NOVEMBER 2009 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Ireland, 2009

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.

This Policy Brief presents the assessment and recommendations of the 2009 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.

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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. ■

How will the economy rebalance?

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 investments 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.

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. ■

What is needed to return the financial sector 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.

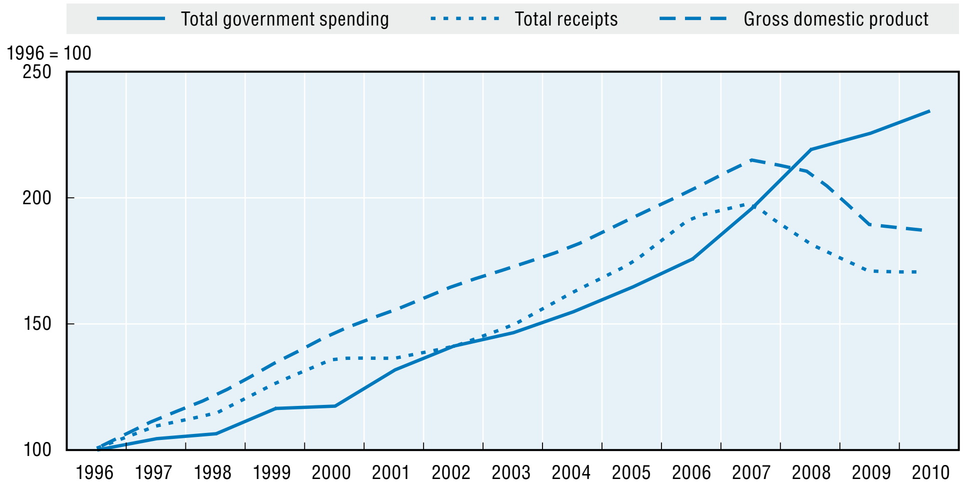
A range of policy actions has been taken to stabilise the banking system. A government guarantee has been extended to banks covering most liabilities, while deposit insurance has been made more generous and effective, although *consideration should be given to increasing the speed of pay-out further.* The provision of liquidity by the 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.

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.*

Figure 1.

REVENUE AND SPENDING HAVE BECOME MISALIGNED

In real GDP terms



Source: OECD Economic Outlook 85 Database.

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.

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. ■

How can the public finances be repaired?

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.*

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.

Figure 2.

REPLACEMENT RATES ARE HIGH FOR LOW-EARNERS[1] EXPERIENCING LONG-TERM UNEMPLOYMENT, 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*.

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.* ■

Can long-term unemployment be avoided?

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*.

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.* ■

How can sustainable long-run growth be achieved?

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.* ■

For more information

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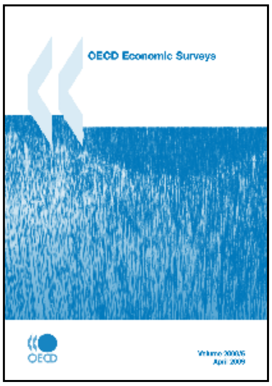

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