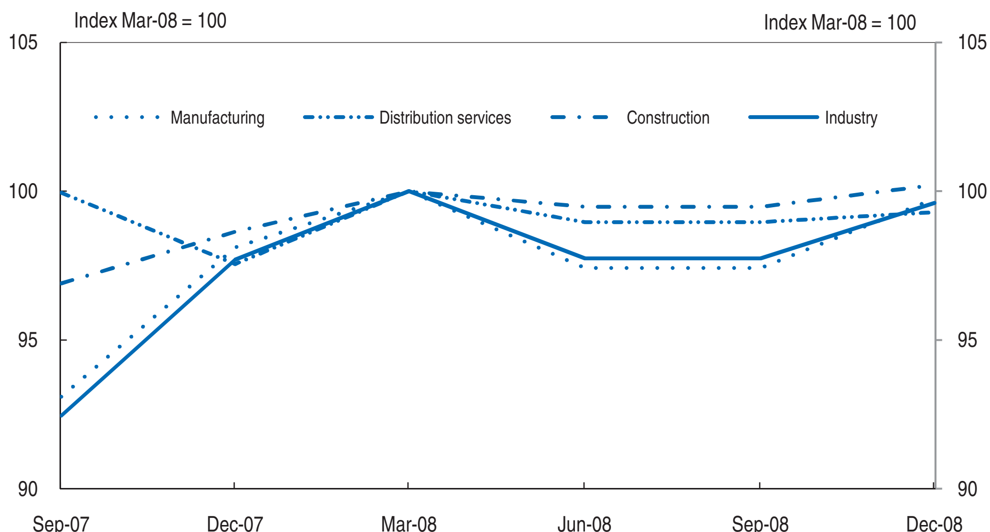
Variation in the number of unemployed people depends on the inflows into unemployment from work or outside the labour force and outflows back into employment or inactivity. Larger inflows or slower outflows raise the average duration of spells of unemployment and thereby raise the number of unemployed, in particular long-term unemployed. Analysis derived under some assumptions from data on average unemployment spells from 1983 to 2007 suggests that Ireland has had both relatively low inflows into and outflows from unemployment on average, a pattern more typical of continental European than English-speaking economies, and both have been equally important in explaining variation in unemployment (OECD, 2009a).[5] At times, emigration has also provided a very important exit route from joblessness: over the decade of persistently high unemployment up to 1994, cumulative net migration amounted to around 8 per cent of the labour force.

Lower wages are essential but the necessary adjustment will be difficult to achieve

Lower product real wages would underpin stronger demand for labour through improved competitiveness, thereby increasing the level of employment and lowering unemployment as occurred in the early 1990s recovery. Widespread evidence suggests that wages are falling fast in Ireland. However, the required adjustment is large. The amount and speed of wage adjustment will depend on how far unemployment or the fear of job losses influences pay. This depends in turn on labour market institutions and policies.

Irish nominal wages appear already to have begun to fall, although the official data only show average hourly earnings in many sectors as being fairly flat up to the end of 2008 (Figure 3.5). The fall in financial services has been marked. The reliability of some earnings series may be imperfect and new statistics have already been introduced in some areas.[6] In the public service, the Pension Levy reduces pay by around 7% on average. Anecdotal evidence points towards larger falls in wages in the range of 5 to 10%, although this may

Figure 3.5. **Average hourly earnings by sector**



Source: Central Statistics Office.

StatLink http://dx.doi.org/10.1787/732623800383

relate more to the extent of cuts by firms that have reduced wages rather than the overall changes in wages including firms that have maintained or raised pay rates. The Irish Business and Employers Confederation (IBEC) Business Sentiment Survey for the first quarter of 2009 (taken in February) showed that two-thirds of the sample intended to implement pay freezes in the next three months, while a fifth planned to cut wages and a substantial number were considering cuts. A survey for the Irish Small and Medium Enterprises Association (ISME) based on 400 of its members showed that, over the six months to March, half of the sample had implemented a pay freeze and 41% had cut wages with an average reduction of 13%. Most construction firms had cut wages and around 40% of services firms had implemented reductions.

Nominal wage reductions of this size are essentially unprecedented in the experience of OECD countries (Box 3.1). Even rapid and substantial falls in real wages on this scale are rare and have typically occurred as the result of inflation exceeding the growth of nominal wages. Wages deflated by the GDP deflator fell by 7% in Finland in three years after 1990. Most other instances of falling real wages occurred around times of unstable and rising inflation, so that *ex ante* nominal wages were sufficient to match *ex post* increases in prices. Falls in real wages are rare because rising trend labour productivity implies that wage increases on average are positive. Real wage adjustment therefore is more common through declines in real unit labour costs. The most prominent recent example of this among OECD countries is Germany, where real unit labour costs declined by 10% in the first seven years of this decade because real wages remained relatively flat as productivity increased. This is the same mechanism by which Ireland regained wage competitiveness in the mid-1990s.

Box 3.1. **Falling nominal wages are rare in OECD countries**

Aggregate nominal wages have fallen only on rare occasions in OECD countries: money wages fell for about a year in Finland in 1992 and the Netherlands from 1997, declining by around 3% and 5% respectively. Wages in Japan fell over a six-year period by almost 10% from their peak in 1996, declining at a year-on-year rate of over 3% at times and during a period of sustained price deflation. The frequency of falls in nominal wages among developed economies has increased somewhat as trend inflation has fallen. There are number of reasons why nominal wages cuts may be resisted. The economic literature suggests that firms fear that cutting nominal wages will damage worker morale and people can be averse to nominal losses in a wide range of economic situations, including the labour market. The effect this has on employment may, however, be attenuated by other factors. In particular, firms may anticipate that it is binding and so temper nominal wage increases to lower the possibility of future reversal (Elsby, 2006). The effect of cutting nominal wages may also be to change the distribution of benefits around a worker-firm job match, reducing profits but not leading to reductions in employment. Analysis based on comparing the median with the average year-on-year change in wages in household-level data to detect evidence of truncation of the distribution around zero suggests that nominal wage rigidity in Ireland was low compared with other OECD countries for the period 1993 to 2001 (Dickens *et al.*, 2006). Real wage rigidity was moderate by international comparison using the same analysis, although the strong growth in Ireland and higher average inflation over the sample might limit the relevance of these comparisons.

The role of Social Partnership in achieving wage flexibility is now unclear

In the past, wage formation and restraint in Ireland has been helped by the Social Partnership process. Tripartite national pay negotiations have taken place every three years under successive social partnership agreements since 1987. The agreement is negotiated between the Department of the Taoiseach; employers represented by the Irish Business and Employers Confederation (IBEC) and the Construction Industry Federation (CIF); and the Irish Congress of Trade Unions (ICTU), which represents over 40 trade unions and around a third of employees. Wage agreements under partnership are extended to all industries and employers, not just those represented at the negotiations. But, the agreements are voluntarist: they are not legally enforceable. Unions can reach any other agreement with employers at the local level. Employers may also invoke an "inability to pay" clause and, in case of dispute, unions can challenge this in the Labour Court. In practice, wage rates agreed in Social Partnership have acted as pay norms in the private sector in recent years, although the relationship to increases in aggregate pay has not been particularly close. In addition to limited legal enforceability, the impact of negotiated wages in the private sector is constrained by low unionisation: in 2007, only a little over one fifth of workers belonged to a union outside the health, education and public administration sectors. By contrast, union membership in these sectors was 58% so partnership has had a key role in setting public-sector wages.

The current partnership agreement, *Towards 2016* (Department of Taoiseach, 2006), was concluded in June 2006 with the pay agreement renewed in autumn 2008. The private sector element of the deal remains in force but appears to have been sidelined through large-scale reductions in pay using the full flexibility provided by the partnership system, although some firms and sectors have continued to apply the negotiated increases. In the public sector, wages have been frozen and a Pension Levy introduced unilaterally after consultation with the social partners failed to achieve agreement on these issues. This fragmented situation creates inconsistencies between the pay rates of different workers, with some being awarded negotiated increases while others receive very much less but to varying extents. This may create unhelpful tensions. While some previous partnership deals were able partly to trade wage restraint for support for disposable incomes from cuts in taxes and increases in social benefits, this approach would not be possible in the current fiscal situation and might have unwanted long-run fiscal implications. Furthermore, in the run up to the current slowdown, the partnership process did not prevent a misalignment of wages with productivity and an erosion of competitiveness (Honohan and Leddin, 2006).[7] One problem is that union coverage is unbalanced between the private and public sectors. These agreements therefore risk extending a public sector deal to the entire economy. This carries particular risks as productivity is difficult to assess in the public sector and therefore the bargained wage that results may not be closely linked to the factors relevant for the private sector.

This raises the question of whether the Social Partnership process remains useful in the present circumstances, particularly as regards wage setting. Although it is valuable to have dialogue between the social partners, there may be other ways of structuring this relationship. The current circumstances are undoubtedly a severe test of any arrangement. In terms of wage-setting, international experience suggests that either highly centralised or very decentralised bargaining can be effective: centralised bargaining encourages social partners to fully consider the impact on employment of the agreed wage level, while very localised bargaining is close to the market outcome (Calmfors, 1993). There is a case for

abandoning the Social Partnership framework altogether, while providing other fora for dialogue between the social partners. If it is retained, there are a number of options for reforming the partnership process:

- A narrower partnership deal either excluding pay negotiation altogether or excluding negotiation over private sector pay, at least in internationally competitive sectors. Under such a system, market-determined wage developments might act as a guide to pay in the sectors covered by the pay deal, although it should not necessarily be a benchmark given differences in productivity growth.
- A wider partnership process that deals with pay alongside other factors that contribute to economic competitiveness.
- Returning to the original partnership process focussed on pay and related issues, rather than wider issues of economic and social development.

There are few general conclusions about the effectiveness and design of bargaining institutions across countries,[8] but it is important that they work well and keep the overall wage level at an appropriate level. The structure of the Irish economy has changed considerably since Social Partnership was introduced and, within monetary union, there are strong external incentives to discipline wages and inflation that did not exist previously when there was the possibility of devaluing the currency. In addition, the nature of employment has shifted away from basic manufacturing to higher value-added production in industries that are not heavily unionised.

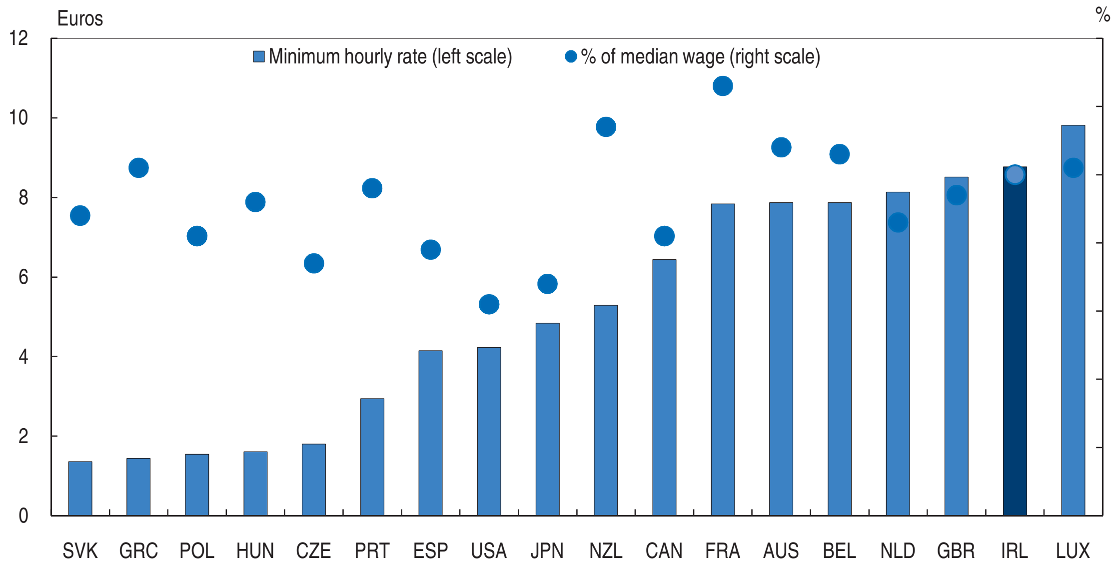
The minimum wage may become a more important constraint for low-skilled workers

A minimum wage can limit downwards wage flexibility if it is set at an inappropriately high rate relative to its objective of achieving decent minimum living standards. This is the first serious downturn where Ireland has had a minimum wage, as it was introduced in 2000. It is currently € 8.65 an hour with reductions ranging from 10 to 30% for those under 18, people in their first year of work and trainees. This is the second highest in the euro area (Figure 3.6). But, the proportion of full-time workers on the national minimum wage has been very low at around 3% (Eurostat, 2008). While firms may have been able to sustain high rates of pay when demand was strong enough for high labour costs to be passed on to customers, this will be more problematic when demand is weak. The high level of the minimum wage by European standards is not itself a major issue for international competitiveness, but it could be a problem if it is set at too high a level to clear the market for unskilled labour. This depends in part on the level of unemployment benefits, as discussed below.

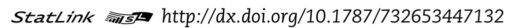
As nominal wages fall significantly, it is important that the minimum wage is adjusted to maintain its value relative to market wages, thereby avoiding further downwards pressures on demand for low-skilled labour. In addition, this should also be reflected in the level of social welfare payments so as not to reduce the incentive to work for those with low wages. Currently, around one-tenth of workers earn less than € 10 per hour: these low-wage workers are the most vulnerable to the minimum wage becoming binding as overall wages fall. This proportion is around one third in parts of the services industry. The national minimum wage is determined by the government on the basis of a recommendation either from the Labour Court, a body composed of both industry and union representatives, or agreed by employers and trade unions in a national pay agreement. The government must take the economic and labour market effects into

Figure 3.6. **The minimum wage is high by international standards**

Statutory minimum hourly rate, 2007



Source: OECD *Labour Force Statistics* and Eurostat.


StatLink http://dx.doi.org/10.1787/732653447132

account when evaluating the recommendation and explain to parliament if the proposal is rejected. This process should be modified so that the minimum wage is reviewed on an annual basis to better reflect changing economic circumstances. Some sectors, such as hotels and hairdressing are covered by Employment Regulation Orders, agreements drawn up by sector Joint Labour Committees and which can be registered with the Labour Court and extended over the sector as a whole. Sectoral minima set in this way are typically slightly higher than the national minimum. This mechanism can also determine other elements of working conditions, which can have a substantial impact on labour flexibility and costs, such as overtime pay or Sunday working arrangements. In other sectors, such as construction, the sector minimum is set through a Registered Employment Agreement (REA). These collective agreements can also be registered with the Labour Court and can become legally enforceable. Some of the minimum wages that result are high, such as € 18.60 per hour for craftsmen in the construction sector. The arrangements for sectoral minima should be reconsidered. Un-coordinated arrangements in different sectors create a risk of overall pressure on wages. In addition, they can lead to be wages and conditions that are uncompetitive in particular sectors. This risk is heightened where the minimum wage is negotiated and then extended to a wider group of workers and firms. The government is considering the introduction of an "ability to pay" clause to REAs.

Policies should do more to encourage the unemployed to get back to work

Unemployment will inevitably run at a high level in the coming quarters. The key challenge is therefore to ensure that this level of joblessness does not persist further ahead. If workers become discouraged or detached from the labour market, unemployment will remain high for a prolonged period and the downward pressure on wages will be reduced, thereby prolonging the economic adjustment. Avoiding this outcome requires increasing the incentive to work by reducing the level of unemployment benefits, stronger activation measures and effective active labour market programmes.

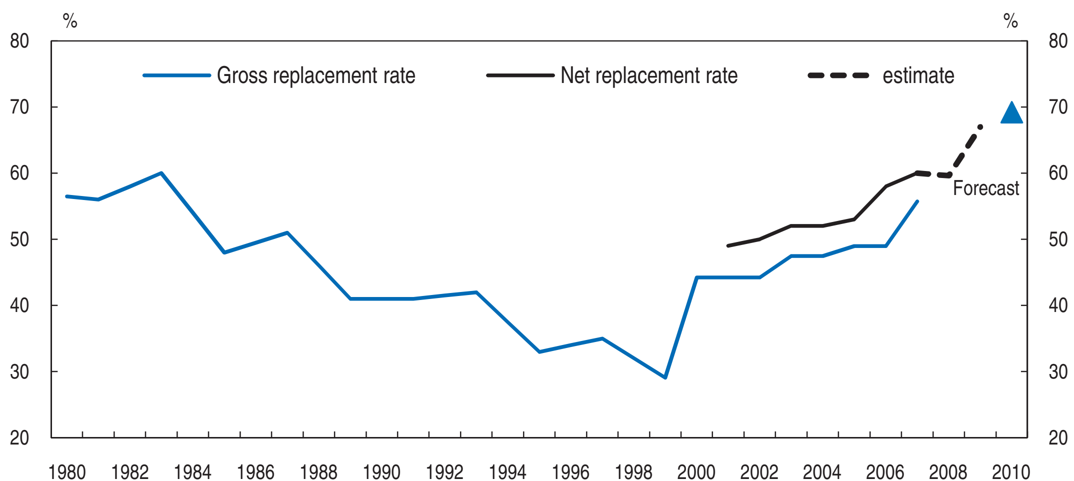
Incentives to get back to work should be improved

Unemployment-related social benefits should aim to mitigate the impact of losing a job, both by providing short-run support for household income and appropriate incentives to the unemployed to return to work. There are two social benefits associated with unemployment in Ireland:[9] Jobseeker's Benefit (JB) is a social insurance payment tied to the recipient's past Pay-Related Social Insurance (PSRI) contributions, while Jobseeker's Allowance (JA) is a means-tested safety-net payment. For an unemployed worker coming from a full-time job, the payment under either scheme is around € 204 per week for a single person in 2009.[10] The main difference between the two payments is that the JA is subject to a means test and a habitual residency condition, while eligibility for the JB is based on social security contributions paid.[11] The JB is payable for up to 12 months, reduced from 15 in the Budget for 2009.[12] Taken together, unemployment-related social payments for an individual with a given set of family circumstances can effectively amount to an indefinite fixed payment, unless there are sufficient other resources in the household for means testing to apply on the JA. The overall level of support is higher when a range of other associated benefits is taken into account. These include housing supports and the Medical Card, which entitles recipients to free generalist and hospital treatment.

