

## Economic Survey of Ireland, 2003

### Summary

Having slowed down sharply, the Irish economy is now faced with the challenge of securing the basis for future growth. Income expectations seem to be adjusting to the new reality, and so does the 2003 budget. Yet difficult tasks remain in safeguarding cost competitiveness, moving up the value chain, securing sound public finances, ensuring value for money in public services and making growth environmentally sustainable. Safeguarding cost competitiveness and enhancing welfare require new initiatives to contain housing prices as well as stepped-up reform efforts in much of the sheltered sector of the economy, including the public sector, which affects prices through both taxation and public charges. Fiscal policy needs to guard against complacency, and to move back towards balance, or a surplus if circumstances require, over the medium-term, while focussing on improving the structure of the economy. To maintain a growth-friendly tax environment and ensure fiscal sustainability, it is essential to further improve the management of public expenditure by: harnessing an output orientation and top-down approach in budgeting; assessing projects on their relative merits; giving local governments both greater freedom and responsibility in decision making; and taking advantage of market mechanisms in some appropriate areas of the provision of merit goods. To break away for good from the legacy of protecting producer interests, the National Policy Statement on Regulation should establish principles for the regulatory system that are firmly based on the idea of promoting competition. Linked to this, the high value-added orientation of business investment strategy

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*This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Ireland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

requires enhanced quality of human capital and capacity for innovation, the efficient provision of which is most likely achieved through a system where competition plays an important role. In sum, with the Irish economy moving to a rather slower growth path than in the second half of the 1990s, both income expectations and public finances are having to adjust. But taking full advantage of Ireland's growth potential requires a range of structural reforms, in both the public and the private sectors, to create a more competitive environment and contribute to continuing prosperity and enhanced welfare. ■

### **What are the policy challenges for Ireland in a slower growth environment?**

The extraordinary growth in the second half of the 1990s, the era of the "Celtic Tiger", has given way to a more normal, albeit still rapid pace of expansion since 2001, though the extent of the slowdown has been more marked outside the multinationals sector. Some slackening in growth was in any case inevitable and even desirable given increased tensions in the economy, manifest in high inflation, worsening traffic congestion, rapidly rising house prices and recruitment difficulties. While the slowdown is closely linked to the burst of the ICT bubble, it also reflects a deterioration in Irish cost competitiveness. This has been due to strong inflation in the sheltered sector of the economy, reflecting the combined influence of large wage gains emanating from the tradables sector, low productivity growth in the sheltered sector and the generally expansionary effects of very low real interest rates since Ireland joined the European Monetary Union. The future trend growth over the medium term is now widely believed to be between 4 and 5 per cent for real GDP and a shade lower for GNP, a view shared by the OECD. The policy challenge facing the Irish economy in the immediate future is to ensure that both income expectations and public finances adjust to a slower growth environment. The former is necessary to guard against deterioration in international competitiveness, while the latter is required to ensure fiscal sustainability and the maintenance of a growth-supportive tax environment. Over a longer term, the broad aim of the authorities should be to ensure that the economy will continue to grow at a reasonably high rate and that policies will be more clearly oriented towards protecting interests of consumers rather than producers, notably through enhanced competition in service sectors.

At 6 per cent, real GDP growth was relatively well maintained in 2002, but in terms of real GNP, a measure not of domestic production but of national economic activity, growth was much weaker at well below 2 per cent. The wide gap between GDP and GNP that is accounted for by net factor income payments has been a consistent feature of the Irish economy, but a growth gap of over 4 per cent is unprecedented and attributable to a strong performance of the biomedical and pharmaceutical sectors where, margins are exceptionally high and accrue largely to foreign owners. The economy has lost momentum since late 2002 with a further slowdown in exports and a substantial weakening in business confidence. The demand for labour slackened throughout 2002, leading to a rise in the unemployment rate from its historical lows to 4.4 per cent in 2002. The current weak trend in activity is expected to prevail during 2003 but is forecast to give way to modest acceleration in 2004 on the assumed recovery of export markets. Construction activities are likely to remain a major source of buoyancy due to rapid development of the physical infrastructure and continued strong demand for housing. ■

### **Are necessary adjustments taking place?**

There are signs that adjustment in income expectations has begun to take hold. The recent central wage agreement of 7 per cent over the next eighteen months indicates that income expectations are adjusting to the new situation and will help to moderate inflation. The partnership process seems to have contributed to this outcome by promoting the common understanding of the emerging economic reality, even without a tax concession as offered by the government in the past. The new partnership agreement nonetheless included a series of special initiatives to deal with certain social issues. On the other hand, strong price pressures that prevail in the sheltered sector of the economy suggest that the adaptation of income expectations to slower growth still has some way to go. Inflation in the sheltered sector, however, could be expected to subside with wage moderation, though remaining higher than in the sector open to international competition. One reason for this projected inflation gap is the level adjustments to public sector wages following the benchmarking exercise, which put upward pressure on indirect taxes and public charges. It is important that future wage adjustment in the public sector should be strictly conditional upon the demonstration of higher efficiency.

