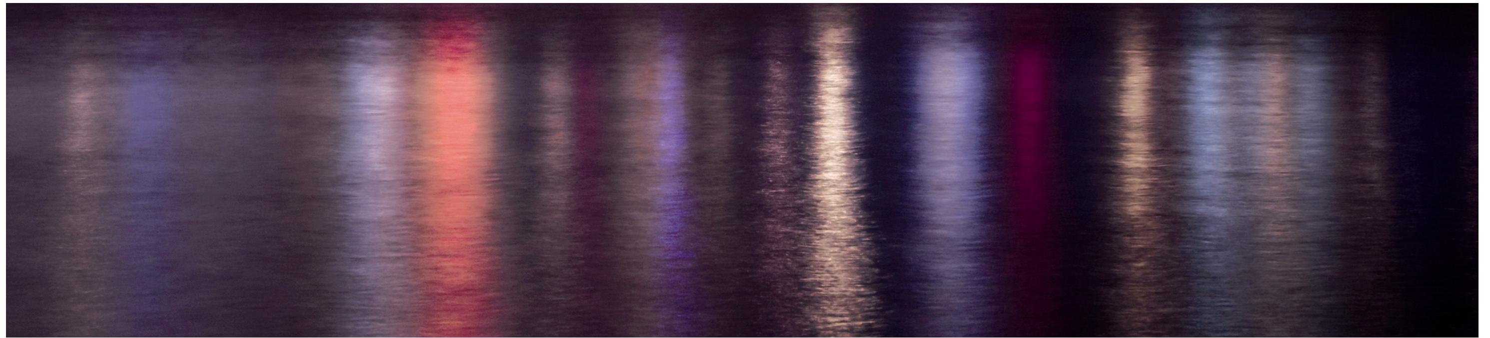
OECD Economic Surveys IRELAND

OCTOBER 2011

OVERVIEW



Summary

The Irish economy was hit by a severe crisis in 2008, after over a decade of strong growth that propelled Ireland to the fourth highest level of GDP *per capita* in the OECD. Initially growth was well founded on solid productivity increases. However, during a period of low-cost funding on international markets and low risk aversion globally, the expansion became increasingly reliant on a speculative housing bubble financed by lax bank lending standards and excessive credit expansion that collapsed in 2008 in the midst of the global economic and financial crisis. During the latter part of the boom, the acceleration of wages eroded international cost-competitiveness and the banking system became over-extended and, once the bubble burst, would have been insolvent without state support. Capital injections to help resolve the crisis have resulted in a sharply higher public debt. In the aftermath, households have been hit by wage cuts, job losses, tax increases and falling house prices, though living standards and perceptions of well-being remain high by international standards.

Since 2008, the government has carried out a very sizeable fiscal consolidation. This effort is continuing. The three-year adjustment programme with financial support from the IMF and EU is on track and has started to tackle the roots of the imbalances. Following comprehensive stress tests, the banking system has been recapitalised, but the banks still require liquidity support from the Eurosystem. Good progress is being made to cut the fiscal deficit, but more needs to be done. Against a challenging international backdrop of contagion risk and uncertainty about the policy of euro area governments on sovereign debt, financial-market sentiment towards Ireland worsened considerably but did improve somewhat during the summer. The crisis caused a sharp rise in joblessness and large numbers of young less-educated males remain unemployed. The risk is that joblessness becomes persistent, which could undermine the social consensus that is underpinning the economic and fiscal adjustment. A modest recovery is underway, driven by gains in competitiveness and increases in exports, but it comes with significant downside risks associated with market fears regarding financial stability in the euro area.

While government gross debt as a share of GDP has reached one of the highest levels in the OECD area and official financial support remains indispensable in the near term, an orderly return towards a more balanced financial position is possible, provided that tight fiscal policies and wage restraint are in place sufficiently long. To increase the chances of success, the authorities need to continue vigorously implementing the measures required to complete the unwinding of imbalances, ensure that the burden is fairly shared and capitalise on the structural strengths of the Irish economy. These include its business-friendly environment, its flexible labour markets and a skilled labour force.

