Policy Brief

OECD

Economic Survey of Ireland, 2001

Summary

Ireland has now had 10 years of rapid growth, with the unemployment rate having been brought down from some 14 per cent to under 4 per cent. But rather than slow as might have been expected, Ireland experienced spectacular growth of well over 10 per cent in 2000 due to the confluence of several one-off factors which are now disappearing. Growth is expected to slow to under 8 per cent representing a more sustainable level. Inflation, although falling, remains a concern but unequal productivity growth between sectors is likely to leave inflation above the euro-area average for some time to come. The forces of growth are firmly embedded in the economy through favourable demographics, rising human capital formation and a high rate of technology-oriented investment. The authorities have created a favourable business climate for growth and this policy will need to be refined as Ireland moves up the value-added chain. This will require continued reforms to improve the efficiency of the public sector as well as the quality of regulation and to develop competitive markets more fully, notably in the network industries. The public sector, especially at local government level, will have to be streamlined and focused on the efficient delivery of public services. While automatic stabilisers should be allowed to work, fiscal policy should be oriented to maintaining a significant surplus for some time to come so as to smooth tax pressures by, for example, putting aside funding for future pension liabilities. More generally, fiscal policy will need to focus on improving the structure of the economy, including the efficient provision of infrastructure, while avoiding excessive pressure on resources. To keep the demand for new infrastructure within limits, the density of urbanisation should be increased in the Dublin area. With public sector pay systems continuing to be reformed, the social partnership agreements will need to evolve towards setting general principles guiding pay bargaining, while imposing less constraints on budgetary decisions. Rapid growth has also served to highlight the difficulty of meeting international environmental obligations. Policy in this area should make greater use of economic instruments to achieve objectives at least cost. In sum, Ireland has continued to grow at a rapid pace due in great part to the favourable framework conditions which have been created. Policies need to be refined so as to sustain the growth process. If this is done, the standard of living could continue to improve at an impressive pace in the coming years. ■

This Policy Brief presents the assessment and recommendations of the 2001 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.

OECD Observer

Organisation for Economic Co-operation and Development

What issues has strong growth raised?

Confounding the expectations for a slowing of growth at the time of the last *Economic Survey* in 1999, economic activity surged last year to well above 10 per cent with exports expanding by some 20 per cent. Contributing factors included cyclical strength in the OECD area, buoyant demand in the information and communication technology sector (ICT) and a favourable exchange rate for the euro. Such rapid growth was associated with strong business investment made possible by a continuation of large inflows of foreign direct investment. Employment grew by 6¼ per cent in 1999 and by 4¾ per cent in 2000 while the unemployment rate fell to under 4 per cent by the end of the year. Rising employment, higher wages and lower taxes resulted in private consumption expanding by some 8½ per cent and underpinned strong demand for housing which saw prices continuing to rise by around 15 per cent in 2000. Despite rising wages and prices, competitiveness (as measured by relative unit labour costs in manufacturing) actually improved due to extraordinary productivity growth; and the current account remained in balance, a strong trade surplus offsetting profits earned by the growing stock of foreign direct investment. On the other hand, rapid growth has also been associated with some negative consequences. Pressure has mounted on infrastructure, especially the road and the public transport systems, with congestion rising. Such problems and strong inflation pressures have focused policy discussion on the sustainability of the growth process, both in the short and medium run.

The significant inflation differential between Ireland and other members of the euro area has been a major concern for policy makers. After converging to levels in the euro area in the run up to EMU, the differential on the basis of the Harmonised Index of Consumer Prices widened from 1½ percentage points in October 1999 to 3¼ points a year later and was still some 1½ points in March of this year. Such a situation has been interpreted by some as indicating serious overheating as the result of excess demand. But such an interpretation clearly needs to take account of the process of inflation in a small, open and growing economy in a common currency area. This is not always straightforward. With imports and exports together accounting for some 160 per cent of GDP, inflation in 2000 was more heavily influenced in Ireland than elsewhere by the weakness of the euro, in particular against the currencies of key trading partners, notably the pound sterling and the dollar. Wages grew rapidly in the tradables sector, underpinned by strong demand, large productivity gains and the favourable exchange rate. Under conditions of full employment these wage increases were also reflected in the domestic non-tradables sector. But, with lower productivity growth in that sector, this resulted in higher price inflation there. The associated real exchange rate appreciation, which is likely to continue for some time to come, is an inevitable process of adjustment for a country like Ireland. Excess demand, including strong demand in the services sector, is certainly pushing up service prices and wages, but with the current account roughly in balance it would not be appropriate to characterise the situation thus far as simply one of overheating. ■

What are the prospects and risks?