The likely impact on incentives to work of the level of out-of-work payments can be assessed using the net replacement rate, the ratio of income including benefits while unemployed compared with work income. For a worker on average wages, the net replacement rate when a person is first unemployed is substantially below the OECD average and generally lower even than in other countries that have similar social systems. By contrast with some continental European countries where initially pay outs are closely related to the level of previous earnings, payments under both the JB and JA are basically the same irrespective of earlier wages and so the net replacement rate is higher for lower levels of earnings. For a worker earning 67% of the average wage, the net replacement rate is higher than for a worker on average wages but in Ireland is well below the OECD average and benefits in comparable countries. However, the current level of unemployment benefits is the result of a sustained increase in benefit levels: from 2002 to 2007, the real value of benefits increased by almost a half and the replacement rate rose substantially (Figure 3.7). Furthermore, taking into account the projected fall in wages together with the Income Levy and other increases in taxation, the replacement rate would increase substantially further even if unemployment benefits were maintained at the current level in nominal terms. Current policy settings therefore imply that the replacement rate could begin to reach relatively high levels for those with low earnings potential and even for those on average wages. There is a risk that incentive to work will be weakened as a result. At the least, unemployment benefits need to be adjusted in line with falling net labour market earnings. Unemployment benefits for those aged under 20 were halved in 2009, reducing the replacement rates for younger workers dramatically, but this measure is only a small part of ensuring that unemployment-related social benefits are at an appropriate level.

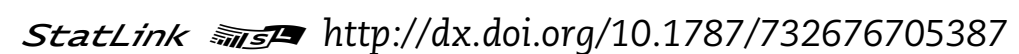
In Ireland, unemployment benefit payments remain basically unchanged for as long as people are unemployed. The main exception is where claimants have sufficient resources to lose support due to means-testing under the JA applying when their JB entitlement ends. It is fairly unusual among OECD benefit systems for payments not to fall, the longer people claim: in most countries, benefits are cut as the unemployment spell lengthens until the social assistance minimum is reached. These systems are therefore able to combine greater income insurance in the short run through more generous

Figure 3.7. **Lower-skilled unemployed workers face high replacement rates**[1]



1. Gross replacement rates are calculated for one-earner families without children on full-time earnings of 67% of average wage. They do not include household costs and compare unemployment benefits with the previous gross earnings of the sole earner (not the household). Net replacement rates are also calculated for one-earner couples without children on full-time earnings of 67% of average wage, they represent the fraction of household income that is maintained after becoming unemployed. The estimated net replacement rates for 2008 and 2009 assume average wage growth in line with *Economic Outlook* 85 and for 2009 take into account the Income Levy and increased Health Levy. The forecast for 2010 further assumes nominal benefit payments are unchanged from 2009.

Source: OECD *Benefits and Wages Database* and OECD *Economic Outlook* 85.

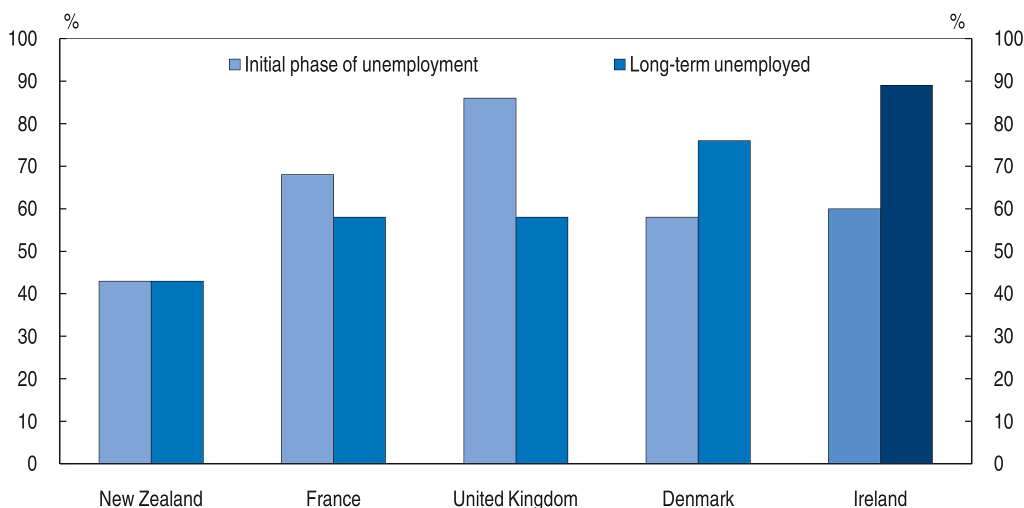

StatLink http://dx.doi.org/10.1787/732676705387

benefits, while eventually giving a stronger incentive to return to work. It is also useful to reduce unemployment benefits with duration because prolonged periods of inactivity can lead to a loss of skills or employability, lowering the real wage that can be expected from a prospective employer. Reducing unemployment benefits with time matches this pattern of reservation wages. Indeed, by getting people back to work faster, such reductions in benefits can actually lead to a smaller overall reduction in wages for those returning to work. An important consequence for Ireland of the fairly flat time-profile of benefits is that the net replacement rate, while currently relatively low for initial claimants, is around the OECD average or higher for the long-term unemployed. This is especially true for those with lower earnings potential, such as the low-skilled (Figure 3.8). A step has already been taken to address this problem through the reduction in the JA for 18- and 19-year olds, which has been cut to € 100 for a single person.

The intensity of the incentive to move back to work and the type of work sought depend on the marginal gains of moving from social benefits to earning income from work. This can be measured using marginal effective tax rates (METR), based on detailed modelling of the tax-benefit system which takes into account all forms of taxation and welfare payment.[13] Although the importance of basically flat-rate payments in the Irish social welfare system tends to reduce disincentives to work at the margin that are typically associated with means-testing, there are nevertheless important elements of means-testing within the benefit system. In particular, the JA is means-tested at household level. METRs can be very high for some situations and some levels of earnings if people return to work.

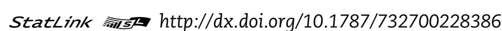
Many of these problems arise from benefits other than the principal unemployment benefits. Firstly, the loss of secondary benefits when moving to employment or higher income can be substantial. Since 2003, the Medical Card can be kept for three years after returning to work, which eliminated a strong disincentive. By contrast, Rent Supplement

Figure 3.8. **Replacement rates are high for low-earners[1] experiencing long-term employment, 2007**



1. Net replacement rates calculated for one-earner families with no children. Earnings at 67% of average wage. The initial phase of unemployment follows any waiting period and long-term unemployment applies to those who are jobless for longer than 60 months.

Source: OECD, *Benefits and Wages*.



remains in place, although reforms were introduced in the 2009 Supplementary Budget and individuals can work up to 30 hours. The Supplement is withdrawn at a rate of 100%, so METRs are extremely high over this range for the 85 000 households who receive it.[14] Secondly, the interaction of various means-tested benefit components can create high METRs, particularly for weekly earnings around half the average, and so net incomes do not vary much over quite a wide range of gross earnings and METRs can be very high at some points. These effects are part of a wider problem for the supply of labour with the incentive to increase household hours worked often limited on below-average wages or for part-time employment. For example, the in-work Family Income Supplement, which is paid to a small number (30 000) of families and requires a minimum of 19 hours work per week, has a 60% taper rate over a wide range. These high marginal effective tax rates may act as barriers to seeking more or better paid work for some people, but may also hinder the return to work altogether by discouraging the kind of part-time work that might keep workers close to the labour market in the absence of full-time work.

The design of such means-tested benefits inherently involves a trade-off between the taper rate at which benefits are withdrawn and the number of people whose net incomes are affected. The wide range of different benefits and schemes, which are not integrated with each other, worsens this trade-off by introducing a complex range of taper rates at different points in a somewhat arbitrary way: a simpler system could help to avoid "benefit traps" due to very high METRs by allowing withdrawal of benefits to be spread more evenly across different situations. Furthermore, the high level of the replacement rate on basic benefits implies that more support is required to provide strong net income gains from employment for those with high benefit incomes already. Some benefits continue to be received at levels of income close to working full-time at the average wage. The system and the interaction of benefits should be thoroughly reviewed and a more coherent system developed. A further difficulty is that the complexity of the system makes it difficult for people to understand it

and make good decisions about how much to work. Some of the necessary calculations are complicated, while others require the Department for Social and Family Affairs' own rate tables to work out entitlements (OPEN/EAPN Ireland, 2005). For example, the take up of the Family Income Supplement is relatively low compared with the very large number of households that should in principle benefit. If welfare rates overall are cut, a high priority should be given to raising take up of benefits targeted at families who need them the most.

Activation measures are ineffective

The strength of the incentives to accept job offers and leave unemployment depends on the conditions attached to receiving unemployment-related social benefits, as well as their level. If mutual obligations conditionality is stricter, higher levels of benefits may be compatible with a given a level of unemployment than would otherwise be the case. The National Employment Action Plan (NEAP), established in 1998, aims to prevent long-term unemployment through activation. The NEAP appears to have had good outcomes, against a favourable economic background, according to initial evaluations and has contributed positively to reducing unemployment by lowering the inflow into long-term unemployment and substantially increasing the rate at which the long-term unemployed get back to work (Grubb *et al.*, 2009). These initial effects appear to have been achieved in a highly cost-effective way (Indecon, 2005), although there is a need for more up-to-date econometric analysis of the NEAP. This is subject of on-going research by the ESRI. Despite the apparent success, there appear to be weaknesses in how conditionality is implemented and thus Ireland is in a weaker position than many other OECD countries in confronting the rise in unemployment.

One striking feature of the Irish labour market, highlighted in Grubb *et al.* (2009), is the number of people claiming unemployment benefit, even during the years of apparently full employment (Table 3.2): in most countries, unemployment as measured by the Labour Force Survey (LFS) is higher than the number of those claiming benefits (referred to in Ireland as the Live Register) because the conditions around claiming benefits are stricter than those who report themselves as being unemployed according to the LFS definition. By contrast, in Ireland, benefit claims are much higher than the number of people reporting themselves as unemployed. Even at the top of the economic cycle, 7% of the Irish labour force was receiving unemployment benefits. It appears unlikely that the whole of this phenomenon can be explained by differences between how the two measures are defined, such as those working very short hours, having a larger effect in Ireland than elsewhere. However, some of the high rate of claims on the Live Register could be due to inactive people signing on to claim pension entitlements. In any case, the large number of Live

Table 3.2. **Unemployment benefit recipients and survey-based unemployment**

	Claimant rate % of labour force	Unemployment rate % of labour force	Ratio of claimant rate to survey unemployment
Australia	4.9	4.9	1.00
New Zealand	1.8	3.8	0.47
Spain	6.2	8.6	0.72
Sweden	7.1	7.1	0.99
United Kingdom	3.3	5.4	0.60
Ireland	**7.1**	**4.5**	**1.59**

Source: OECD *Labour Force Statistics*, OECD *Social, Employment and Migration Working Paper* No. 75 and EUROSTAT.

Register claimants than unemployment raises a question about whether the entitlement to unemployment benefits is appropriate.

To claim unemployment benefits, workers must be genuinely seeking full-time work. That is, willing to accept any reasonable offer of suitable employment or training, or using all available services and supports to enhance their chances of getting a job. Claimants are generally required to sign on once every one or two months but can be required to do so weekly. This requirement has been enforced more strictly as unemployment has increased and there has been a move away from electronic communication so that the unemployed have to be present in person. The rapid increase in unemployment has put considerable pressure on the administration of benefits and has created a considerable backlog. This is further complicated by the Supplementary Welfare Allowance, which is available while claims are processed, but is administered by Community Welfare Officers, who are part of the health service, rather than the main social welfare administration.

Under the NEAP, all unemployed for more than three months are automatically referred from the Department of Social and Family Affairs (DSFA) to the Training and Employment Agency (FÁS) to undertake an interview and identify a personal path to re-enter the labour market, although they are advised to do so after one month of unemployment. Four options are available: a job, a place on a training/education scheme, a place on an employment scheme or work experience programme, or referral to the Local Employment Service (LES) for more intensive guidance or counselling. Those who are registered with the LES have the option of staying. The initial three-month period is long compared to the requirements in most other social welfare systems, which either require immediate full engagement with activation measures or apply a more limited requirement for the three-month period in terms of allowing more flexibility about what job offers people are obliged to accept. This referral leads many people to cease claiming unemployment benefit. This deterrence effect is surprisingly strong given the apparent lack of strictness of the conditionality since FÁS has no power to cut benefits other than to refer the case back to the social security administration. However, around one quarter of those invited to attend interview in 2007 came off the Live Register without going through the interview process. This might partly reflect people getting a job anyway, as about half of these people left the Register for employment or education (Grubb *et al.*, 2009), but may also be due to the dissuasive effect of being called to interview. If people remain unemployed, they do not face frequent follow-up compulsory interviews; the overall number of reviews conducted, relative to the number of unemployed, is far lower for example than in the United Kingdom. Compulsory interviews with benefit claimants should begin earlier during a spell of unemployment and be more frequent thereafter.

It is unclear how systematically the Department of Social Welfare responds to information from FÁS. One difficulty is that communication between the two agencies is constrained by current IT systems so that the DSFA may not have a full picture of a client's situation and so may find it difficult to justify applying sanctions (Grubb *et al.*, 2009). Furthermore, extensive appeals are possible before benefits are cut. While the NEAP process operates as intended for most people with the unemployed either going to employment or training or taking up further programmes, there are a number of gaps through which the unemployed can fall: not being referred by the DSFA to FÁS, for example in the case of a second spell of unemployment; "no-shows" who should have attended interviews but did not; and those who attend the interview but remain unemployed and are not receiving on-going support. Furthermore, the penalties for not meeting obligations

are not particularly stringent. Benefits can be withdrawn for up to nine weeks, around the norm among developed countries but much less stringent than in Australia, Spain or the United Kingdom, where sanctions can be applied for over three months (Hasselpflug, 2005). In most other OECD countries, participation in training or employment schemes can be ultimately made obligatory, while only training can be compulsory in Ireland. Sanction rates in Ireland have been very low: in 2006, only a handful of sanctions were applied for refusal to accept suitable work or engage in an employment programme. The sanction rates for insufficient job search are also well below typical experience in OECD countries (Grubb *et al.*, 2009). This would be consistent with FÁS counsellors making little use of unilateral referrals to employment programmes, in line with the policy of developing an agreed strategy with clients. This approach carries the risk that the unemployed can successfully avoid activities they do not wish to undertake and that sanctions cannot be applied. The requirement to work should be enforced more strictly. While it is useful to support those voluntarily trying to enter work, more attention is required on those reluctant to seek work, particularly given that the net replacement rate can be relatively high for those with low earnings potential. Those who do not meet the required conditions should systematically lose their benefit entitlements. Overall, many of the conditions that ensured the early success of the NEAP were relaxed in recent years with not only higher benefits but also less emphasis on conditionality. The result is a system that falls short of the kind of mutual obligations approach achieved in a number of OECD countries (Grubb *et al.*, 2009). A major change in culture and practices will therefore be needed, even if with weak labour demand, these conditions need to be enforced realistically in the short run. However, by creating a strong institutional mechanism to enforce conditionality now, labour market institutions will be better prepared to avoid long-term employment when demand returns.

One difficulty is that there are a large number of agencies involved with providing assistance to the unemployed: the DSFA, FÁS and the local employment services (Box 3.2). This leads to the risk that the unemployed "fall between the cracks" of different supports, either voluntarily or because of the complexity of the system. Most OECD countries have moved to a system of a single agency dealing with the unemployed and handling both welfare payments

Box 3.2. **Agencies dealing with the labour market**

Although Ireland has a small population, it is unusual in the number of agencies that deal with the unemployed:

- The Department of Social and Family Affairs (DSFA) is responsible for the administration of unemployment benefits, and the social security system more widely.
- The Training and Employment Authority (FÁS), which depends on the Department for Employment, Trade and Enterprise (DETE), is the public employment service. It provides placement functions and training, both for the unemployed and the economy more generally.
- The 25 Local Employment Services (LES) operate under contract from FÁS and provide locally-based training and employment matching.
- The Department of Education and Science runs regional technical colleges and the Vocational Training Opportunities scheme for the long-term unemployed.