The adjustment also appears to be taking place in public finances. The 2003 budget seems to be more consistent with slower underlying growth in the tax base than its two predecessors. Both the 2001 and 2002 budgets substantially overestimated revenues while underestimating spending pressures, which resulted in a worsening of the general government position from a surplus of 4.4 per cent of GDP in 2000 to an estimated deficit of 0.1 per cent in 2002. The error in the revenue projection was in part due to the reform of taxation which, despite its positive effects on economic incentives, made forecasting difficult. But it was also attributable to overestimation of Irish growth due to the unforeseen slowdown in global economic activity. The 2003 budget marks a departure from the earlier budgets in that it relies on increased taxation and allows a smaller increase in spending that is allocated selectively to priority areas. Even so, the general government deficit is projected to rise to 0.8 per cent of GDP in 2003.

The budget projections to 2005 in Ireland's latest Stability Programme Update envision the deficit continuing to rise to 1.2 per cent of GDP in the context of economic growth below potential. However, both the spending and revenue shares are projected to fall and the debt to GDP ratio to remain below 35 per cent. In the following decade, it will be necessary to exercise continued budget prudence so as to deal with spending pressures related to infrastructure development and a range of social services and to prepare further for the budgetary implications of population ageing. In an environment of less buoyant fiscal revenues, the need to clearly establish spending priorities and to ensure that value for money becomes the key criterion in all spending areas will become more important than ever. ■

### **What is the scope for enhancing the efficiency of public spending?**

To meet this challenge requires further significant improvements to the public expenditure management system. Despite some progress, further reforms to institutional arrangements will be needed to enhance aggregate spending control and strategic prioritisation. Among the most important is the adoption of a more top-down budgeting process and a rolling multi-annual budget "envelope" system. The move to a multi-annual framework for public investment is a positive step in this regard. Prioritisation of spending could also be facilitated by stepping up the ongoing

efforts for systematic expenditure reviews, and by introducing sunset clauses to new programmes, which should help move resources away from those which no longer serve the original objectives. ■

### **Through a results-focused budgeting?**

To enhance the efficiency of public service delivery, the government should accelerate its efforts to move from input-oriented management and budgeting toward one centred on outputs and outcomes. This will however need to be pursued in conjunction with strengthening accountability for results, which in turn requires developing more specific performance criteria and more effective monitoring and control systems. Routine and systematic evaluation and value-for-money audits should be in place in all spending areas. The government should also take steps to systematically integrate output indicators into the budgetary and policy-making process. Both *ex ante* indicators in the form of goals and *ex post* indicators as a means of verifying performance will need to be integrated to show the effectiveness of alternative programmes. In particular, it will be important to strengthen the role of the Parliament and the Comptroller and Auditor General in results-oriented auditing and reviewing control mechanisms. At the same time, the current efforts to develop the Management Information Framework (MIF) needs to be stepped up. Efficiency gains could also be made from reforms to human resource management in the public service including more open and competitive recruitment and performance-oriented personnel management practices. Given the limited progress made in this area in the past, it will be particularly important to develop the link between public sector pay increases and the modernisation of the public service, which was established in the new partnership agreement. ■

### **A use of market instruments?**

A more extensive use of market-based instruments such as contracting out, vouchers, internal contracts and benchmarking should help generate higher efficiency and better delivery of publicly funded services. In particular, there is still substantial scope for more use of user charges as a mean to contain cost pressures or reduce excessive demand. Water charges are a case in point. Ireland is unique among OECD countries in not charging domestic consumers for water services. A charging regime in this area could contribute to more efficient use of what is

becoming an increasingly expensive resource. In addition, fees for higher education could be re-introduced. Several OECD countries have successfully targeted support for higher education through fees, loans and grant schemes which include provisions for the less well-off. ■