This *Survey* argues that the authorities should:

Persevere on the path of fiscal consolidation:

- Continue to fully comply with the conditions and targets of the EU-IMF programme;
- Reduce the budget deficit to below 3% of GDP by 2015;
- Reduce the budget deficit faster than required by the programme to help regain credibility in financial markets if economic growth allows;
- Focus spending restraint on public-sector efficiency, welfare reform and scaling back infrastructure projects;
- Broaden the tax base by reducing tax expenditures and proceeding with the planned property taxes;
- Strengthen the fiscal framework by focusing on the debt-to-GDP target to be met by a specified date; legislating multi-year budget plans; and introducing a nominal expenditure ceiling.

Exit from the banking crisis and restore the banking system to health:

- As financial market confidence returns, restrict the bank eligible liability guarantee scheme to a narrower range of liabilities, with fees that are commensurate to risk;
- To help prevent future crises, focus supervision on a set of indicators including: a simple leverage ratio; loan-to-value ratio; loans-to-income ratio; and capital requirements linked to bank size. Also establish a credit register to prevent excessive exposures;
- To prevent the recurrence of problems with regulatory forbearance, adopt a process where the breach of identified thresholds, such as excessive growth in overall lending, would accelerate a formal assessment of what, if any, corrective action may be required.

Prevent high unemployment from becoming structural:

- Engage the employment services more actively with job seekers, and require participation in relevant training and job search in return;
- To promote return to work, relate unemployment benefits to unemployment duration;
- Review the work incentive effects of other welfare benefits, especially housing allowances;
- Better attune training programmes to labour market needs; in particular enlarge the set of trades covered by apprenticeships and temporarily close apprentice admission in construction trades;
- Extend the duration of the current cut in employers' social security contributions.

Further improve competitiveness in order to support export-led growth:

- A further decline in unit labour cost is essential to support exports;
- Enhance competition in the electricity sector by clearly separating generation, transmission, distribution and supply;
- Focus feed-in electricity tariff support on the most cost-efficient renewable sources;
- Introduce civil fines in competition law, so as to reduce incentives for anti-competitive behaviour;
- To enhance the quality of education, systematically evaluate teachers' and schools' performance.

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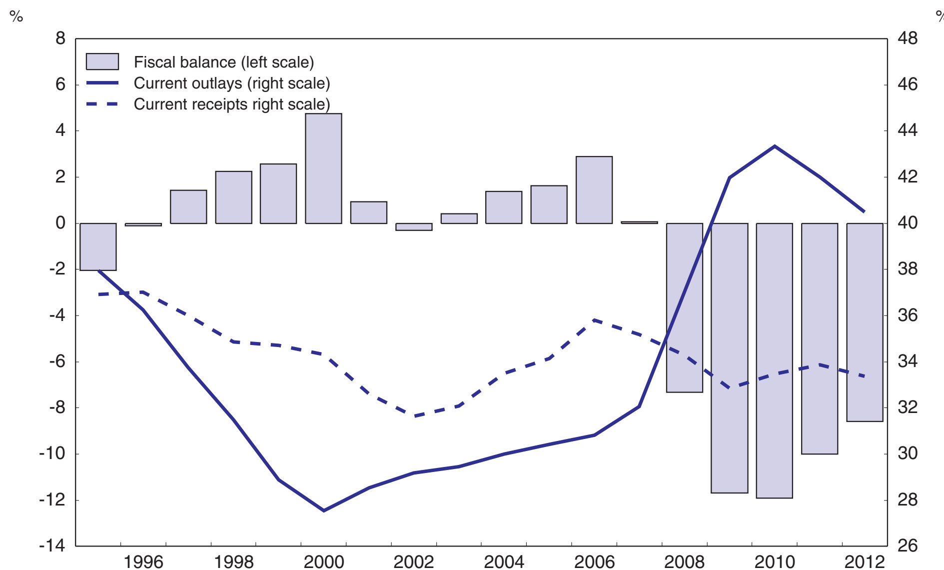
Assessment and recommendations

After more than a decade of very strong growth, Ireland succumbed to a deep recession and a banking crisis