In addition, Pobal, a non-profit company, runs the Local Development and Social Inclusion Programme (LDSIP).

and activation measures. This helps to ensure that the conditionality is effectively enforced and allows for greater efficiency. Ireland should adopt best practice in this area and have a single body dealing with the needs of the unemployed, both in terms of benefit administration and active labour market policies. This would require a redefinition of the role of the bodies involved at present including FÁS and the Department for Social and Family Affaris. Given that Ireland is a small country, the currently large number of agencies involved is inappropriate.

The interaction of unemployment support and the minimum wage may lead to a poor outcome

The interaction of different labour market institutions determines the overall effect on long-term unemployment. As discussed above, a combination of high replacement rates and weak conditionality is likely to sustain high levels of unemployment. Given that replacement rates will be high even for workers around the average wage if no changes in policy are made, the weaknesses identified in conditionality could have a serious effect on unemployment. For low-skilled workers, the minimum wage may become an additional constraint on labour demand if firms cannot offer jobs at more competitive wages and there may be further difficulties if interaction with social benefits is not taken into account. Furthermore, given that the Irish labour market is highly open to foreign workers and migration routes are now well established, a high minimum wage combined with insufficient incentives for Irish workers to accept some jobs or for employers to take on unemployed workers from Ireland could result in vacancies being filled by new migrants while unemployment remains high.

Active labour market policies

Unemployment can have a long-term impact on the prospects of those who lose their jobs if it leads to the loss of human capital or prevents workers from returning to the same quality of job. To avoid unduly large losses of human capital, the main policy objective should be rapidly to re-integrate into employment those who lose their jobs, while maintaining as far as possible the mutual-obligations ethos of the activation regime that is needed in the long run to avoid structural unemployment (OECD, 2009a).[15] An evaluation of 199 active labour market programmes in a wide range of countries since 1995 suggests that job-search assistance has relatively favourable short-run effects, while classroom and on-the-job training shows better medium-run outcomes (Card *et al.*, 2009), and subsidised public sector employment programmes have the least favourable effects. Labour market policy spending in Ireland in recent years has been low by European standards, and considerably lower than in Nordic countries (Table 3.3). However, there has been relatively extensive apprenticeship support by international comparison, much of which was targeted at construction. Spending on passive measures has been low by international standards, but expenditure on direct job creation, notably through the Community Employment scheme, has been high. The design of this scheme is unlikely to have the most favourable effects but it is costly in terms of the support provided per worker and does not necessarily provide the most effective path back to paid employment in the market sector.

Spending on public employment services and administration is low by European standards. Furthermore, a majority of staff are working on unemployment benefit administration rather than the placement of unemployed workers (Grubb *et al.*, 2009). The number of staff in public employment services has fallen relative to the labour force in recent years and left Ireland with fewer resources for the number of potential users than other European countries. Although the proportion of frontline staff appears to be high, the large number of agencies involved and the small size of local offices suggests that services might not

Table 3.3. **Spending on active labour market programmes**

% of GDP, 2006

	Ireland[1]	Nordic countries	Other OECD Europe	OECD non-Europe
Active measures	0.69	1.17	0.77	0.27
Of which:				
Public employment service and administration	0.12	0.22	0.22	0.13
Direct job creation	0.24	0.04	0.10	0.02
Other measures	0.33	0.91	0.44	0.12
Passive measures	1.00	1.45	1.19	0.39
Total	1.69	2.62	1.95	0.66
Memo: Unemployment rate	4.36	5.93	7.53	4.52

1. Data for Ireland scaled by GNP.

Source: OECD (2008) and Grubb *et al.* (2009).

be delivered in the most efficient way in terms of helping those without jobs to stay close to the labour market and get back to work. This leaves relatively few resources to deal with activation and to ensure that it works effectively. Key programmes are discussed in Box 3.3.

Some existing programmes in Ireland are not well adapted to the current circumstances and are not well-designed in terms of having the maximum impact at the lowest cost. Over one-third of FÁS' budget of around € 1 billion, which is part funded by a 0.7% payroll tax on employers together with a larger contribution from the Exchequer, is spent on the Community Employment (CE) scheme. The CE scheme provides public support for part-time jobs in the public and voluntary sectors. Individuals are in principle allowed on the scheme for up to three years,[16] although this may be difficult to apply in practice given that both participants and employers can be reluctant to move on and it can be regarded as a cheap way of providing certain services locally. It is possible that this scheme even reduces employability in unsheltered jobs by keeping people in basic non-market activities. This scheme is therefore relatively close to a form of on-going social assistance rather than a pathway to market employment, placing it in one of the least effective categories of labour market intervention. Furthermore, the scheme is expensive with just 20 000 people on the scheme. No comprehensive evaluation has been carried out of the CE scheme in recent years. A full evaluation of its costs and benefits, taking into account the impact on employability is necessary. Other models should be considered such as the Australian "Work for Dole" scheme, which is part of a strong mutual obligations approach, or Social Enterprises in Finland, which have more limited public subsidisation of jobs and a larger role for commercial activities. In the meantime, given the shortage of resources to support wider activation measures, the CE scheme should be scaled back. It also appears difficult to justify the creation of 400 additional places in the Supplementary Budget. Other training programmes have, in the past, largely been oriented towards sectors, such as construction, for which demand is now limited and there is substantial number of apprentices mid-way through their training under these schemes. The quality of training under these courses has been good, but a more strategic approach may have avoided putting resources towards sectors where demand was unsustainable.

Scaling up programmes to deal with the large increase in the number of unemployed will be a major challenge, particularly within tight budgetary constraints. Automatically referring clients after three months of unemployment to the NEAP is likely to be difficult to implement effectively given current resources as the number of unemployed increases

Box 3.3. **Main employment programmes in Ireland**

The main labour market programmes in terms of size are:

- The Community Employment (CE) scheme is a programme for the long-term unemployed that provides pay and support for up to two years of employment in the non-market sector. There were over 20 000 people on the CE scheme in 2007: more than 1% of the labour force. Some of the specialised functions for those needing intensive support and a period of sheltered employment are needed, but the scheme as a whole is too broadly targeted both in terms of cost and giving insufficient encouragement to join regular employment for those for whom this is most appropriate. A programme along these lines may have a role as a last resort under a mutual-obligations approach, but does not play such a role at present in Ireland.
- Back to Education Allowance (9 000 participants) allows those aged over 21 years to return to education, while continuing to receive benefit income equivalent to unemployment benefits and a Cost of Education allowance. In 2009, the qualification period was reduced to 3 months for second-level education and 9 months for third-level courses. Although it is useful to take advantage of periods of unemployment to improve skills, particularly those that may improve employability afterwards, this scheme is not very specifically targeted at those for whom it could have an additional benefit in terms of raising their labour market prospects.
- Back to Work Allowance introduced in 1993 allowed the long-term unemployed to keep 75% of their unemployment benefits in the first year after returning to work, falling to 25% in the third year, together with some secondary benefits. There were 4 300 participants in the scheme in 2007, far below the original rate of participation and partly reflecting tighter eligibility conditions. It was closed to new entrants in 2009. The Back to Work Enterprise Allowance is a similar scheme for entry into self-employment and has been on a similar scale. In 2009, the scheme was expanded so that only one year of unemployment was necessary to qualify but the duration has been cut from 4 to 2 years. A Short-Term Enterprise Allowance has been introduced, which provides one year of support to those eligible for JB. These schemes carry the risk of heavy deadweight losses as those most likely to exit unemployment are most likely to use the support. Although the new measures may be good for people who are "work ready" but unable to find dependent employment, there is also a risk of cycling. These schemes are quite complex and do not directly engage with some of the important disincentives that currently exist within the system.

In addition, FÁS training centres provides general (Bridging/Foundation courses) and specific skills training. There were around 4 800 participants in such programmes in 2007.

(Grubb *et al.*, 2009). The strategy at present has been to redirect resources from elsewhere in the training budget and provide shorter courses to more people (Box 3.4). This is appropriate in that many of the unemployed were recently in employment and therefore need less intensive "back to work" training. It makes sense to expand programmes that can be scaled up quickly or in a cost-effective way. On the other hand, there is a risk that the quality of training may be less than would have been the case. There are also challenges in dealing with a new population of unemployed: migrants, those with low skills whose long-term prospects have deteriorated sharply as a result of the correction in demand, and professionals who are becoming unemployed. Effective spending on activation measures should be cost effective in the sense that reducing long-term unemployment will boost the economy and reduce social expenditures in the medium term. It is therefore important

Box 3.4. **Labour market measures taken to deal with the rise in unemployment**

The increase in unemployment has been spectacular: claimant count unemployment has risen by around 255 000 to reach around 428 800 by August 2009. New measures costing up to € 370 million, taken from existing budgets, to support those who lose their job have been introduced, in addition to the existing supports.

The main measures are:

- A doubling of training and work experience activation places to 128 000 per year to be provided through FÁS.
- A doubling of places to in the education sector to 146 000 places, including 91 000 training places, mostly on 10-week courses, under the Training Initiatives Strategy; 2 000 additional places in full-time third-level education and further 1 500 in part-time university courses; 2 000 places under the Work Experience Scheme for recent graduates; 1 500 places in Post-Leaving Certificate Courses; and over 41 000 places under a variety of other initiatives.
- A Temporary Employment Subsidy Scheme (TESS) with an initial budget of € 250 million to provide a subsidy of up to € 200 per week per worker to qualifying firms in the manufacturing or traded services sector to retain a person in employment for a period of up to 15 months.

The Back to Work Allowance scheme has been modified so that it will only provide support for those going into self-employment rather than employment. In addition, the duration and extent of support has been limited while the qualifying period has been halved to one year. The Back to Education Allowance has also been made easier to access and greater emphasis given to shorter education and training courses.

The approach through training and education has a number of strengths. Firstly, the emphasis on short courses increases the number of people who will receive some training over a given period within a given level of expenditure. Secondly, the measures are partly targeted at groups that may need greater support to integrate the labour market. This is particularly true of younger workers who may not yet have developed strong attachment to the labour force. Thirdly, the emphasis on training means that these programmes should also contribute to raising human capital.

The impact of the TESS will depend in part on how it is implemented. Although it is in principle targeted at firms that have the potential to grow in the future and have already restructured, the cost per job saved is likely to be relatively high unless a way is found to ensure that only jobs that would otherwise temporarily have been lost are retained. A subsidy aimed at hiring those who have been unemployed for some time might have contributed more effectively to improving labour market outcomes.

The problem, however, is that the overall scale of the programmes is limited compared with the number of unemployed. Although many people who lose their jobs will be able to find work without assistance, it is likely that many of the newly unemployed will not find jobs for some time. Although they have access to existing programmes as well as new schemes, this still represents a large population that cannot be reached within the constraints of the current level of funding. Despite overall constraints on public spending, additional resources in this area would reduce the risk that high unemployment will persist as the economy recovers. Given the fiscal and social costs of unemployment, there would be a high return to redeploying additional resources to effective programmes for support those who lose their jobs as an integral part of a strengthened activation strategy.

that sufficient resources are reallocated to such programmes, even if this requires the scaling back of other existing less effective schemes.

Subsidies may help to support labour demand and manage the high level of unemployment (OECD, 2009a). Given the tight fiscal constraints, however, very costly policies should be avoided. This includes measures that cover the entire workforce, like temporarily reducing employers' social security contributions, which have high deadweight costs for those already employed. International experience suggests that short-time working subsidies are difficult to implement effectively and these are most appropriate for well-defined temporary reductions in labour demand. The Temporary Employment Subsidy Scheme (TESS) is targeted, temporary and in principle only covers with good growth prospects and that have restricted. However, this must be carefully implemented to ensure that the risk of high deadweight loses are avoided. Hiring subsidies can be relatively effective compared with other measures. These should be targeted at groups from whom they are most effective and carry strict conditions for employers. Subsidies could be offered for those unemployed for some time (at least one year) and should be related to net changes in employment, rather than gross hiring, to remove incentives to replace existing employees with subsidised workers. Paying such subsidies as rebates of employer social security contributions paid after one year further strengthens the incentive not to churn employees. This would help to ensure that the flow of new jobs is directed towards preventing long-term unemployment. Public job creation schemes may provide a backstop in a very long and deep recession, both in boosting labour demand and activating the unemployed. This approach, however, is likely to be costly. These schemes must be temporary, to cover the worst of the weakness in demand, and should not become a disguised form of subsidised permanent unemployment like CE.

Migration has begun to reverse

The number of foreign nationals working in Ireland has fallen as demand for labour has contracted, beginning to reverse the strong net inwards migration experienced from the mid-1990s onwards. By the first quarter of 2009, the number of foreign workers has fallen by 16%, 56 000 people since the first quarter of 2008. The full extent of changes in the stock of foreign employees is hard to evaluate in real-time as the QNHS is known to provide an incomplete picture of the immigrant population (Barrett and Kelly, 2008): it reported that 8.4% of the population aged over 5 were foreign nationals in 2006 in the same quarter that the census indicated that the proportion was 13.3%. Other indicators also point towards a reversal of migration trends. The number of work permits issued has fallen, particularly for renewals. The number of new Personal Public Service Numbers (PPSNs), a national insurance number required to work, issued to migrants has fallen dramatically. There have been widespread falls among different nationalities of migrants, but the main driver in the overall slowing in the issuance of new PPSNs is the halving of new migrations from the EU new member states. The gross flows of migrants have always been very large compared with the stock of migrants, consistent with migrants staying in Ireland on average for a year or two only, so that the reduced inflow would be insufficient to maintain the existing stock of foreign workers.

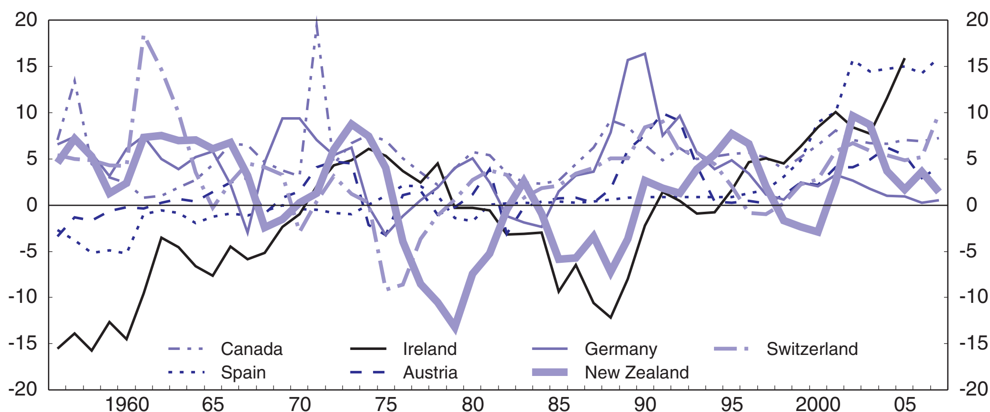
Despite the outward migration, unemployment benefit receipt among foreign nationals has been significant. While it was initially above their share of the labour force at around 20% of those on the Live Register, the proportion has fallen over recent months and the increase in the number of foreign nationals claiming benefits has been small compared with the

increase for Irish nationals. However, it appears that many migrants are remaining in Ireland while unemployed. While the costs of living in Ireland may be high compared with other countries, benefits are also quite generous by international comparison and employment prospects are also likely to be weak in some of the new EU member states and other countries to which EU migrants might go for work. This effect is tempered by the characteristics of the migrants themselves: many left families behind to come to work in Ireland in jobs below their skill level, so staying is unattractive for many non-monetary reasons. It is likely that some EU migrants are claiming the Irish benefits to which they entitled but looking for work at home or elsewhere, which is allowed under EU law under certain conditions and for a limited time. Enforcement measures in 2008 ended benefits for some people claiming benefits but not living in Ireland or fulfilling their requirements.

Migration has long been an important adjustment mechanism in the Irish labour market, prior to the mid-1990s primarily through migration of Irish workers to and from the United Kingdom and also to the United States (Figure 3.9). In the previous *Survey*,[17] it was shown that the semi-elasticity of the net migration rate with respect to a one per cent increase in GDP per capita growth was much higher in Ireland than in any other of 18 OECD countries, at around 0.4, compared with around 0.2 in the group of next most sensitive countries such as Australia, New Zealand Switzerland. In addition, the net inward migration in recent years into Ireland was stronger than could be explained by this long-run relationship.

Figure 3.9. **Net inward migration rates**

Per 1 000 population



Source: OECD (2009), *Population and Vital Statistics – Online database* (June).