### **A reform of local government finance?**

Improving the effectiveness of spending by sub-national governments should be a key element of public expenditure management reform. A wide-ranging programme of local government reform in recent years has greatly enhanced the quality of performance management system at local level. While pursuing the ongoing efforts to improve local accountability, reform should now aim at providing greater flexibility and decision making power to local authorities and increasing the share of funding which is locally levied. In this regard, serious consideration should be given to raising revenues by re-introducing local property taxes on residential housing, which has many advantages as a sub-national tax. The current grant system might be reformed to improve allocative and cost efficiency by moving towards block grants for those services which do not provide clear spillover effects and modifying the financing arrangements for earmarked grants to provide incentive to contain costs. There is also scope for streamlining sub-national public administration, given the plethora of local or regionally-based public bodies that operate outside local government. Efforts should also be made to enhance the level of co-ordination and co-operation between local authorities and between national/local authorities and other public service bodies to achieve effective planning and delivery of services. ■

### **Better planning and increased efficiency in infrastructure investment?**

Costs and benefits of public spending in several priority areas should be carefully considered. One such area is public infrastructure investment. The substantial increase in spending planned under the National Development Plan is justified to respond to the infrastructure needs resulting from strong economic growth in Ireland, in particular, in roads, public transport, and housing. But it is important to get the maximum mileage out of the increased spending. The final costs of the infrastructure investment under the National Development Plan are now envisaged to be

much higher than initially planned. For example, the estimated costs of the national road programme had soared from €5.9 billion in 1999 to €15.8 billion in 2002, due mainly to construction cost inflation, design changes, additional land acquisition costs, and under-estimation of project prices. One way to overcome the constraints in the construction sector will be to accelerate the efforts to increase the import content of construction services, through such measures as further increasing the share of public procurement openly advertised internationally. The Government's intention to expand the involvement of the private sector in the funding and operation of the public infrastructure through Public Private Partnerships (PPP) is welcome in this regard, but in pursuing this strategy the appraisal procedures in place to determine that PPP is the best value option should be rigorously applied. In addition, contracts will need to be designed carefully to allow for an appropriate sharing of the risks associated with such major projects and emphasis will need to be placed on regulation and on providing the right frameworks and incentives. ■

### **Greater effectiveness of healthcare spending?**

Another priority spending area is healthcare. Given the enormous increases in government expenditure on the health services and notwithstanding some real improvements in outputs, concerns remain about the efficiency and productivity of this sector. This is particularly manifest in public dissatisfaction about long waiting times for access to public hospitals, which seems to be exacerbated by a prevailing perception that people with private insurance jump the queue. To respond to the issue of access to care for public patients in public hospitals the regulations which limit the share of public beds occupied by private patients should be fully enforced. To better inform public perceptions and to improve decision making about priorities, greater transparency is required in relation to the existing distribution of resources within, and outputs of, the health services. More generally, the poorly developed information systems in the health sector hamper the measurement of performance, and priority should be given to accelerating efforts to improve the availability of relevant information. Enhancing the efficiency and effectiveness of health spending also requires comprehensive reforms to the organisation and management of the health sector. In particular, more co-ordination across the ambulatory sector and

the inpatient care sector could help to achieve productivity gains and reduce the workload of hospitals. Serious consideration should be given to the proposals calling for a smaller number of health boards with improved governance structure, which would improve accountability and facilitate the rationalisation of service provision. Enhanced co-operation among health boards should be encouraged to reap the benefits from synergies and economies of scale. This would help to ensure consistent application of service and quality standards nation-wide. ■

### How can cost competitiveness be safeguarded?

Getting maximum value for money out of public spending will help to improve the quality of public services and to maintain the current tax environment. This is good for the citizen's welfare and for business development generally. It also helps Ireland to remain an attractive place for the foreign direct investment (FDI) that will continue to play a major role in the growth process. While Ireland's low-tax and other advantages such as English language and well-trained workers will continue to be positive features in attracting foreign investment, their merit is likely to diminish in relation to newly emerging competitors, particularly some of the candidate countries for EU accession. In addition, given the particularly strong response of productivity growth to FDI it would not be difficult for these countries to gain cost competitiveness quickly once the scale of FDI is increased. Faced with this challenge the authorities should at a minimum ensure that inflation in the sheltered sector does not undermine cost competitiveness given that the Irish price level converged to the average EU level and is now becoming among the highest in the region. ■

### Why does inflation in the sheltered sector matter?

Inflation in the sheltered sector of the economy matters for growth in several ways. *First*, it affects the cost competitiveness of the internationally traded sector to the extent that the services provided by the sheltered sector serve as inputs. *Second*, by raising the cost of living of workers it pushes up the wage claims in the internationally competing sector. *Third*, it influences inward migration that is likely to constitute an increasing source of labour force growth. The cost of housing is an important element of domestic infla-

tion and needs to be reined in. The price of housing has been rising rapidly despite the increasing supply, and as more new houses have been built further away from the city centres the commuting time has lengthened and pressures on infrastructure have intensified. While roads and other physical infrastructure are being built within the framework of the National Development Plan, new forms of public transport such as the light rail system currently under construction in Dublin would alleviate the problem of commuting. In parallel, reform in urban planning regulations seems necessary to promote the housing capacity within the cities.