GDP growth is projected to slow to 7¾ per cent this year and in 2002, close to the Secretariat's estimate of short-term potential growth. Two factors are driving the return to more normal rates of growth. First, exports are projected to slow in 2001 as the cyclical peak in the OECD area passes and demand for ICT products weakens. How far this latter process will develop remains uncertain although at the start of the year expectations for exports fell sharply. The appreciation of Ireland's nominal effective exchange rate since last October will reinforce this process. Slower exports are expected to lead in turn to a cut in business investment, which will be partially compensated by an increase in public investment on infrastructure and by buoyant demand for housing. Second, the increasing scarcity of labour will also reduce growth. The expansion of the labour force may have peaked during 2000. Even though ongoing changes in the tax system should encourage labour force participation and immigration, the growth of the labour force is likely to fall below 3 per cent in coming years. Inflation is projected to decelerate in the context of slower growth and somewhat tighter monetary conditions.

In the near term the key uncertainty concerns the development of exports. Ireland is much more dependent on the European than the US market, but if the latter were to show sustained weakness, FDI flows into Ireland could also decline. Even though growth prospects might be only reduced temporarily, concern has been expressed that the shock could lead to a bursting of what some presume to be a speculative bubble in house prices with broader implications for consumption through the wealth effect. There is, however, no strong evidence to suggest that a speculative bubble exists, although some prices might well have overshot their fundamental level. Indeed, recent indicators suggest that the rate of house-price increases is beginning to moderate. While financial supervisors will need to remain vigilant, household debt is still rather low and exposure by banks to the real estate sector is not excessive, so that downside risks might remain for the time being limited. The possibility of a foot and mouth outbreak and the impact on tourism of related precautionary measures represent a further risk to the growth projection. Another concern which is often expressed (and which has driven a great deal of recent policy decisions) is that wage and price adjustments in the context of rapid growth may develop their own dynamic leading to "overshooting" and to a sharp correction at some point. The risk of such a "hard landing" should not be exaggerated either, since even if wages did overshoot, the correction would likely not be sharp but involve a gradual adjustment via weaker employment and net exports, with the current account moving into deficit. Since there is no balance of payments position to defend, some time would be available for real wages to adjust back down to appropriate levels. ■

How has the policy framework changed since joining the euro area?

With entry into the euro area at the start of 1999, interest rates fell by some 3 percentage points and, with inflation higher than in the rest of the area, real rates fell to historically low levels. In combination with the weakness of the euro up to the start of this year, monetary conditions have thus been extremely easy in recent years leading to very rapid credit expansion. Faced with such a large monetary shock, fiscal policy in principle might have been tightened so as to fully offset the aggregate demand impact of this shock. And indeed, fiscal policy, as measured by the cyclically-adjusted budget surplus, did tighten in both 1999 and 2000. However, it was also clear to the authorities that it would be politically difficult to continue to increase an already large surplus.

Reflecting the concern to control inflation and to avoid a wage-price spiral, the government negotiated the Programme for Prosperity and Fairness (PPF), in early 2000. The PPF, the most recent agreement of this kind, covers the period 2000-2002 and involves moderate pay increases combined with tax reductions to raise net take-home pay by up to 25 per cent or more during the period up to and including the budget for 2003. The agreement is not binding and wage growth in the private sector last year was considerably above the agreed limits as wages rose to equilibrate the labour market. The argument behind the partnership agreement is that it preserves industrial peace and provides a base for negotiations in the private sector, serving to anchor expectations. That may be true but the question is whether it is worth achieving such a benchmark at the cost of binding commitments on tax policy and, increasingly, spending policy. It might be advisable to make any future agreements bear more on general principles guiding pay determination while imposing less constraints on fiscal policy than hitherto.

An important barrier to relaxing the commitment to the social agreement is the situation in the public sector where the wage agreement is most relevant – and most controversial. Indeed, a significant part of the PPF is devoted to the public sector. To deal with rising tension about pay relativities both within the public sector and *vis-à-vis* the business sector, a bench marking group was established. What is ultimately required is a more efficient public sector which can compete with the private sector in attracting employees. This problem needs to be dealt with directly but it is not clear that the terms of reference of the benchmarking commission will allow them to propose more fundamental changes to the parameters of public sector employment. ■

What is appropriate fiscal policy this year and beyond?