StatLink http://dx.doi.org/10.1787/732727564083

The migration into Ireland since the mid-1990s is likely to have a substantial permanent impact on the Irish labour market, despite recent cyclical outward migration. Of the three groups of migrants identified in the previous *Survey* (OECD, 2008a), some or even most of the migrants in each category are likely to stay: Irish return migrants and British immigrants are well integrated and likely to stay, even if some Irish workers continue to look for employment opportunities abroad; the large contingent of migrants from the new EU member states are perhaps the most sensitive to the state of the economy, which has been reflected in the composition of outward migration to date, but some have established roots in Ireland and

will stay; and migrants from the "rest of the world", a diverse group coming from outside Europe or the United States, will have varied experiences as some have come to Ireland for specific employment opportunities but others who have come as refugees or asylum seekers are likely to have fewer good options to return home.

With a substantial foreign population likely to stay, the primary policy challenge remains the integration of immigrants. Non-EU migrants had unemployment rates around 3 percentage points higher than average, even when labour demand was strong. The previous *Survey* identified a particularly large gap between the skills of migrants and the jobs they were employed to do. Improving language training, both for adult migrants and their children, would help to address this, as well as accelerating work on the recognition of foreign qualifications and introducing an on-the-job skill assessment programme. In some ways, the recent ebb in migration has made the issues facing integration of immigrants simpler by removing some of the uncertainty about the extent to which migrants were likely to settle and it makes it easier to focus attention on the population that will remain rather than the transitory cohort of migrants from the new member states of the EU.

The Irish approach to providing services for migrants is based on directing immigrants to mainstream services such as health, labour market, education and housing rather than through separate settlement and adaptation programmes. This strategy reduces the risk of creating poorly integrated "enclaves" of migrants, although it is equally important that access to services is adequate to ensure the immigrants have the skills to be full members of society. The 2008 Statement on Integration provides a strategy for dealing with integration issues (Office of the Minister for Integration, 2008).

Immigration policy for the long term

Ireland is only able to influence immigration at the margins through policy. Appropriate selection policy is important for ensuring that an economy with a small pool of domestic workers is able to provide the skills necessary for the development of the multinational sector and high value-added clusters such as ICT industries in Cork and the IFSC in Dublin. Of the 1 500 staff at Google's European headquarters in Dublin, 1 200 are non-Irish and there are 58 different nationalities.[18] Migrants with complementary skills to native Irish labours can help to increase the productive capacity of the economy and improve the prospects of existing workers. While unskilled labour that has been important to dampen costs in sectors such as construction is likely to be available from new EU member states where wages are much lower than Ireland, it may be important to attract highly skilled workers with specific skills and abilities from outside Europe to help sustain long-term productivity.

A number of policy initiatives have been taken in the recent past, mostly concerning immigration from outside the European Economic Area (EEA).[19] Significant changes in legislation in 2007 concerned the two main migration channels:

- The "green card" scheme was introduced. This gives employees the right to work for two years (with the possibility of indefinite extension), allows immediate family reunification and gives fast access to long-term residence status. Applicants must have a valid job offer, usually with a salary of at least € 60 000 (lowered to € 30 000 for occupations in a restricted number of sectors facing skills shortages).[20]
- The work permit scheme was modified. Building on reforms in 2003 to focus more on highly skilled workers, it now covers occupations in the € 30 000 to € 60 000 range with

few exceptions. There is also a list of ineligible occupations. A tougher labour market test was introduced. The permit is now issued directly to the worker, strengthening their status. Family unification is possible after one year.

- Changes were also made to some of the other channels. The intra-company transfer scheme, allowing for temporary management transfers within multinationals, was reintroduced in 2007 after having been suspended in 2002 following abuse. The Third-Level Graduate Scheme was introduced, allowing non-EEA students who have studied in Ireland to work for six months after graduation and apply for a "green card" or work permit.

The impact of these measures is difficult to evaluate, even two years after their implementation, given the overall fall in labour demand. The total number of permits issued fell by almost half in 2008 compared with 2007. Take up of the "green card" scheme may also initially have been held back by lack of awareness.[21] The main industries benefitting from the two permit schemes are the services sector, catering and the health. Just 1 264 permits were issued for industry in 2008.

The approach taken to migration selection is employer-driven and gives them a large role in choosing workers from abroad. This contrasts with more supply-driven systems in countries that use a points system, where qualified potential migrants are selected on the basis of criteria (such as education, language ability, and work experience) and may then enter the country to search for employment. Given the small number of non-EEA nationals that are likely to be needed, the simplicity of the "green card"/work permit system probably makes it the most suitable approach. Many European countries have moved to using such an employer-driven system and supply-driven systems have increasingly shown their limitations (Chaloff and Lemaitre, 2009). The potential drawbacks of Ireland's employer-driven policy suggested in the previous *Survey* do not appear to have materialised so far: the loss of control of overall numbers in the absence of numerical limits, bias in favour of older workers because of the salary threshold, and favouring certain occupations that happen to be in the middle-salary ranges. There is no evidence that these schemes particularly hindered necessary wage adjustments or have had long-term consequences, as employers focus on their own labour needs rather than the overall merits of bringing someone into the country. The policy framework should, however, continue to be monitored to ensure that they are achieving their objectives and the frequent reviews of the occupational list for work permits are a good practice.

The overall quality of life is important to attracting highly skilled migrants, for whom there may be strong competition from other countries looking for the same resources. This underscores the importance of policies not only to ensure high disposable incomes and a reasonable cost of living, but also much wider quality of life issues such as the availability of childcare, good quality health and education and high standards of infrastructure. Migration policy can help by providing the legal stability to encourage migrants to establish themselves in Ireland, including bringing the families with them, and by minimising the administrative burden of their situation. The proposed 2008 Immigration, Residence and Protection Bill would be useful in this regard. The new status of long-term resident would give those with at least five years legal residence, less for "green card" holders, access to the labour market and state-funded services on the same basis as Irish citizens,[22] and allow multiple re-entry visas for resident foreigners, who currently need a new visa each time they leave the country, thereby substantially lowering the administrative burden facing highly mobile workers.

Policies to raise employment in the long term

Even during the years of strong economic performance, some groups continued to have low employment rates (Table 3.4). These include: women, lone parents, people with long-term health problems or a disability, those aged under 25 years of age and those over 55. It is common experience among OECD countries for these groups to have more marginal attachment to the labour market. Furthermore, these groups are most vulnerable to becoming detached from the labour force through their exposure to the risk of unemployment and the likelihood that this becomes permanent. Indeed, there is a risk that some social welfare benefits, particularly those related to old age and disability, become alternatives to pathways away from the labour market and into inactivity. This would become more likely if unemployment benefits are reduced or conditionality is more strictly enforced. Reforms to maintain or raise employment among these groups are important to expanding the labour force in the long run.

Table 3.4. **Employment as a share of population by group**

	Working-age population	Females	20-24 years of age	55-64 years of age
Ireland	**69.0**	**60.3**	**69.8**	**54.1**
EU15	67.0	59.6	58.0	46.4
UK	72.3	66.3	67.4	57.4
Australia	72.9	66.1	76.8	56.7
Sweden	75.7	73.2	63.1	70.1

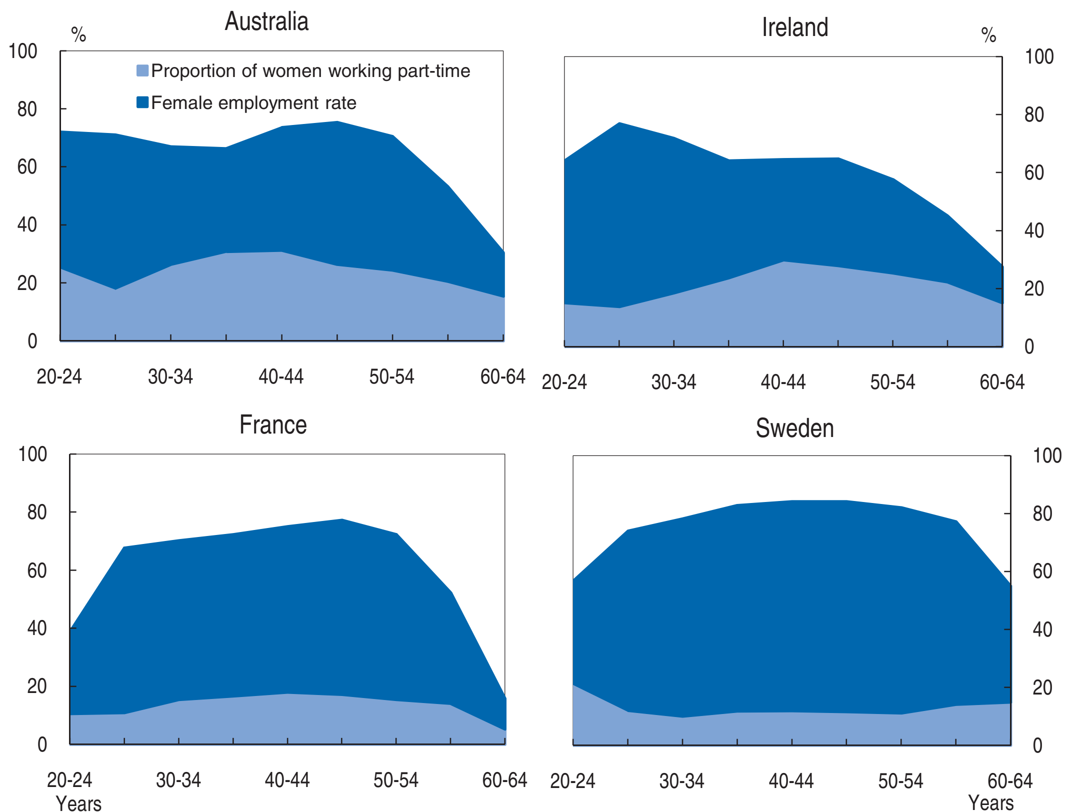
Source: OECD, *Labour Force Statistics*.

The Irish welfare system is based on a "contingency" approach so there is a wide range of different social benefits available for people in different situations. These generally offer relatively similar benefits, although the exact amounts and conditions may differ. This complexity increases the likelihood that there are poverty traps and makes the administration of the benefit system more complex and costly. As discussed below, several benefits are not designed to encourage people to work to fulfil the maximum of their potential. Consideration should be given to introducing or moving towards a single welfare payment for working-age adults to replace the existing range of payments, a direction in which some other countries are moving. Some of the measures discussed below go in this sense by suggesting more similar treatment across different groups, particularly with respect to the requirement to look for work or participate in training. Such a single payment should be means-tested and based on an assessment of the work capacity and need for support to participate in the labour market.

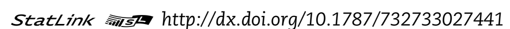
Raising female participation

Female participation in the labour force has increased in past years, rising by around one percentage point per year on average to reach 60% in 2007. Although the increase has been very rapid by international standards, female participation in Ireland is only marginally above the OECD average and well below those in other English-speaking and Nordic countries. Furthermore, part-time employment is more common in Ireland so that the actual supply of labour by women is lower by international comparison than the participation rate would suggest (Figure 3.10). The rate of participation for women with children is particularly low. Women have so far been substantially less impacted during

Figure 3.10. **Female employment and part-time employment rates, 2007**



Source: OECD, *Labour Force Statistics.*


StatLink http://dx.doi.org/10.1787/732733027441

this recession than men in terms of the fall in employment, the increase in unemployment and lower participation. This difference, however, may narrow as job losses spread to sectors where women are more heavily represented in the workforce. It will be important to avoid the cyclical downturn in female employment and participation from becoming permanent. In particular, women are over-represented in low wage activities, such as services, and so may be adversely affected by the high level of the minimum wage and the current level of social benefits.

The incentives for second earners to work full-time have a strong effect on female participation. While the sensitivity of the primary earner to changes in income taxes is generally quite small, the response of second earners is typically much stronger (see Johansson *et al.*, 2008, for a review of recent evidence). With marginal direct taxes for people earning around average wages having increased in broad terms by 4 percentage points due to the Income and Health Levies, it is likely that female participation will be affected. Ireland has a hybrid income tax system, where married couples can choose the most favourable option from both being assessed as single person, separate assessment (where some tax credits may be divided equally) and full joint taxation, which is usually the most favourable in terms of the overall tax burden. Comparing discrete options in terms of working hours, there are disincentives within the tax system that could be removed, increasing female participation and raising more revenue for a higher level of total hours worked (Callan *et al.*, 2007). The benefit system can have similar effects: for

example, means-testing on household resources may create weak incentives for the spouse of an unemployed person to seek part-time work.

As argued in the 2006 *Survey* (OECD, 2006),[23] high childcare costs and limited supply have been a major obstacle to female participation. The National Childcare Strategy is on course to provide an additional 50 000 childcare places, broadly equivalent to enough places to provide childcare for every child born in a single year, and has led to a substantial increase in the childcare capacity, both in terms of facilities and the availability of qualified staff. The supply of out-of-school-hours provision has also been limited and, although 5 000 additional places have been provided, this is a tiny fraction of the number of children aged 6-12. Efforts should continue to develop the cost-effective solution of making school buildings available for after-hours community projects.

Government support for childcare, both direct and through the tax system, has not been well targeted in recent years as it has been available on the same basis to non-working as well as working families. This is changing as the universal Early Childcare Supplement for families with children under the age of six, introduced in 2006, was cut from € 1 104 to € 498 in May and eligibility cut to five years of age. It will be abolished in 2010 and replaced by a new free pre-school year for those aged between three and five years in Early Childhood Care and Education (ECCE). This is expected to benefit some 70 000 children, the majority of its target population. This will provide some help with childcare while parents are at work, although the scheme is not specifically targeted at this group so there is some dead-weight loss. It should, however, also contribute to raising human capital and helping children from disadvantaged backgrounds.

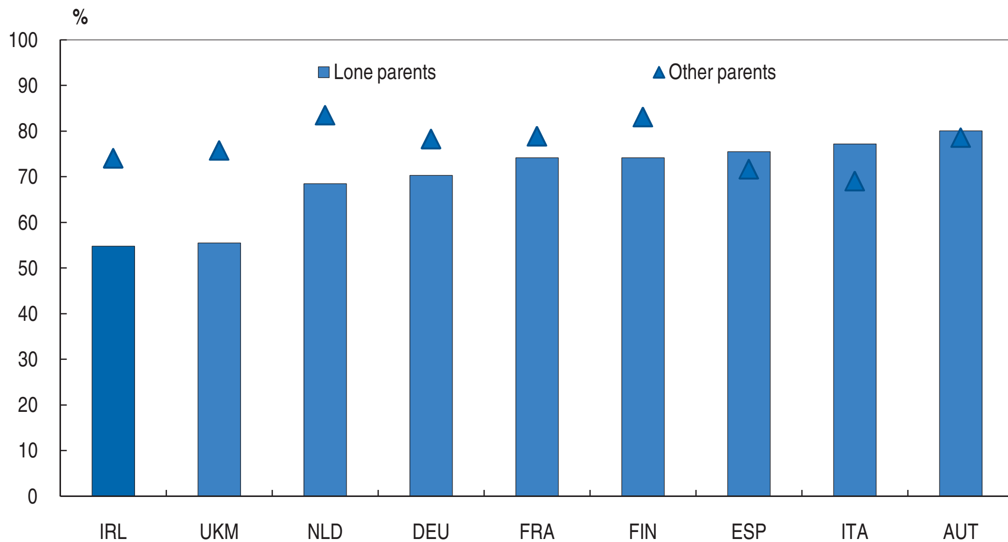
Helping lone parents to work

Lone parents are an important part of the population in Ireland with almost one in four children being raised in a family headed by one adult (CSO, 2007). Lone parents also represent a sizeable group of the potential labour force with almost 4% of the working-age population in this family situation. Employment rates for lone parents are low at around 55%. The gap between the employment rate of lone parents compared with all those with children living at home is particularly large by international standards (Figure 3.11). Closing this gap could increase the workforce by the order of 1%. The low employment rates of lone parents are not only a labour market issue but also raise wider social questions. Lone-parent households are poor on average: 38% have equivalised household income of less than 60% of the median, the standard measure in Ireland of the at-risk poverty rate, and one fifth are in consistent poverty (CSO, 2008).[24] This compares with a 14% at-risk poverty rate for two-adult households with children and the small number of such families in consistent poverty.

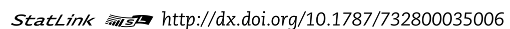
Lone-parent families are heavily dependent on social welfare payments. In addition to the universal Child Benefit, around three quarters of lone parents received the One Parent Family Payment (OPFP). This is a means-tested benefit worth € 250 per week for a lone-parent household with two children. A 12% increase in the payment in 2007 contributed to a substantial fall in the numbers of families officially defined as being in poverty by either of the measures discussed above. However, this is in part because the value of social benefits for a lone parent family is relatively close to these measures of the poverty line and therefore the numbers of people defined on this basis as being in “poverty” can be very sensitive to changes in benefits and overstate the degree of real improvement in living standards that has been achieved. The continuing high poverty rates among lone-parent households

Figure 3.11. **Employment rates for parents**

Share of working age population



Source: Eurostat and Central Statistics Office.