Regulatory reform in the sheltered sector could contribute importantly to enhancing the growth prospect by weakening the pricing power of incumbents and boosting productivity. Good progress has been made in strengthening competitive forces in some areas such as telecommunications and taxis. Moreover, the Competition Authority has seen both its independence and resources substantially reinforced in line with the recommendations made by the OECD. In contrast, progress has been sluggish in most other areas, including pubs and legal and other professions, and further steps are necessary even in those areas where good progress has been made. In electricity, the creation of a power exchange would considerably promote the development of additional generating capacity by independent generators. This could and perhaps should be further encouraged by making an ownership separation between generation and transmission assets, and splitting the Electricity Supply Board's generating capacity into a number of competing units. In pharmacies, an arbitrary rule limiting the operation of pharmacists trained outside the country should be abolished. New initiatives to bring in more competition to land transport and airport operations are welcome, but they need to be followed through. ■

### Why is the strengthening of focus on consumer interests important?

A key to future reform process, however, is the proposed National Policy Statement on Regulation that sets down the principles for the regulatory system. To mark a clear departure from the traditional policy focus on producer interests, the principles should anchor the regulatory system firmly in competition policy. There appears to be an increasing realisation among Irish people that the legacy of protecting pro-

ducer interests in the sheltered sector at the expense of consumer interests is not only hurting their own welfare but also the competitiveness of the economy. The anti-inflation initiative in the new partnership agreement is a concrete manifestation of such a realisation. It is hoped that this initiative reinforces the role of the Competition Authority in fighting unhealthy pricing power in sectors where competitive forces are still inadequate. ■

### What is necessary to move up the value chain?

While safeguarding cost competitiveness helps, for a high income country like Ireland to continue to grow there is no escaping a shift in the supply structure towards higher value added. The authorities are now trying to promote higher value-added investment, through encouraging existing domestic and foreign companies to engage in knowledge-intensive activities and by inviting innovation-oriented new FDI. Given the large-scale presence of high-tech foreign companies, there appear to exist some economies of agglomeration, as illustrated by successful cases of domestic venture start-ups and diversification of activities by multinationals, notably in Dublin. The success of the strategy of upgrading business activity will, however, depend importantly on how many high-skilled workers and researchers Ireland can provide or attract.

With the rapidly upgrading skill requirements, higher education institutions now face the challenges to increase enrolment and retention rates, to maintain high standards of teaching and to further develop research capability. Research and development activities at the universities are being strengthened by the unprecedented increase in the funding for research, which needs to be allocated based on competitive evaluation by a third party. In addition, more systematic efforts will be needed to address the weaknesses in technology transfer and commercialisation of research results through an improved co-operation between businesses and higher education institutions, while ensuring competition between different consortia. Emphasis has also been placed on improv-

ing human capital at work, by encouraging lifelong learning and business investment in training, for example through the “skillnets” initiative. Flexible arrangements are being introduced to allow employed early school-leavers to obtain certificates on a part-time basis. The increased number of mature age students seeking learning opportunities could be accommodated more effectively by introducing flexibility into the traditionally rigid system of student selection and administration in higher education institutions.

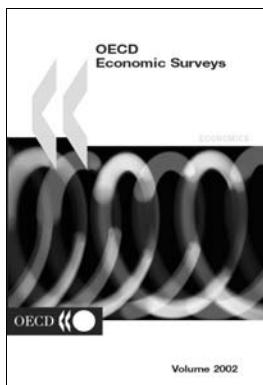
Continuing economic growth should also be environmentally sustainable. Achievement of this objective is being aided by the increasing use of economic instruments. Carbon taxation is being considered to reduce greenhouse gas emissions and would be a step forward, provided that tax rates are uniform across all sectors and in line with expected prices for EU emission permits. The peat industry should not be exempt from such taxation. Waste management is also moving in the right direction with the introduction of a landfill tax, weight-based charges for households and use of producer responsibility levies. Taxes and levies should, however, be soundly anchored to measured externalities and should not be used to meet arbitrary targets. While there is no shortage of water and clean rivers, water quality has deteriorated. There seems no reason to continue to finance household water supplies and waste water treatment from general taxation. The main environmental problem, seen as excess nutrient content in rivers, will be addressed in the context of the development of a national action programme to give effect to the Nitrates and other Directives. This effort should include the use of economic instruments. ■

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