The budget for 2001 has been set within the framework of the government's continuation of the policy to promote growth and its strong commitment to maintaining the PPF. The process of lowering corporate taxes on activities which are not internationally traded to the unified target rate of 12½ per cent has continued. Further progress has been made in restructuring the household tax system to favour labour force participation, especially by women, and to reduce high marginal tax rates for single workers at higher levels of income. This makes tax rates now compare well with those in the UK with which the Irish labour market is closely linked via immigration. The budget decisions were also oriented to distributional issues. with income tax cuts aimed at low-income earners, and large increases in child benefits to meet criticism following the previous budget. As part of the re-negotiation of the PPF in December the standard rate of VAT was reduced by one percentage point and some fuel duties were also cut to achieve an early reduction in headline inflation. Old-age pensions were increased by around 11½ per cent. In sum, the full-year cost of income tax cuts and changes in social security contributions is around 1.2 billion pounds (1½ per cent of GDP), following cuts of 940 million in the budget for 2000. The annual cost of social welfare improvements is about 0.6 billion pounds (¾ per cent of GDP), again about twice the level in the previous year. Current expenditures are set to rise by 10 per cent with the public sector wage bill budgeted to rise by some 12 per cent. The budget also provided for a further 28 per cent rise in infrastructure spending (after a massive increase of 38 per cent in 2000).

Despite these deep cuts in taxes and large increases in expenditures, the government estimates that the budget surplus should fall by only some 0.3 per cent of GDP this year to around 4.3 per cent of GDP. However, the cyclically-adjusted budget surplus is estimated by the government to fall by a cumulative 0.7 per cent of GDP this year and next, before rebounding by 1¼ per cent of GDP in 2003. This gives the impression of substantial fiscal policy easing in the short run even at a time the economy is fully employed. However, the government has adopted cautious estimates of tax revenues so that *ex ante* easing might actually be *ex post* neutral or even tighter, as has been the case in previous years. The Secretariat projects only a small decline in the surplus this year, and the apparent easing in the cyclically-adjusted surplus of some ¼ per cent of GDP can be explained by one-off receipts of tax arrears in 2000. Thus, the authorities seem to be avoiding added impetus at a time when the economy is fully employed.

Even though it is difficult to determine the overall fiscal stance with any degree of certainty, the public sector will be making greater demands this year on scarce resources. Despite the tightness of the labour market, the budgeted public sector employment growth will correspond to around 10 per cent of the likely increase of the labour force. Increased allocations to construction come at a time when new tender prices are already rising by up to 15 per cent. With labour force participation already rising incentives to increase labour supply are bound to have a lesser impact. In short, this year is not a suitable moment to increase pressure on resources so that the budget has taken greater risks than were advisable. Looking ahead, the Stability Programme envisions a surplus of 4.6 per cent in 2003, but to achieve this the plan foresees current non-interest expenditures falling as a share of GDP by more than 1 percentage point. In the light of current budget decisions and the difficulty in resisting public demands at a time of a sizeable budget surplus, the plan to hold down expenditures looks somewhat ambitious. Consideration should hence be given to re-inforcing the multi-annual budgetary framework through financial envelopes on departmental spending. In the medium term, there is a need to maintain a budget surplus in order to smooth tax pressures over time by accumulating financial assets for future liabilities – though pressures in this regard are less pressing than in the majority of euro-area countries.

The authorities made a bold move in prepaying the pension liabilities to privatised enterprises in 1999 and in 2000 (thereby apparently worsening the fiscal situation) and have now established a pension fund which will receive at least one per cent of GNP each year up to 2025. The fund already amounts to 6 per cent of GDP, having received privatisation funds in 2000. Payments to the fund represent a financial transaction (below the line) for national accounts purposes so that from the accounting perspective it will simply lower the repayment of public debt. However, from the political economy perspective, contributions serve to lower the exchequer surplus and to make clear to the public the need to make provision for future liabilities. ■

Has policy been providing a favourable business environment?

The authorities have continued to develop their policy of attracting mobile capital and technology through providing a favourable business environment. The strategy has been successfully adapted to support a steady rise in real incomes: new investment is associated with more high paying jobs than in the past and is also being encouraged, with some success, to locate in areas other than Dublin. With respect to infrastructure, the National Development Plan (NDP) 2000-2006 involves expenditures of Ir£ 17.6 billion, *inter alia* on transport, water and sewage. However, given already very tight supply conditions in the construction sector it will be critical to organise tenders so as to attract more overseas civil engineering enterprises into the process; and to the extent that foreign supply is not adequately forthcoming, a slower rate of spending might be required to avoid money simply dissipating in higher costs. A problem with the infrastructure programme is that it is coming before the government has decided a national spatial strategy to ensure more balanced territorial development than at present, and this in many ways could pre-empt choices. Such a plan should deal with key issues such as developing counterweights to Dublin and increasing the density of urbanisation in Dublin itself. It is important to re-align the NDP at its mid-term review in 2003 with the spatial strategy. ■

How worrying are rising house prices?