StatLink http://dx.doi.org/10.1787/732800035006

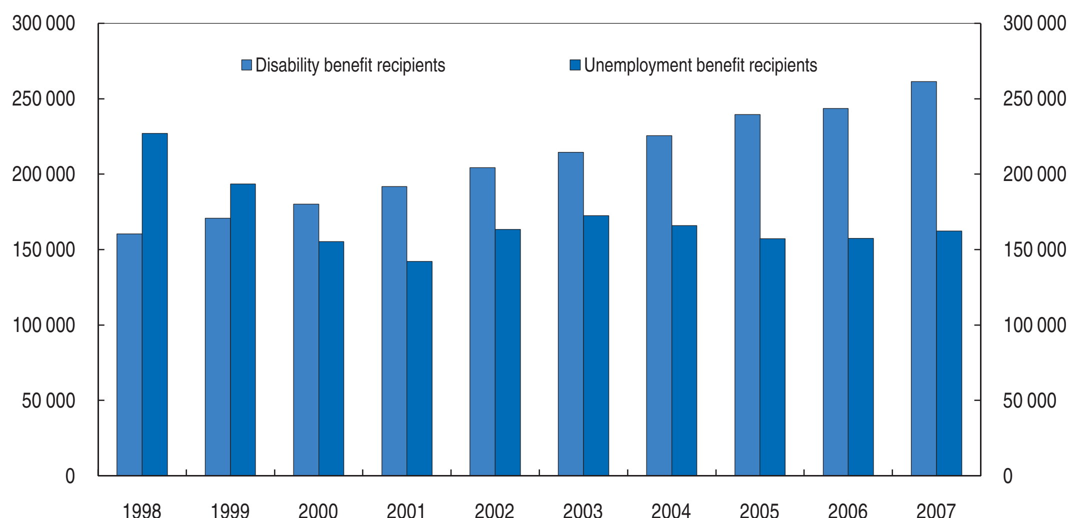
underlines the limits of the approach of raising benefits used in recent years to tackle poverty in this group, benefits which already cost 0.6% of GNI.

Raising the employment rate of lone parents would therefore help both to boost the labour force and tackle poverty. Although incentives to work are good for some groups such as those able to earn around the average wage, the benefit system and limited childcare provision create some barriers to returning to work for those with lower potential wages, which is often the case with lone parents who are less well educated on average than the population as a whole. Survey evidence suggests that there is a strong desire among lone parents themselves to undertake training and enter employment (Murphy *et al.*, 2008). The employment rate of those on Rent Supplement is just 15%, much lower than for those receiving other forms of housing support. Ireland is unusual among OECD countries in not requiring lone parents with school-age children actively to look for work as a condition for receiving benefits; only a handful of other countries do not require mothers of teenage children to work. Germany, Norway and Sweden impose the requirement once the youngest child is 3 years old. For this policy to work effectively, it is important that those subject to these requirements have appropriate support and are given high priority in terms of access to childcare. Well-designed activation and training measures are also important. Substantial reforms in this area are planned but progress has been slow (DSFA, 2006).

Sickness and disability

The number of recipients of long-term sickness and disability benefits has more than doubled since 1990, despite general improvements in health and living conditions as well as strong demand for labour (Figure 3.12). Although this partly reflects a widening of eligibility in 1996, the number of claimants increased by almost one third in the five years to 2007. This increase may partly be explained by the increase in the level of sickness benefits and tighter conditions on claiming unemployment benefits. Disability benefit recipients account for almost 9% of the labour force, a share that appears to be somewhat

Figure 3.12. **The number of disability recipients has increased**



Source: Central Statistics Office.

StatLink http://dx.doi.org/10.1787/732830231462

below that in the OECD countries with the most severe problems but nevertheless above the OECD average. The employment rate of people with disability is about half the overall rate with around one third in work, even with the tight labour market in 2007. This is a significant social problem as it partly reflects barriers and disincentives faced by those with disabilities in accessing work. Furthermore, this leads to a high dependence on minimum social benefits and an incidence of poverty that is several times higher than in the population as a whole.

Inflows to disability schemes have remained high and the number of disability allowance recipients is projected to reach 100 000 this year, an increase of almost 9% on the previous year.[25] Eligibility for the allowance is based on a medical certificate from their general practitioners, which is revised by an assessor at the DFSA and may be subject to a medical examination. International experience shows that general practitioners are not well suited to acting as gatekeepers to this type of benefit: all disability benefit claims should be based on a rigorous medical examination by the DFSA's own medical staff to ensure that the rules are being consistently and correctly applied. Stricter enforcement measures on those claiming for lower back pain led to a large number of claims being terminated. By international standards, the approach to existing disability recipients is generally rather passive and reactive. For example, the Supported Employment scheme run by FÁS helps the disabled unemployed towards private sector employment but it is small in scale and is designed for those already looking to go into employment. A recent OECD report identified four major areas of weakness where improvements could be made (OECD, 2008b):

- The benefit system is complex, leading to inefficiencies, and there is too little assessment overall of claimants' work capacity. This assessment should be strengthened along the lines of the Australian Job Capacity Assessment. In line with normal practice in the OECD, sickness benefits should not be paid indefinitely: after one year, recipients should be regarded as disabled and subject to a comprehensive work-capacity assessment. Consideration should be given to extending conditionality to those with disabilities, based on their capacity to work. Experience suggests that a mandatory scheme, requiring

attendance at an interview in the first stage, is likely to be much more effective in encouraging labour market participation than voluntary schemes. Requirements to seek work or undertake training could be applied to some groups.

- Engagement with the disabled is fragmented, with the DFSA dealing with benefit administration and FÁS/DETE having the primary response for training and employment. This may explain why few disabled people have received any training. Systematic engagement should be implemented and adequately resourced with closer interaction of the different agencies around each person.
- Employment support for the disabled is often specialised, rather than in "mainstream" programmes, and is not focussed on transfer into open employment. This process should be better managed and the performance of training programmes in terms of employment outcomes monitored and evaluated rigorously.
- There are disincentives to return to work. Factors that affect the whole population, such as the high level of benefits for those with low market wages and the loss of secondary benefits, may impact the disabled more strongly given the intrinsic difficulties they may face in the labour market. Although the Medical Card can be retained for three years after a recipient returns to work, this may be a significant behavioural barrier for those with poor health. Consideration should be given to how support is most effectively channelled to the disabled returning to work, either through existing supports or by extending the Family Income Supplement.

The National Disability Strategy, launched in 2004, is working towards a more active case management approach and the DETE is seeking to improve services and engage more with new entrants. However, progress has been very slow and substantial further efforts are required to ensure that those with disability are able to benefit from the upswing in the labour market when this occurs. Efforts should concentrate both on controlling inflows and managing the stock of disability recipients more effectively. This would help those with disabilities to participate in the labour market, which is important both for their welfare and for supporting wider social objectives.

Youth employment

Young people have been more severely hit by the contraction in labour demand than the workforce as a whole. The fall in employment has been much sharper and the unemployment rate is close to one quarter of the labour force for young men. Such a pattern is common in economic slowdowns because worker-job matches are less established for younger workers as they typically have less job-specific human capital. The poor experience of young male workers in this episode is likely to reflect their strong presence in the construction industry. It will be a major challenge to reintegrate these workers into other sectors of the economy: this will require a substantial and targeted investment in training and rapid action to ensure that their attachment to the labour market is not broken. More generally, younger workers tend to have low earning power and so their employment as the recovery begins is vulnerable to being held back by the high level of the minimum wage and unemployment benefits.

Youth employment poses problems in many OECD countries. In Ireland, employment rates for those aged under 25 are relatively high by international comparison (OECD, 2008c).[26] This is in part because young people leave education at an earlier age and because demand for labour was strong. However, as elsewhere, there are young people that are not

in education, employment or training (NEET). The NEET share of the cohort population in Ireland is somewhat below European and OECD averages. However, the underlying problems is of a similar nature to those in other countries: 12% of those aged 20 to 24 with below upper secondary education were neither in employment or education in 2006, compared with just 4% among the those with upper secondary-level qualifications (OECD, 2008d). Although Ireland performs above the average in achieving high rates of completions up to at least upper-secondary level, it remains below the best-performing countries. More effective activation policies and appropriate training would strengthen this group's attachment to the labour market and raise their skills and productivity. Raising the school leaving age from 16 to 18 could help to reduce youth employment created by the crisis. This should include vocational education and apprenticeship options and there should be a requirement to work towards a recognised qualification.[27]

Keeping older workers in the labour force

The employment rate falls quite sharply after age 55 and is only around 45% for those aged 60 to 65 years. This partly reflects low levels of female participation among these cohorts due to past social and economic conditions, as well as early retirement that is voluntary. However, the labour market attachment of older workers is likely to be weaker than for prime-aged workers and it may be difficult for them to find new suitable employment if they lose their job. This can make older workers vulnerable to the economic slowdown and poorly-designed social policy. Although the unemployment rate of older workers has not deteriorated especially rapidly during the downturn, the employment rate has fallen by over two percentage points during the current labour market contraction, more than for younger workers. There is a risk that, when older workers lose their jobs, this leads to a permanent exit from the labour market. In earlier years, the Pre-Retirement Allowance provided a channel from unemployment to retirement without returning to work for those between 55 and 66 years of age. This has now been removed and older workers are in principle subject to the same job-search requirements as anyone else, although heavy reliance within the Irish system on people being motivated to activate themselves may be particularly ineffective for those who see themselves as close to retirement. Disability benefits, however, can be a pathway out of the labour force for older workers. The number of people claiming the Invalidity Pension has increased substantially in recent years: recipients of this benefit now account for around 12% of those aged 60 to 65. Alongside disability benefits, access to this benefit should be tightened in line with best practice elsewhere and greater emphasis should be put on activating those currently receiving this payment. Ireland should avoid making the mistake of many other OECD countries in the early 1990s in trying to remove older workers from the labour force as this reduces overall labour supply while doing little to encourage younger workers.

Box 3.5. Summary of recommendations on labour markets

Labour markets appear to be adjusting rapidly to lower demand but there are risks that unemployment will persist even as the economy recovers due to weaknesses in structural policy settings. Longstanding barriers to full labour force participation should be removed.

Reducing long-term unemployment and inactivity

- Unemployment benefits should be reduced in line with falling earnings. Further reductions may be necessary once the recovery begins if the level of benefits creates disincentives to return to work.
- The design of unemployment-related social benefits should be improved to remove strong disincentives to enter employment, particularly for benefits with high taper rates such as Rent Supplement.
- Tighten activation requirements for the unemployed. All unemployment-benefit claimants should be required to subject to early and regular interaction with employment services. Failure to comply with these requirements should be actively enforced by reducing benefit payments. FÁS counsellors should follow up on job referrals and participation in labour market programmes. Claimants should ultimately be required to enter an active labour market programme if other options are not taken up.
- Unify the administration of unemployment-related policies in a single government body, including the processing of unemployment-related benefit claims, placement activities, and the operation of labour market policies that are currently administered the Department for Social and Family Affairs and FÁS and others.
- Active labour market policies should be further adapted to the current unemployment problem. Cost-effective programmes targeted at the needs of those without jobs should be expanded and additional administrative resources allocated to activation policies. Given overall budgetary constraints, this will require a re-allocation of resources and limiting existing programmes that are not designed in a cost-effective way.
- The level of the minimum wage should be re-assessed in line with falling wages and reviewed on an annual basis. The system of sectoral minimum wages should be re-considered.

Raising overall participation and employment

- Consider implementing a single welfare payment for other working-age adults to replace a range of existing schemes, with all subject to activation measures as appropriate.
- Increase the supply of childcare further. Continue to encourage more out-of-school-hours care where school facilities are suitable. Consider measures to link childcare support to employment status. Phase out the Home Carer's Tax Credit. Prioritise access to community childcare to working parents, especially lone parents.
- Ensure that higher tax rates and burdens do not unnecessarily impact on the incentives of second-earners to work. Consider moving to full individual taxation.
- Require lone parents to seek work once their children reach school age.
- Assessment for eligibility for disability benefits should be independent. The work capacity of disability benefit recipients should be systematically evaluated. Illness benefit should be limited to one year, after which recipients should be assessed for their work capacity under disability programmes. Incentives and support should be given to encourage those with disabilities to participate in the labour force.

Box 3.5. **Summary of recommendations on labour markets** *(cont.)*

- Engagement with the disabled should be more systematic. Employment services for those with disabilities should be improved and focussed on helping people to access mainstream employment. Consideration should be given to extending conditionality to some groups with disabilities.
- Raise the school-leaving age to 18 and provide appropriate training options.
- To increase the incentive to stay in work, offer an actuarially-equivalent increase in the state pension for deferred retirement. 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. Increase the flexibility to work past age 65.
- Continue to monitor the impact of policies towards migration. Create flexible visas, such as multi-use, multi-entry visas. Ensure the appropriate level of support for language training for adult migrants and provision of language classes for all ages of children. Continue to monitor the integration and labour market situation of migrants.

Notes

1. The main source of labour market-related data in Ireland is the Central Statistics Office (CSO) Quarterly National Household Survey (QNHS), which superseded the annual Labour Force Survey in 1997. The aggregate data given in this chapter, such as the overall employment rate, are taken from the *OECD Economic Outlook* (OECD, 2009), while disaggregated series such as the employment rate for females is taken directly from the QNHS as published by the CSO unless otherwise stated. Although both based on the same underlying QNHS data, there may be small inconsistencies between the two sources due to different seasonal and other adjustments. The labour force includes the military. The working age population is defined as individuals 16 through to 64 years of age. Employment for the purposes of deriving productivity is based on the national accounts concept rather than the labour force survey.
2. There are two main sources of data relating to unemployment in Ireland. The *Quarterly National Household Survey* (QNHS) is based on the International Labour Organisation (ILO) definition of "unemployment" as being without any work and available and taking specific steps to find employment. The Live Register is based on administrative data and covers recipients of Jobseekers Benefit and Jobseekers Allowance (with a few exceptions) and those signing on for PRSI credits. The Live Register total is considerably higher than ILO unemployment as the definition is broader, partly because it includes those working part-time but legitimately signing on. The Standardised Unemployment Rate is a monthly series based on the Live Register but benchmarked each quarter to the QNHS.
3. This tends to raise labour productivity per hour worked by shifting the composition of output towards more capital-intensive activities.
4. See Table 1.A2.1 (OECD, 2009a). This analysis is based on a decomposition of observed variation into cyclical and trend components using a band-pass filter.
5. The cyclical variation is captured using a band-pass filter, see Annex 1.A3 (OECD, 2009a). The main assumptions are that unemployment changes only as a result of contemporaneous changes in flow rate and that all transitions are between work and unemployment.
6. The Central Statistical Office has introduced a new comprehensive earnings survey, the Earnings, Hours and Employment Costs Survey. This currently only covers industry and financial intermediation.
7. See also Chapter 1.
8. See Chapter 3 (Wage-setting Institutions and Outcomes) of OECD (2004).
9. The unemployed are defined in terms of eligibility for benefits as those who are less than 66 years old and are unemployed for at least 3 days in each period of 6 consecutive days, capable of work, available for full-time work and genuinely seeking employment.

10. These payments were known respectively as Unemployment Benefit and Unemployment Assistance until-2006.
11. A JB claimant must have 52 weeks of paid PSRI contributions and have made adequate PSRI contributions in the two previous complete tax years.
12. 12 months for claimants having made at least 260 paid weekly contributions and 9 months for those having made fewer.
13. See the OECD benefits and wages models (OECD, 2007).
14. Rent Allowance allows an individual to work up to 30 hours without losing access to the benefit.
15. See Chapter 1 "The Jobs Crisis: What are the implications for Employment and Social Policy?" of OECD (2009).
16. Up to six years if aged over 55.
17. See Annex 6.A1 of OECD (2008a).
18. "What we do is fail – and fail fast", *Business and Finance*, 20 November 2008.
19. Excluding the citizens of Bulgaria and Romania, who will only be able to work in Ireland without a permit from 2012. Under EU rules, nationals from these two countries should have priority over non-EEA citizens.
20. Civil and mining engineers and all construction professionals were removed from the list of occupations subject to the lower limit in November 2008.
21. See "Slow take-up on green cards by immigrants", *The Irish Times*, 4 January 2008.
22. Periods of short-term study or asylum application do not count towards the five-year qualification period.
23. See Chapter 6 "Removing Obstacles to Employment for Women" of OECD (2006).
24. Those who in addition to low incomes are deprived of two or more goods or services considered essential for a basic standard of living.
25. *The Irish Times*, "Increase in numbers claiming disability allowance", Monday, 18 May 2009.
26. See Chapter 1 "Off to a Good Start? Youth Labour Market Transitions in OECD Countries", OECD (2008c).
27. All children must complete three years of basic secondary education, up to the Junior Leaving Certificate, regardless of age.

Bibliography

Barrett, A. and E. Kelly (2008), "Using a Census to Assess the Reliability of a National Household Survey for Migration Research: The Case of Ireland", *ESRI Working Paper*, No. 253.

Bassanini, A. and R. Duval (2006), "Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions", *OECD Economics Department Working Papers, No.* 486.

Bergin, A. (2008), "Job Mobility in Ireland", *The Economic and Social Review*, Vol. 39, Winter 2008, No. 3.

Blanchard, O. (2000), "The Economics of Unemployment: Shocks, Institutions and Interactions", London School of Economics Lionel Robbins Lectures.

Callan, T., A. van Soest and J. Walsh (2007), "Tax Structure and Female Labour Market Participation: Evidence from Ireland", *IZA Discussion Paper*, No. 3090.

Calmfors, L., "The Extent of Centralisation of Wage Bargaining and Macroeconomic Performance", *OECD Economics Department Working Papers*, No. 131, 1993c.

Card, D., J. Kluve and A. Weber (2009), "Active Labor Market Policy Evaluations: A Meta-Analysis", IZA Discussion Paper No. 4002.

Chaloff, J. and G. Lemaitre (2009), "Managing Highly-Skilled Labour Migration: A Comparative Analysis of Migration Policies and Challenges in OECD Countries", *OECD Social, Employment and Migration Working Papers, No.* 79.

CSO (2007), *Census 2006 Vol. 3 – Household Composition, Family Units and Fertility*, May.

CSO (2008), *Survey on Income and Living Conditions in Ireland (SILC) 2007*, December.

Department of Taoiseach (2006), "Towards 2016: Ten-Year Framework Social Partnership Agreement 2006-2015", June.

Department of Taoiseach (2007), "Ireland – Implementation of National Reform Programme: 2nd Annual Progress Report", October.

Davia, M. (2005), "Job Mobility and Wage Mobility at the Beginning of the Working Career: A Comparative View Across Europe", ISER Working Paper No. 2005-03, Institute for Social and Economic Research.

Department of Social and Family Affairs (2006), *Proposals for Supporting Lone Parents*, Dublin.

Dickens, W.T. *et al.* (2006), " The Interaction of Labor Markets and Inflation: Analysis of Micro Data from the International Wage Flexibility Project", *mimeo*, Brookings Institution.

Duval, R., J. Elmeskov and L. Vogel (2007), "Structural Policies and Economic Resilience to Shocks", *OECD Economics Department Working Papers, No.* 567.

Elsby, M. (2006), "Evaluating the Economic Significance of Downward Nominal Wage Rigidity", NBER Working Paper 12611.

Eurostat (2008), "Minimum Wages 2008", *Statistics in Focus*, No. 105, Eurostat, Luxembourg.

FÁS (2009), *Irish Labour Market Review 2008*, Dublin.

Gianella, C., I. Koske, E. Rusticelli and O. Chatal (2008), "What Drives the NAIRU? Evidence from a Panel of OECD Countries", *OECD Economics Department Working Papers, No.* 649.

Grubb, D., S. Singh and P. Tergeist (2009), "Activation Policies in Ireland", *OECD Social, Employment and Migration Working Papers, No.* 75.

Hasselpflug, S. (2005), "Availability Criteria in 25 Countries", *Ministry of Finance Working paper, No.* 12/2005¸ Copenhagen.

Honohan, P. and A. Leddin (2006), "Ireland in EMU: More Shocks, Less Insulation?", *The Economic and Social Review*, Vol. 37, No. 2, Summer/Autumn.

Immervoll, H. and M. Pearson (2009), No. 81: "A Good Time for Making Work Pay? Taking Stock of In-Work Benefits and Related Measures Across the OECD", *OECD Social, Employment and Migration Working Papers, No.* 81.

Indecon (2005), "Review of National Employment Action Plan Preventive Strategy: Draft Final Report", Indecon International Economic Consultants, Dublin.

Johansson, A. *et al.* (2008), "Tax and Economic Growth", *OECD Economics Department Working Papers*, No. 621.

Murphy, C., P. Keilthy and L. Caffrey (2008), *Lone Parents and Employment: What are the real issues? Key Findings, Conclusions and Recommendations*, One Family Research Report, November.

OECD (2003), *Babies and Bosses: Reconciling Work and Family Life*, Vol. 2, OECD, Paris.

OECD (2004), *OECD Employment Outlook*, Paris.

OECD (2006), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2007), *OECD Benefits and Wages*, OECD, Paris.

OECD (2008a), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008b), *Sickness, Disability and Work – Breaking the Barriers (Vol. 3): Denmark, Finland, Ireland and the Netherlands*, OECD, Paris.

OECD (2008c), *OECD Employment Outlook*, OECD, Paris.

OECD (2008d), *Education at a Glance*, OECD, Paris.

OECD (2008e), *International Migration Outlook: SOPEMI 2008*, OECD, Paris.

OECD (2009a), *OECD Economic Outlook*, No. 85, June, OECD, Paris.

OECD (2009b), *OECD Employment Outlook*, OECD, Paris.

Office of the Minister for Integration (2008), *Migration Nation: Statement On Integration Strategy And Diversity Management*, May, Dublin.

OPEN/EAPN Ireland (2005), "Out of the Traps: Ending Poverty Traps and Making Work Pay for People in Poverty", Dublin.

© OECD 2009

Chapter 4

Boosting competitiveness and raising living standards

Living standards in Ireland will remain high, despite the severe contraction, but stronger structural policies would encourage sustainable long-run growth. Hard times can be a good time to make overdue reforms and these would also help improve competitiveness. Policies are already favourable to competition in many respects, but market forces are weak in the network industries and parts of the services sector. Prices could be lowered by measures to increase competition. The infrastructure has been upgraded but more investment is needed, although plans in the short term need to adjust in light of budgetary constraints, and the efficiency of infrastructure use could be improved. Ireland has benefitted from past improvements in education. While performance is good, there is scope to improve educational outcomes. Pre-primary education and in-work training should ultimately be increased. Innovation spending has increased rapidly but from a low base. Achieving environmentally sustainable growth is a major challenge and it will be difficult for Ireland to meet its commitments to reducing carbon emissions. While environmental policy has improved, there are significant weaknesses in management of waste.

Living standards in Ireland measured by national income per capita in PPP terms will remain among the highest in Europe, even though the economic contraction is more severe than in other euro area countries. However, GNP per capita will have fallen substantially during the downturn. Ireland retains many economic advantages, including a relatively young population; a skilled workforce; and a flexible, internationally open economy. As a result, the Irish economy has the potential to expand somewhat faster than the euro area average once the crisis has passed, although at a much slower pace during the period of economic catch up in the late 1990s. However, there will remain a gap with the best performing OECD economies in terms of living standards and Ireland will be starting from a weaker initial position than reached at the most recent peak.

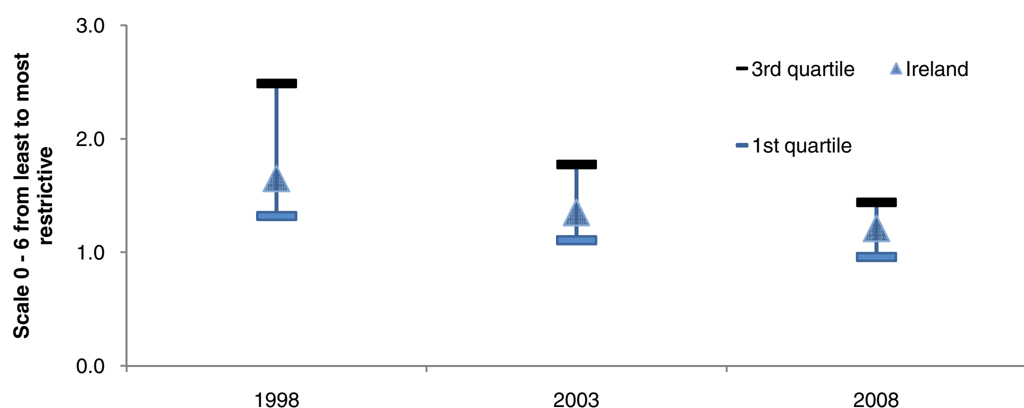
It is therefore important to take structural policy measures now to ensure that Ireland achieves strong and sustainable growth in living standards for the long term, despite the immediate pressures of restoring macroeconomic and financial stability. These issues have been extensively discussed in previous *Surveys* (OECD, 2006 and 2008) and the OECD's *Going for Growth* studies (OECD, 2009). Some of these issues are addressed in the government's framework for sustainable economic renewal, *Building Ireland's Smart Economy*, which sets out plans to support the enterprise sector, increase high-quality employment, secure energy supplies and improve the infrastructure (Department of the Taoiseach, 2008). The need for such measures is even clearer with the reversal of the credit cycle, taking with it unsustainable gains in economic performance and exposing a weaker underlying position than previously thought. As discussed in Chapter 1, it is inevitable that a number of policy settings will become less favourable to growth, particularly the higher taxes necessary to rebuilding the public finances. Improving other structural policy settings could help to offset this. In the near term, undertaking such reforms would contribute positively to the economic adjustment. In particular, policy measures that help to reduce costs would boost non-price competitiveness. Less restrictive policy settings would also assist in the reallocation of resources as the economy adjusts, including by lowering structural unemployment.

There has been some progress in many areas of structural policy, as outlined in this chapter and the annex. But, progress has often been extremely slow and piecemeal; significant scope remains to make policies more favourable to long-run growth. While it can be difficult to make reforms when the economy appears to be prospering, political economy suggests that hard economic times can be a good time to undertake necessary and over-due reforms because the need is more apparent and the bargaining power of some sectional interests may be constrained. The weak fiscal position, however, means that costly measures may have to be delayed until consolidation has progressed further or public resources are reallocated from lower priority activities. This chapter provides an overview of significant weaknesses that need to be addressed, in addition to those to boost labour market participation discussed in Chapter 3.

Competition is weak in some sectors

Competition is important to achieving an efficient allocation of resources, high productivity and keeping prices low, making it a key part of ensuring that the Irish economy is competitive. The regulatory environment for the business sector is fairly light-handed and competition friendly. However, while this was a clear advantage for Ireland relative to other OECD countries a decade ago, a faster pace of reform in the most regulated economies implies that Ireland is now close to the OECD average, despite some further liberalisation of Irish markets (Figure 4.1). It is relatively easy to establish a new business, administrative burdens are fairly light and it is easy for foreign firms to enter the Irish market. However, the burden of different licences and permits is relatively heavy, the government remains heavily involved with providing infrastructure, and barriers to entry in the network industries remain higher than the OECD norm (Wölfl *et al.*, 2009). State ownership is more extensive than in some other OECD countries with government-owned firms having monopoly or strong positions in postal services, energy, health insurance, television and forestry. Such firms are likely to enjoy some competitive advantages, which is a barrier to full competition, and the efficiency and innovation it can bring. The sale of these firms after financial markets have recovered could also contribute to rebuilding the public finances. However, the most significant weakness in the regulation of product markets is in a numbered of sheltered sectors, discussed below, where competition is limited and consumer interests take second place.

Figure 4.1. **Aggregate regulation (integrated PMR) and its dispersion across countries over time**[1]



1. Level in index points, 0 = least- and 6 = most-restrictive.

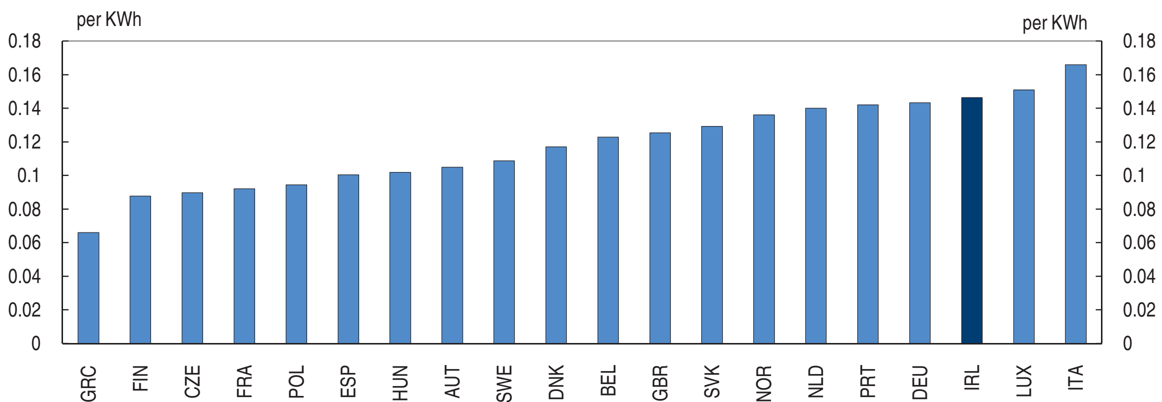
Source: OECD *Regulatory database*, 1998, 2003 and 2008.

StatLink http://dx.doi.org/10.1787/732862136814

Electricity and gas

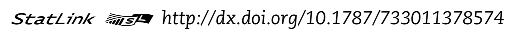
Electricity prices in Ireland are very high in pre-tax terms by European standards (Figure 4.2). Although there is legal separation between network and generation activities, these remain integrated on an ownership basis in the hands of the Electricity Supply Board (ESB). In addition, on the basis of Grid Development plans put forward by the transmission company (EirGrid), the ESB remains responsible for maintenance and capital investment in the transmission network. This proximity may discourage new entrants to the generation market through their need to connect to the grid, and there is no clear advantage in

Figure 4.2. **Electricity is expensive in Ireland,[1] 2007**



1. Electricity prices for household consumers are defined as follows: Price in euro per kWh without taxes applicable on 1 January each year for annual consumption of 3 500 kWh in euro per kWh.
2. Retail distribution.

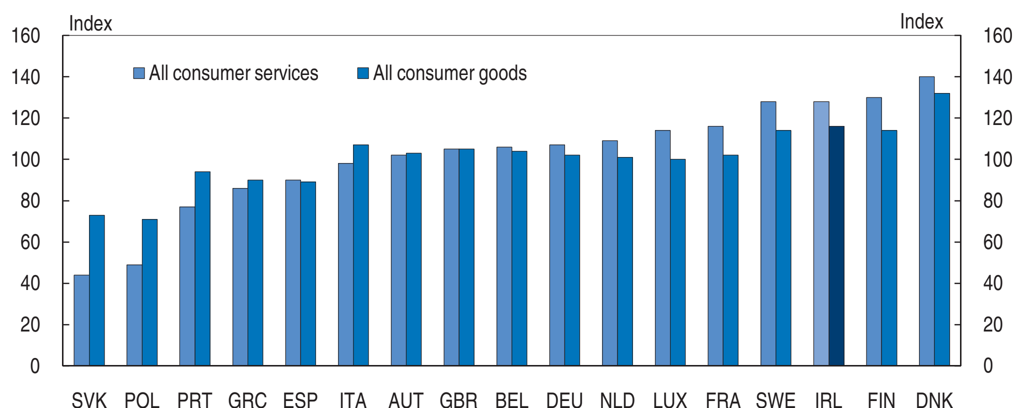
Source: Eurostat.


StatLink http://dx.doi.org/10.1787/733011378574

maintaining integration of the generation and network functions. In addition, the ESB continues to have a strong position in the all-Ireland electricity generation market, even if it has been required to divest a substantial part of its production and is on target to reduce its share to 40%, as envisaged in its agreement with the regulator. The on-going upgrading of connection with the electricity grid in Northern Ireland and the construction of interconnectors across the Irish Sea will help to raise competition. In the retail market, the ESB also holds the licence to the distribution grid. While high voltage users rely heavily on independent suppliers and these providers are also active in the market to supply small and medium enterprises, the domestic retail market is almost entirely supplied by the ESB (Commission for Energy Regulation, 2008). However, Bord Gais Eireann and Airtricity both entered the domestic retail market in 2009 and appear to be making some inroads. Further efforts should be made to increase competition in the electricity market, rather than relying on regulation, by separating the ownership of different activities. The gas market has many of the same features and Bord Gais Eireann also owns the network. This should be reformed along the same lines as the electricity market.

Prices of consumer goods and services are relatively high in Ireland (Figure 4.3). While this is partly related to high labour and land costs, weak competition explains part of the high level of prices: detailed analysis of cost differences in retail operations in Ireland compared with the United Kingdom suggests that Irish costs are modestly higher, but by less than the difference in retail prices (FORFÁS, 2008). Higher operating costs in Dublin only add 5-6% to the total cost of retail goods compared with Belfast, and stores in other cities in Ireland should be cheaper. A striking feature of this analysis is that such a wide range of goods and services used as inputs in the retail sector are more expensive in Ireland, including professional services and energy, which points to a wider weakness in the competitive pressures. The planning system is a major obstacle to new entry and greater competition in the retail sector (ICA, 2008). Caps on the overall size of retail premises prevent the entry of very large format retailers. Incumbents have the right to object to new developments and the new entrants are required to make an economic case for entry. Although there has been some entry in recent years by foreign retailers, this may have served only to dilute rather than eliminate high mark-ups. The planning system should be reformed

Figure 4.3. **Price level indices for consumer goods and services, 2006**



Source: Eurostat.