Rapidly rising house prices last year became an important subject in the negotiations for the PPF. The government introduced a third package of measures in July designed both to cut speculation, which it considered to be a problem, and to speed up the release and development of land. Some of these measures were subsequently amended at the start of this year in light of their impact on the rental sector. Zoning procedures have been altered to require local authorities to develop housing strategies and Strategic Development Zones are being created with fast-track provision of infrastructure and planning approval. Developers will face fines if their land is not developed within a given period, which partially addresses a concern expressed in the last *Survey* that land was not associated with any holding charge. Whether the planning capacity is up to the challenge remains to be seen, especially in view of the strains arising from the simultaneous implementation of the NDP. Despite simplifications and more restrictive rights to appeal planning decisions, the capacity of local authorities remains a problem. The number of housing completions has continued to rise and the rate of price increase has shown some signs of slowing more recently. Nevertheless, housing demand remains high due to demographic factors and the growth of household disposable income so that pressures to acquire houses will continue for some time yet. ■

What are the remaining concerns that need to be addressed?

With rising house prices receiving most attention, concern with urban sprawl, increased commuting times and endemic congestion seems to have in effect taken second place. Pressure last year to bring down rising house prices led to tax measures to cut the speculative activities of investors and therefore to reduce pressure on the construction sector. It became quickly apparent that the incentive to develop denser rental housing had been weakened leading to the withdrawal of the anti-speculative property tax in March. Urban sprawl is in part encouraged by the failure to charge fully for externalities and for infrastructure. There are no water charges, even though the supply of these facilities is very expensive and there are no local household rates. The *OECD Environmental Performance Review* of Ireland recommended the introduction of water pricing based on the installation of meters even if only for new houses. Moreover, commuters do not pay the full social costs of transport with fuel taxes too low for the externalities involved. Until pricing is brought into line with planning objectives, urban development will remain an area of concern. However, the general impression remains that too little has been done too late so that infrastructure policy will have to become oriented to supporting the urban system which has just sprung up.

An important element of the growth strategy has been to augment the provision of skills demanded by the economy. In the short run this involves a skills-oriented immigration policy, and training for the unemployed is now receiving greater emphasis. A large number of persons are still occupied in make-work programmes under the Community Employment Programme, which does not have a good record in reintegrating people into the labour force. Although access to the programme has been tightened, a faster run-down than currently foreseen is required together with the creation of more training places. The NDP involves substantial investment in human capital formation through training programmes to cover a wide range of high and low skills and this is appropriate. Other programmes are oriented to those with tertiary qualifications but here the use of public funds is more questionable since there are already incentives for individuals to sponsor themselves. A skills fund has been set up to support enterprise training but with the labour market tight, the logic of the programme, which still needs to be more closely specified, is not clear. A network has been started for companies to identify shared training needs and this will deepen the already close contacts between industry and the educational authorities which has been a hallmark of Ireland's successful strategy. ■

What should be the next steps in regulatory reform?

Over the years there has been steady progress in reducing barriers to entry and entrepreneurship, and improving market openness. Indeed, the *OECD Regulatory Reform Review of Ireland* of April 2001 concluded that, in a number of respects, Ireland has a light-handed regulatory environment. However, competition policy needs to be strengthened. The transfer to the Competition Authority of responsibility for mergers and take-overs is a positive move, but the Authority still needs to be made independent in its budget and in appointments. To support the goals of administrative reform, Ministries should be obliged to request the Authority's view on the competition implications of new legislation and regulations which would be made public prior to the proposal entering the legislative process. With respect to enforcement, particularly in the difficult area of hard-core cartels, the Authority should have the power to implement a leniency programme for both firms and individuals to strengthen its capacity of investigation. Steps also need to be taken to improve the familiarity of courts and judges with the application of competition law.