StatLink http://dx.doi.org/10.1787/733014663375

to remove unnecessary obstacles to new entrants. In the licensed trade, competition between pubs should be enhanced by reforming the licensing system. In particular, the requirement that a new licence can only be granted if another is extinguished, which keeps the total number of pubs fixed, restrains new entrants and hinders competition.

Professional services

Competition in professional services is generally low, due to a number of restrictions to entry and price competition. As a result, professional fees are high. The Irish Competition Authority (ICA) has conducted a number of studies in this area, mostly recently for veterinary practitioners. Common difficulties that emerge are restrictions on advertising, price competition, and commercial companies providing these services. Although some restrictions on who can undertake certain activities are necessary, the rules can be excessively limiting. In addition, intake into some professions has been too low to meet the need, thereby increasing the market power of qualified professionals. Self-regulation in the legal profession hinders competition for legal services (ICA, 2006). Although barriers between solicitors and barristers have been lowered, there is no independent regulator for the legal profession, as is the case in some other countries, to ensure that regulation is run in the interest of clients rather than the profession.

Pharmacies and health professionals

Limited competition in the pharmacy sector leads to high margins, but the Pharmacy Act 2007 has introduced important reforms, including the abolition of the "three-year" rule that formerly restricted the entry of foreign-trained pharmacists. The number of places to study pharmacy in domestic institutions has increased substantially, and the overall number of pharmacies has grown. Wholesale and retail mark-ups are determined on the basis of contracts between individual pharmacists and the Health Service Executive (HSE), and have historically been excessive. New legislation in 2009 gave the Minister for Health and Children the power to set new terms for payments to health professionals, and the payments to community pharmacists for wholesale delivery and dispensing have been reduced. Consideration should be given to whether additional structural changes could help to ensure that fees are at an appropriate level in light of international best practice.

The number of medical school places is also low, which contributes to high medical fees. Restrictions on the number of places to study medicine should be removed.

Competition law and practice

Ireland's competition law is distinctive in its emphasis on criminal rather than civil law to enforce the rules (OECD, 2006). The Irish Competition Authority (ICA) has no binding powers to sanction anti-competitive behaviour and must instead bring cases through the criminal courts. Although the basic legal framework is in line with other countries, criminal law standards of proof make it difficult to enforce the rules compared with other countries. There have been some successes, including the imposition of a limited number of prison sentences, but the number of cases remains small. In addition, the courts have often imposed relatively low fines. A higher probability of being sanctioned together with more severe punishments is essential as a credible economic deterrent to anti-competitive practices. Some progress has been made in both regards and the ICA has made efforts to increase judges' awareness of international best practice, but it may be useful to include clearer guidance on fines to the judiciary in the forthcoming review of the 2002 Competition Act. Furthermore, consideration should be given to whether an approach based on civil law would be more effective. The scope of competition law should not be narrowed as has been done with the exemption from its provisions of voice-over actors, freelance journalists and session musicians. Although these particular groups are small, there is no reason why their services should not be subject to the same competitive pressures as other products and services. Furthermore, allowing any exceptions risks creating a precedent and encouraging other professions to seek similar exemptions with more widespread consequences for the economy. Competition law is currently being reviewed. The proposal that government departments should be required formally to consider and respond to reports of the ICA is useful and would bring Irish practice into line with other countries. This should help to increase the impact of ICA research.

While there has been some progress in strengthening competition in recent years, overall progress has been slow (Table 4.1). The most significant changes are arguably the result of initiatives taken at the EU level rather than domestically. During the recent years of strong credit-driven growth, firms may have been able to charge high prices relatively easily and the negative impact on Ireland's competitiveness was masked by strong domestic and international demand. It is now very important to raise the level of competition through more effective policy actions.

The infrastructure has improved but further investment is required

Ireland began its period of economic catch up with poor infrastructure in many areas. Public investment accelerated as the economy expanded and has averaged around 4.7% of GNP since the start of the decade, among the highest rates in the OECD. While it is difficult to identify the exact impact of infrastructure spending on economic growth, econometric evidence from a wide range of different specifications points fairly robustly towards the conclusion that infrastructure investment can boost growth but that more is not always necessarily better because diminishing returns often set in (Égert *et al.*, 2009). The returns to investment also depend on policy: how robust the decision making process is in choosing investment projects, the existence of competitive pressures and effective regulation in network industries (Sutherland *et al.*, 2009).

Table 4.1. **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.
Revise the retail planning guide to allow bigger stores.	No change but retail planning guidelines are being reviewed.
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.	50% retail mark-up reduced to 20%, partly offset by an increased dispensing fee. No auctioning of pharmacy licences. The three-year rule was abolished at the end of 2008.
Remove the ceiling on the number of pub licenses.	A Bill to reform the licensing regime will be published in 2009.
Remove unnecessary restrictions in the legal profession including abolishing the 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.	The All-Ireland electricity market is now in place and work is on-going to build a second North-South and an East-West electricity interconnector. The transfer of transmission assets to EirGrid from the ESB is ongoing. ESB has sold some of its generation assets to Endesa and its All-Ireland market share is now 35% with some addition through its independent trading arm.
Liberalise the bus market. Appoint an independent regulator and remove restrictions on the number of bus routes that can be operated by private firms.	Legislation is in place to facilitate the appointment of an independent regulator for the Greater Dublin Area, but this also gives the incumbent a 5-year guarantee that its routes will not be subject to open tender. Further legislation is promised to overhaul the outdated route licensing regime. The European Commission is investigating whether state aid to bus companies is legal.
Reduce state ownership.	No progress.

Substantial progress has been in upgrading the physical infrastructure. The inter-urban motorway network linking Dublin with Waterford, Cork, Limerick and Galway and the Border/Belfast, is due to be completed by 2010. This network closes a substantial gap in Irish infrastructure. In the area of broadband, regulatory issues around access to local telecommunications network have been resolved and take-up of broadband services has recently increased at a fast pace. Excluding mobile broadband, penetration rates still lag behind the best performers, although there is substantial take up of mobile broadband services in Ireland. Environmental infrastructure, where substantial investment and progress has taken place, still has some ground to make up. While the physical infrastructure in general has improved at a fast pace, consideration should also be given to measures that would help ensure that this capital is used in an efficient way through pricing mechanisms (Table 4.2), including for roads through tolls and congestion charging.

High levels of capital investment emphasise the importance of a vigorous framework for appraising capital investment. A reinforced capital appraisal and value for money framework has been put in place, which should help to ensure that the impact of investment is optimal. The weaker economic circumstances will require both a re-evaluation of projects in the light of changing needs and require even more robust selection of projects. In particular, priority should be given to those projects which promise the best contribution to economic recovery and which provide a high economic return and enhance national productivity and competitiveness

Table 4.2. **Progress in structural reform: Upgrading infrastructure**

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
Upgrade the infrastructure for transport, energy, waste and broadband internet. This requires substantial investment, as well as measures to ensure that investment gives the highest returns.	Public investment has been reduced substantially but remains at a reasonable rate.
Improve infrastructure planning:	
• Introduce a "silence is consent" rule to increase the incentive for planning board to comply with its statutory deadlines.	No progress.
Strengthen cost-benefit analysis for major investment projects.	A substantial capital appraisal framework is in place. CBA is a requirement for all major investment projects over € 30 million.
Allow for better use of infrastructure services through appropriate user charges:	
• Charge the full cost of providing drinking water and collecting and treating sewage.	Households continue to receive free water and sewerage collection, although meters for most non-domestic users have been in place since 2007.
• Introduce a congestion charge in central Dublin when public transport alternatives improve.	No progress.

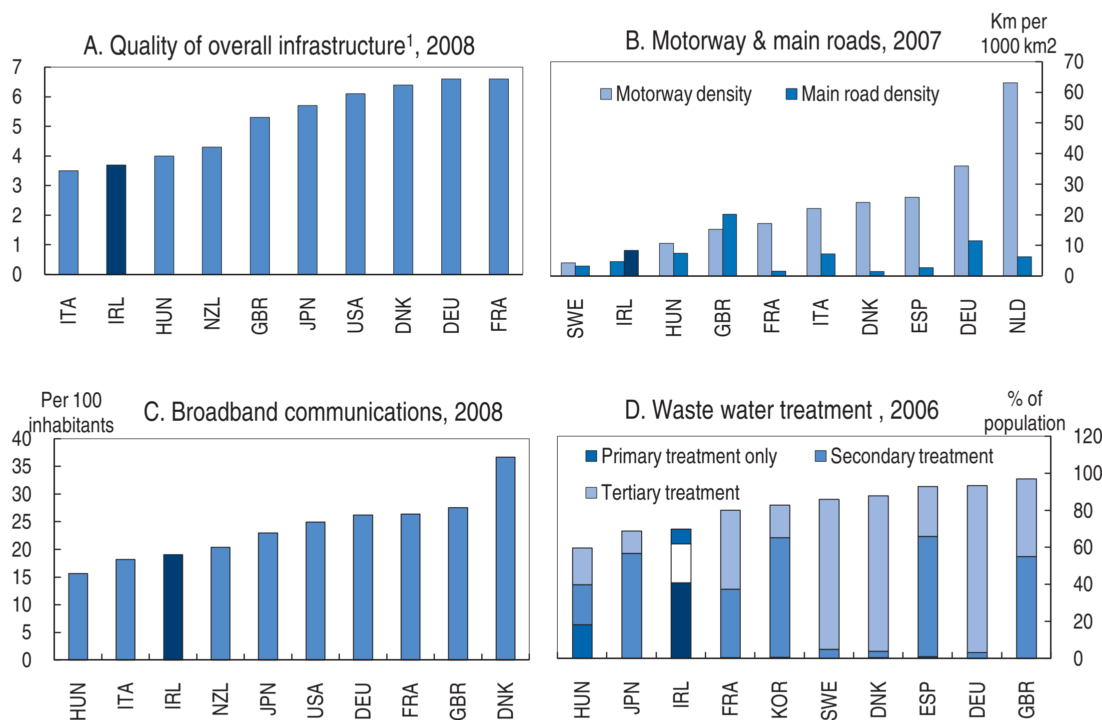
The budgetary situation places a constraint on the rate of public investment in coming years. As discussed in Chapter 2, government capital expenditure should be reduced in line with current plans. This will allow Ireland to keep making substantial improvements to its infrastructure without contributing to an excessive strain on the public finances. In the short run, infrastructure spending is likely to help to support construction demand. Lower construction tenders due to weak demand elsewhere in the economy imply better value for money can be obtained. Given the severe adjustment Ireland is undergoing, projects should be re-evaluated in light of possible changes in needs due to the new economic situation and evaluation should be extremely careful given the tight overall constraints on government resources (Figure 4.4). Finally, the Government should prioritise those projects which promise the best contribution to economic recovery and which provide a high economic return, enhance national productivity and boost competitiveness.

Education and skills are the key to long-run growth

Investment in a highly educated workforce is a key part of raising Ireland's living standards in the long run, with the rising level of educational attainment in the adult population an important factor in the increase in productivity since the mid-1990s. Given that real wages are high by international comparison and an ambitious strategy for long-term growth based on research and other skill-intensive activity, it is essential that the education system performs well. Overall, the education outcomes at secondary level are good relative to the OECD average but not as good as in the best performing countries. The proportion of the population aged 25 to 34 having reached at least upper secondary education is high but lower than in several countries (OECD, 2008b). OECD PISA scores suggest that Irish students at age 15 perform relatively well at reading, but the performance in mathematics and science is less impressive than in many other high-income countries (Figure 4.5). Measures discussed in Chapter 2 to increase public sector efficiency could also help to raise standards, including greater school autonomy.

Other features of the education system are also important for growth. Pre-school attendance in formal education remains low in Ireland by international standards, despite a considerable increase in the number of childcare places in recent years (Table 4.3). There has been a major effort to increase the number of qualified staff and only 12% of staff do

Figure 4.4. **Infrastructure**

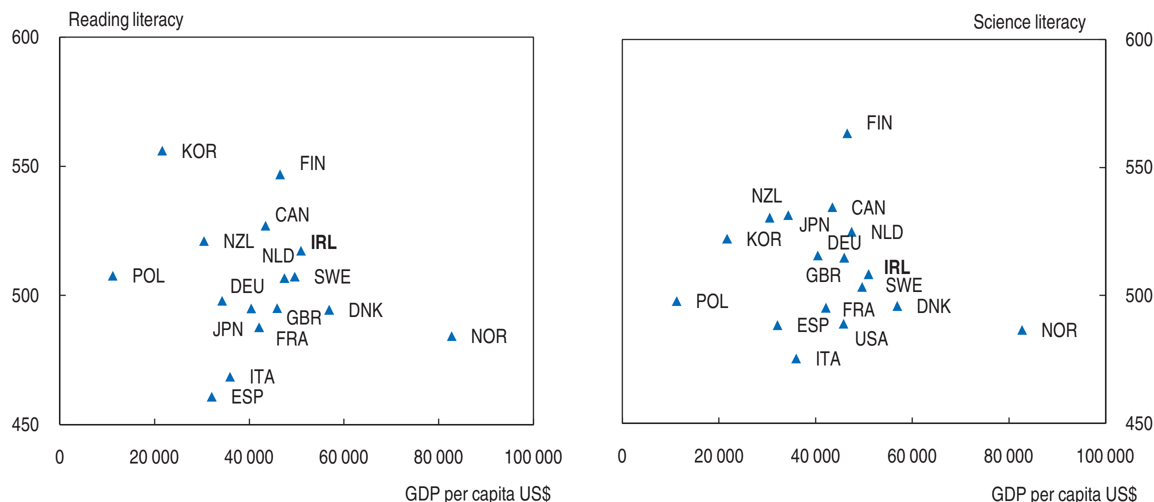


1. General infrastructure in the country is (1 = underdeveloped, 7 = extensive and efficient by international standards).

Source: World Economic Forum, *The Global Competitiveness Report*; European Commission, Directorate for Energy and Transport: *Energy and Transport in Figures 2009*; OECD Broadband Portal (2008) and OECD *Key Environment Indicators*.

StatLink http://dx.doi.org/10.1787/733055086862

Figure 4.5. **PISA scores in science are lower than in many countries**



Source: *PISA Database* 2009.

StatLink http://dx.doi.org/10.1787/733078386775

not now have formal qualifications. The introduction of the pre-school Early Childhood and Education Scheme (ECCE) from 3 years and 3 months will help to address the need for more generalised early years' education, although the hours will remain relatively short. Much later in the educational cycle, the introduction of third-level tuition fees, discussed

Table 4.3. **Progress in structural reform: Education**

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
Invest in pre-primary schooling by generalising pre-primary education from the age of three, avoiding infant classes of more than 30 children, and expanding the duration of daily classes.	The Early Childcare Supplement is being abolished and will be replaced by a pre-school Early Childhood and Education Scheme (ECCE) for those aged 3-4. With effect from September 2009, one teacher will be allocated for every 28 pupils at primary level.
Ensure that resources for special needs learning is well targeted at students who need help.	The system remains that, in high incidence areas, resources are allocated based on enrolment.
Increase resources for universities and improve incentives by levying fees that students repay from their subsequent earnings. Public funding should be not be reduced as fees are introduced.	No progress.

in Chapter 2, would give students more power to demand better performance from universities and increasing their own incentives to make the most of their studies. In-work participation in training appears to be relatively limited: enrolment rates for those aged over 30 are either at or below the OECD average with particularly low participation by older workers (OECD, 2008b). This is surprising given that Irish workers enter the labour market fairly young and that older workers may need additional training given their low initial levels of education. Raising the skills level of labour force is an important part of sustaining productivity growth. This should be taken into account in the re-evaluation of labour market programmes suggest in Chapter 3, both for using the current downturn to train workers and further ahead.

Research and development (R&D) activity has increased

As Ireland has sought to move to higher value-added activities, a healthy base of R&D activities has become more important. There has been some success in attracting and building up more R&D activity, particularly in pharmaceuticals, life sciences, and software. The rate of increase of R&D spending has been among the highest in developed countries (FORFÁS, 2009). However, the overall level relative to national income remains relatively low. Most R&D activity is undertaken by foreign firms, although there is some activity in indigenous firms, such as in the food sector.

Recent policy actions have sought to encourage higher volumes of R&D by increasing tax credits (Table 4.4). Improving financial incentives in this way can encourage additional innovation activity but these measures are not well targeted: although the credits apply to incremental R&D, the base year is 2003 so that the system is moving ever closer to giving credits for the volume of research. Since 2009, the tax treatment of carried interest has switched from being treated as income to being taxed as capital gain, lowering the tax rate. This is likely to be attractive to venture capital activities and may encourage additional innovation activity. The effectiveness of the system of tax credits for R&D and related issues should be reviewed. There are plans to invest up to € 500 million through a new channel, Innovation Fund Ireland, linked to Enterprise Ireland for projects in R&D-intensive SMEs. This would support companies in the early stages of research and development. As argued in previous *Surveys* (OECD, 2008), improving the effectiveness of publicly-funded research by ensuring an efficient allocation of funding remains important.