The key remaining regulatory problems concern t inefficiencies in the state sector and unfinished pro-market regulatory regimes in some of the network sectors and in transport. With respect to the former, the government has for some years been implementing the Strategic Management Initiative (SMI) to modernise the operation of the civil service. The system of preparing legislation is being modernised, ministries have had to consider their output more carefully and expenditure reviews have been introduced. The initiative places special emphasis on promoting competition, as well as protecting consumer interests. To this end, a quality regulation checklist against which all new legislative proposals must be measured has been introduced. Moreover, a central group has been set up to introduce more formalised Regulatory Impact Assessment. These initiatives need to be pursued since a broader framework for policy will also enable objectives such as those associated with better environmental performance to be incorpo rated into policy decisions using least-cost solutions. The competition policy criteria in the SMI checklist may be too general and will need to be made more operational in the future. The delivery of public services also requires reform to make it more focused and efficient. Many areas such as maintenance of social housing and water supply are serviced by a fragmented local government sector. This fragmentation does not enable economies of scale to be achieved while the absence of market competition has implications for the quality and cost of other services.

As well as opening up network-related markets in line with EU directives, Ireland has also been developing pro-market regulatory regimes. Independent regulators have been established in electricity, telecommunications and airports. More recently, the government has set about improving transparency and accountability of these regulators and in clarifying relations with each other and with the Competition Authority. These efforts are welcome and should be accompanied by periodic reviews to check on performance and in what ways the regulatory authority needs to be changed to deal with evolving circumstances. More progress is required in telecommunications where competition is weak, especially in the mobile sector. A proposed new law to extend the authority of the regulator and provide greater enforcement powers is a positive development. In the electricity sector, the incumbent integrated company remains in a dominant position and has also been awarded access to scarce gas supplies, effectively limiting entry by others to the small market for the next few years. Although operational control of the grid has been passed to a new legal entity, ownership and maintenance responsibilities remain with the incumbent. Complete vertical separation would resolve the competition problem better than regulation of behaviour so long as incentives are also strong for the network operator to extend the grid, which is not the case at present. However, in a small economy such as Ireland the only way forward will be to continue to develop an all-Ireland market and perhaps to enforce divestiture of some generating capacity of the dominant company. Finally, the regulator for the sector might be overburdened with a number of non-competition objectives assigned to it including promoting energy efficiency. These responsibilities will need to be reviewed, particularly when broader measures are undertaken to deal with environmental issues. ■

What should be done to meet environmental commitments?

Despite large investments within the framework of the NDP, it is apparent that the current environmental policy mix of command-and-control regulation, direct investment and subsidies will not result in compliance with international agreements including Kyoto and EU regulations. The government has now agreed to the National Climate Change Strategy which aims to reduce the emissions of greenhouse gases by 20 per cent relative to the business-as-usual base line, with significant savings foreseen in the energy, transport and agriculture sectors. There is not yet a strategy for dealing with acid precursors, which needs to be addressed. The general policy direction is for the introduction of a greenhouse gas tax regime although further regulatory measures including voluntary agreements with emitters are also planned. Moreover, the authorities have expressed a great deal of interest in emissions trading. Ireland should actively pursue the adoption of trading at international level with no restrictions on the share of emissions that can be offset against permits bought from abroad. It could well turn out that Ireland would become a net purchaser of rights since, with its favourable demographics and growth prospects, achieving the Kyoto limits could impose a high domestic cost. Until international agreement is reached, domestic trading should be introduced for stationary sources in such areas as unused emission quotas, although the limited size of the domestic market makes an extension to carbon dioxide emissions probably impossible.

Preliminary proposals for the new greenhouse gas tax envision that companies will be able to establish agreements with the authorities about emissions, the efficiency of energy use, etc. which would then lead to an exemption from the tax. Such a system would not represent a least-cost solution but would be expensive to administer, highly complex and subject to rent-seeking activity. To be efficient, the tax will also have to be based on CO_2 equivalents but there is no word about applying the tax to peat, a high emissions energy source. Indeed, even though it reduces emissions, the decision to replace six old peat-fired generators with two new ones creates major problems for developing such a tax. Moreover, the reduction in some fuel taxes in the budget for 2001, in this sense, goes in the opposite direction. More generally, there is a tremendous scope for taxes and charges to signal environmental scarcity and to implement the polluter pays principle. Such instruments need to be applied comprehensively in areas such as waste disposal, water supply, the control of fertiliser use and transport for externalities generated. ■

For further information

More information about the *Survey* can be obtained from

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For further reading

- **OECD Economic Surveys:** Economic Surveys review the economies of Member countries and, from time to time, selected non-Members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at *www.oecd.org/bookshop*.

- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at *www.oecd.org/eco/eco/*.

- **Economic Outlook No. 69**, June 2001. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: *www.oecd.org/eco/out/Eo.htm*.

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