Table 4.4. **Progress in structural reform: Research and innovation**

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
Improve economy-wide framework conditions as they are the most important determinant of R&D.	No progress.
Consider rebalancing the science budget by making more use of market-led measures and scaling back direct grants. Evaluate the new tax incentive and channel more assistance through it if successful.	The tax credit for incremental research and development (R&D) expenditure has been raised from 20% to 25% with new options to offset credits against past corporation taxes or received cash where credits are exhausted. 2003 has been made a permanent base year for calculating incremental expenditure so that the scheme will become essentially volume-based over time. Conditions for including spending on buildings have been relaxed.
Consider where public funding is too thinly spread and whether resources should be focussed on world-class centres of excellence.	A new Strategy on Higher Education in Ireland will be finalised by the end of 2009.

Sustainable development and climate change

Achieving economic growth that is environmentally sustainable is a major challenge. Some aspects of this, such as climate change, are global issues where Ireland should play its part. Others, such as air and water quality, have a local impact on living standards. Since the mid-1990s, environmental performance has improved on a wide range of measures as the result of stricter standards and improved incentives, voluntary action, and changes in the structure of the economy. However, the sharp increase in economic activity over that period has added to underlying pressures on the environment.

Ireland has managed to achieve a substantial decoupling between the pace of GNP growth and increases in emissions of carbon dioxide (CO_2), the main greenhouse gas. This has largely been achieved by improved performance from electricity generation, only partly offset by higher emissions from transport. Nevertheless, Ireland now needs to achieve very significant reductions in CO_2 outputs to achieve its Kyoto target under EU burden sharing arrangements. It is required to reduce emissions to 13% above the 1990 baseline over the period 2008-12, even though these emissions had risen by 2007 to stand 25% above the original baseline. The Carbon Fund, used to purchase additional credits under the Kyoto Protocols flexible mechanisms, will make some contribution to meeting the target, alongside the impact of existing measures and the growing importance of renewable energy. The government has a target of producing 40% of electricity using renewable energy sources by 2020, above European norms. The main challenge, however, is to address the rising CO_2 output from both freight and passenger transport. A number of measures have been introduced to curb the growth in road transport and increase its efficiency, including an overhaul of motor taxation which linked the rate of taxation to the level of emissions and provisions exist that could be used to extend this principle to the taxation of company cars. On-going improvements in public transport will also help but more is required to increase the alternatives to car travel and to counter the effect of urban sprawl. As discussed in Chapter 2, carbon emissions are largely controlled through the EU Trading Emissions System (ETS); transport and agriculture are the main sectors outside the scope of the ETS but road vehicles and fuel are already highly taxed, although taxes may need to be adjusted to be consistent with ETS prices. The ETS will be extended to aviation. The most important policy measure, rather than additional taxes in this area, would be to remove subsidies to domestic aviation and electricity generation from peat, and tax concessions on fuel oil.

The framework of environmental policy has been strengthened in other areas in recent years with better water and air quality, waste management and protection of the environment (OECD, forthcoming). Compliance with EU rules on waste water has improved substantially as the result of considerable investment, but further progress is needed to meet targets set for 2015. Despite improvements, around 30% of drink-quality water is lost in the Dublin area with much higher rates of leakage elsewhere. This is much worse than the norm in other developed countries (OECD, forthcoming). Water charges for domestic households are now essential to create an efficient water services sector. This would increase incentives to avoid leaks and improve sewage treatment. In addition, providing water services is the responsibility of 34 local authorities acting through 32 different bodies. This fragmented responsibility leads to inefficiency. Stricter rules, better enforcement and improved incentives through levies and schemes like volume-based collection charges have helped to improve waste management. But, the overall amount of waste has increased in line with the economy and *per capita* waste generation is among the highest in the OECD. The organisation and infrastructure for waste management and recycling should be improved in the context of the on-going comprehensive review of waste management policy.

Box 4.1. **Summary of recommendations to promote sustainable long-run growth**

This summarises policy recommendations to promote sustainable long-run growth, other than the labour market issues in Chapter 3. The implementation of any recommendations that require additional public expenditure must be carefully considered in the short run given constraints on public finances. This chapter's main recommendations are:

Competition

- Competition law should continue to be strengthened by increasing sanctions. Consideration should be given to giving the judiciary clearer guidance on appropriate fines and improving the court process and to whether a framework based on civil law would be more effective. The scope of competition law should not be narrowed through the exclusion of certain sectors.
- In the electricity market, transfer the ownership of the transmission network assets from the ESB to EirGrid. Continue to integrate the electricity market with the United Kingdom.
- In the retail sector, remove planning restrictions that discourage competition by lifting caps on the overall size of retail premises, dropping the requirement for new stores to make an economic case for their implantation and removing the right to object of incumbent stores. The restriction on the number of pubs should be removed.
- For pharmacies, consideration should be given to what additional changes can be made to raise competition and lower margins in the pharmacy sector. Restrictions on the number of medical school places should be removed.
- In the legal profession, remove unnecessary restrictions. Speed up the registration process for foreign professionals. Establish an independent regulator for the legal profession.
- Reform the bus market by removing the restrictions on the bus routes that can be operated by private firms more quickly, overhaul the route licensing regime and appoint independent regulators to cover the entire network.

Box 4.1. **Summary of recommendations to promote sustainable long-run growth** *(cont.)*

Infrastructure

- Continue to upgrade the infrastructure for transport, energy, waste and broadband internet by sustaining investment as fiscal conditions allow. Cost-benefit analysis should be strengthened to ensure that funds are well-used and projects reviewed rigorously in the light of changing economic conditions.
- Extend user charges to improve the use of infrastructure services. Charge households for the provision of water, and sewage collection and treatment.
- Introduce a congestion charge in central Dublin.

Education

- Generalise pre-primary education from the age of three and expand the duration of daily classes when resources permit.
- Introduce fees for third-level education to increase university funding and to improve incentives. This should be accompanied with the introduction of income-contingent loans.

Innovation

- Evaluate the cost effectiveness of the system of tax credits for R&D.
- Continue to concentrate direct support for research and development in fewer world-class centres of excellence. Improve co-ordination between researchers and with industry.

Bibliography

Commission for Energy Regulation (2008), *Electricity Retail Market Information Report*, CER/08/090, June.

Department of Taoiseach (2008a), "Building Ireland's Smart Economy: A Framework for Sustainable Economic Renewal", December.

Department of Taoiseach (2008b), "Ireland – National Reform Programme 2008-2010", October.

Economic and Social Research Institute (2008), "Medium-Term Review 2008-2015", May 2008, Number 11.

Égert, B., T. Kozluk and D. Sutherland (2009), "Infrastructure and Growth: Empirical Evidence", *OECD Economics Department Working Papers, No.* 685.

FORFÁS (2008), *The Cost of Running Retail Operations in Ireland*, December.

FORFÁS (2009), *2008 Annual Report*, December.

ICA (2006), *Solicitors and Barristers – Final Report*, Dublin.

ICA (2008), *Grocery Monitor Report No. 3: The Retail Planning System as Applied to the Grocery Sector: 2001 to 2007*, Dublin.

National Economic and Social Council (2008), "The Irish Economy in the Early 21st Century", June.

OECD (2006), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008a), *OECD Economic Surveys: Ireland*, OECD, Paris.

OECD (2008b), *Education at a Glance*, OECD, Paris.

OECD (2009), *Going for Growth*, OECD, Paris.

OECD (forthcoming), *Environmental Performance Review: Ireland*, OECD, Paris.

Sutherland, D. *et al.* (2009), "Infrastructure investment: links to growth and the role of public policies", *OECDEconomics Department Working Papers, No.* 686.

Wölfl, A *et al.* (2009), "Ten Years of Product Market Reform in OECD Countries – Insights from a Revised PMR Indicator", *OECDEconomics Department Working Paper*, No. 695.

ANNEX 4.A1

Progress in structural reform

This annex reviews actions taken on recommendations from previous Surveys, other than those covered in the main text of this chapter.

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
HOUSING POLICY	
Phase out the bias in the tax system towards home ownership either by reducing mortgage interest tax relief or introducing a property or capital gains tax on owner-occupied housing. Reduce the tax incentive for speculative investment on properties.	Mortgage interest tax relief has been eliminated after the first seven years of a mortgage but increased for the first 5 years. Interest relief will be kept under review with a view to eventual abolition over successive budgets.
Introduce a property tax to fund local infrastructure and services, broadening the tax base and redistributing some of the windfall gains to those living close to public infrastructure projects.	A € 200 local authority charge on non-principal private residences was introduced in Budget 2009. The future financing of local government is being considered by the Commission on Taxation.
Social housing policy should become more tenure-neutral by less reliant on direct provision of publicly-owned housing and providing more assistance through alternative methods such as the Rental Accommodation Scheme (RAS).	The Social Housing Investment Programme is being restructured, including using long-term lease arrangements to provide social housing at least 2 000 additional homes. Combined with additional provision through the Rental Accommodation Scheme, leasing will account for approximately 50% of all social housing completions this year.
FINANCIAL STABILITY	
Enhance transparency further by regularly surveying off-balance sheet exposures of banks.	A further survey was carried out in mid-2008.
Improve stress testing further.	A complete review of the methodologies of such exercises will be undertaken in the light of recent financial developments.
Consider the efficacy of Ireland's deposit guarantee arrangements.	The ceiling on the deposit guarantee scheme has been raised to € 100 000 and all retail deposits are guaranteed until September 2009. Coinsurance has been eliminated. Pay outs should now be made within 20 working days.
PENSIONS	
Use the opportunity provided by the Green Paper on Pensions to undertake a major reform package. This would include setting long-term objectives for the state pension, linking the standard retirement age to longevity, and replacing in-kind allowances with an equivalent cash increase to pensions.	After consultation process, a report on the Green Paper issues has been published.
Encourage workers to stay longer in the labour force by offering an actuarial-equivalent to the state pension for deferred retirement, considering a tighter link between the pension and years of contributions, and further limit means-testing for the non-contributory pension.	A long-term framework for pensions is under consideration by the government shortly.

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
Modernise public-sector pensions by reconsidering the basis for up-rating pensions in payment, phasing in the minimum retirement age of 65 more rapidly and ensuring that arrangements evolve in line with changing needs and practices in other sectors.	A public service pension-related deduction was introduced in March 2009, although the system remains largely pay-as-you-go.
Make Personal Retirement Savings Account (PRSA) membership "opt out" for those without occupational cover and income above a threshold where the state pension offers a high replacement rate.	No progress.
Replace tax breaks for pension contributions with a system of (capped) matching contributions. Tax breaks for households aged over 65 should be reduced as part of a wider package.	The earnings limit for tax-relievable contributions has been reduced to € 150 000 from € 275 239 and indexed.
Consider changing the funding standard for defined-benefit (DB) pensions schemes to a continuing basis.	The Pensions Board will allow longer periods for recovery plans (greater than ten years) in appropriate circumstances to deal with current investment losses. This will be reviewed by early 2011. Greater flexibility has been introduced to restructuring scheme benefits.
Reconsider the requirement to purchase annuities with retirement savings by allowing access under all schemes to Approved Retirement Funds (ARFs) or similar instruments.	In December 2008, a temporary option was introduced for members of Defined Contribution occupational pension schemes to defer the purchase of a retirement annuity until end-2010.
Increase the flexibility to work past 65 in occupational pensions and change tax rules to allow people to continue to work for the same employer.	No progress.
MIGRATION	
Provide increased support for adult migrant language training and consider the level of provision for children of all ages, including pre-school children.	For adults, there is now a range of provision. Over 49 000 participants undertook adult literacy tuition in 2008 through Vocational Educational Committees, for which 12 500 studies English for Speakers of Other Language (ESOL). For children, there are over 1 500 English as an Additional Language (EAL) teachers in primary and post-primary.
Accelerate work on the recognition of foreign qualifications and introduce an on-the-job skill assessment programme.	The availability of services in this area has been publicised to migrant groups. Country Education Profiles have continued to be developed to give "rapid response" turnaround of applications.
Introduce a permanent migration channel and create flexible visas. Ensure that policy is administered flexibly and is not excessively burdensome.	Enhancements in the visa system have been to make the system more user-friendly.
Collect better statistics on immigrants and fund research into migrant experiences.	The Irish Naturalisation and Immigration Service has increased resources in this area.
FISCAL POLICY	
Public spending growth should slow to reflect lower revenue growth with upgrading infrastructure given priority over current expenditure.	With a sharp and unanticipated fall in revenue, the necessary budgetary measures have been taken to raise revenue and constrain expenditure (this appears to say that enough has been done). It is appropriate to have reduced capital spending, although maintaining it at a substantial level.
Further steps should be taken to reconsider the large number of tax expenditures and those that are shown to be inefficient should be eliminated.	The Commission on Taxation has examined these issues. Some tax expenditures have been reduced or eliminated.
Expensive commitments on public-sector pay should be avoided. The link between higher pay and improved performance should be more explicit and transparent.	Public-sector pay growth was constrained by the October 2008 national pay deal. This has since been superseded by a wage freeze. The Pension Levy reduces public-sector take-home pay further. A moratorium on recruitment and promotions was introduced and an examination of the remuneration of higher level posts in the public service is currently being undertaken.
A transparent, top-down budgeting process should be adopted, building on the potential of the United Budget, with multi-annual budgeting for current as well as capital expenditure. A balance sheet should be produced for the government.	Multi-annual plans are included in the budgetary projections giving the paths for taxation, current expenditure and capital investment to 2011.

Recommendations from previous *Surveys*	Action taken since the April 2008 *Survey*
Public sector management should be improved by improving the flexibility of human resources management; moving further from input control to output management, including strengthening the output statement framework and the Management Information Framework (MIF); and using analysis more systematically for decision-making, by for example using the Value for Money Initiative more thoroughly in setting budgets.	The OECD Review of the Irish Public Service, Towards an Integrated Public Service, was published in April 2008. A Task Force on the Public Service was set up and published a report on Transforming Public Services, along with a major Government statement. A Special Group on Public Service Numbers and Expenditure Programmes has reported, a new National Public Procurement Operations Unit has been created and a new round of value-for money and policy reviews is underway.
FEMALE PARTICIPATION	
Encourage more out-of-school-hours care where school facilities are suitable.	Schools are encouraged to participate in after-school provision and significant progress has been made. The target of creating an additional 5 000 places will be met.
Implement plans to increase the supply of training places for childminders.	Progress is on-going.
Gradually introduce a link between childcare support, such as the Early Childcare Supplement, and employment status or the use of formal childcare.	The Early Childcare Supplement is being abolished and will be replaced by a pre-school Early Childhood and Education Scheme (ECCE) for those aged 3-4.
Phase out the Home Carer's Tax Credit.	No progress.
Prioritise access to community childcare to working parents, especially lone parents.	Community childcare services are supported through the Community Childcare Subvention Scheme (CCSS) to enable them to charge reduced childcare fees to disadvantaged and low income working parents, in particular lone parents. In 2009, up to 58 million is expected to be spent on these supports.
Continue reducing average and marginal effective tax rates on second earners. Consider moving to individual taxation.	The Commission on Taxation is examining the overall design of the tax system. Taxes on income in general have increased, although this has been required by the deterioration in the fiscal position.
Introduce fines for employers found in breach of Equal Pay laws.	No progress.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(10 2009 17 1 P) ISBN 978-92-64-05453-0 – No. 56969 2009

OECD Economic Surveys

IRELAND

SPECIAL FEATURE: LABOUR MARKET

Most recent editions

Australia, October 2008
Austria, July 2009
Belgium, July 2009
Canada, June 2008
Czech Republic, April 2008
Denmark, February 2008
Euro area, January 2009
European Union, September 2009
Finland, June 2008
France, April 2009
Germany, April 2008
Greece, July 2009
Hungary, May 2007
Iceland, September 2009
Ireland, November 2009
Italy, June 2009
Japan, September 2009
Korea, December 2008
Luxembourg, June 2008
Mexico, July 2009
Netherlands, January 2008
New Zealand, April 2009
Norway, August 2008
Poland, June 2008
Portugal, June 2008
Slovak Republic, February 2009
Spain, November 2008
Sweden, December 2008
Switzerland, November 2007
Turkey, July 2008
United Kingdom, June 2009
United States, December 2008

Non-member Countries: Most recent editions

Baltic States, February 2000
Brazil, July 2009
Bulgaria, April 1999
Chile, November 2007
China, September 2005
Estonia, April 2009
India, October 2007
Indonesia, July 2008
Romania, October 2002
Russian Federation, July 2009
Slovenia, July 2009
South Africa, July 2008
Ukraine, September 2007
Federal Republic of Yugoslavia, January 2003

Subscribers to this printed periodical are entitled to free online access. If you do not yet have online access via your institution's network contact your librarian or, if you subscribe personally, send an e-mail to **SourceOECD@oecd.org**

Volume 2009/17
November 2009

ISSN 0376-6438
2009 SUBSCRIPTION
(18 ISSUES)

OECD*publishing*
www.oecd.org/publishing

ISBN 978-92-64-05453-0
10 2009 17 1 P