From 1994 to 2007 the Irish economy was a stellar performer. GDP growth averaged 7% per annum pushing Irish living standards to the fourth highest in the OECD. Growth was initially well-founded and genuine progress in the Celtic Tiger years has left Ireland with one of the most structurally sound economies in the OECD. However in its later years the expansion became unbalanced and in 2008 Ireland was hit by a widespread banking crisis associated with a deep recession (Table 1). Ineffective prudential supervision in a context of low-cost funding on interbank markets and low risk aversion globally allowed an unsustainable expansion of bank credit, which fuelled a housing market bubble and propelled domestic spending. With the burst of the housing bubble, the Irish banking system suffered financial losses of historical proportions. The government decided to rescue the banking sector by guaranteeing almost all their liabilities and recapitalising the banks with public funds. Although this worked for a while, the accumulation of large banking losses put pressure on the fiscal position (Figure 1) and, in the autumn of 2010, financial markets concluded that sovereign debt sustainability had been jeopardized. Risk spreads surged and Ireland effectively lost access to sovereign bond markets (Figure 2). The government thus called on financial assistance from the IMF, EU and ECB (Troika) in support of its economic adjustment programme (Table 2). Financial pledges of EUR 85 billion (including EUR 17.5 billion of Ireland's own resources) have been made to cover the fiscal deficit, bank recapitalisation costs and debt maturities over 2011-13, thus providing breathing space for Ireland to improve its situation. The government has implemented measures in a transparent manner and the programme is on track.

Figure 1. General Government Fiscal Position[1]
As a percentage of GDP



Note: Fiscal balance excludes bank support measures of 2.5% of GDP in 2009 and 20.1% of GDP in 2010.
1. Projection for 2011 and 2012.

Source: Ireland Stability Programme Update April 2011, Ireland Budget 2011; OECD Outlook database.

Table 1. Key Macroeconomic Developments

	2007	2008	2009	2010	2011	2012	2013
	Current prices Billion EUR	Percentage changes, volume (2008 prices)					
GDP at market prices	189.9	-3.0	-7.0	-0.4	1.2	1.0	2.4
Private consumption	90.6	-1.3	-7.3	-0.9	-2.5	-0.5	0.7
Government consumption	31.7	1.2	-3.7	-3.1	-3.4	-2.0	-4.2
Gross fixed capital formation	48.5	-10.4	-28.7	-24.9	-6.3	-3.3	1.2
Final domestic demand	170.8	-3.4	-11.7	-5.8	-3.3	-1.3	-0.4
Stock building[1]	1.7	-1.1	-0.9	1.0	1.1	-0.2	0.0
Total domestic demand	172.5	-4.6	-12.8	-4.7	-1.9	-1.5	-0.3
Exports of goods and services	152.5	-1.1	-4.2	6.3	4.2	3.3	5.8
Imports goods and services	135.3	-2.9	-9.3	2.7	0.7	1.1	4.2
Net exports[1]	17.2	1.2	3.4	3.7	3.7	2.5	2.7
Memorandum items							
GDP deflator		-2.3	-4.1	-2.4	-0.2	1.4	1.0
Hamonised index of consumer prices index		3.1	-1.7	-1.6	1.3	0.9	1.2
Private consumption deflator		3.0	-4.2	-2.2	1.2	1.0	1.3
Unemployment rate		6.0	11.7	13.5	14.2	14.2	13.9
General government financial balance[2,3]		-7.3	-11.7	-11.9	-10.0	-8.6	-6.5
General government gross financial liabilities[2,4]		49.7	71.2	94.9	108.4	114.4	117.2
Current account balance[2]		-5.6	-2.9	0.5	0.5	1.7	2.1

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods (http://www.oecd.org/eco/sources-and-methods).

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. Excludes the one-off impact of recapitalisation in the banking sector of 2.5% of GDP in 2009 and 20.1% in 2010. In 2011, it is assumed that until Eurostat makes a ruling that none of the funds injected into the banks by the government are a capital transfer and therefore they have no impact on the headline deficit.
4. Maastricht Treaty Definition

Source: OECD Economic Outlook database.

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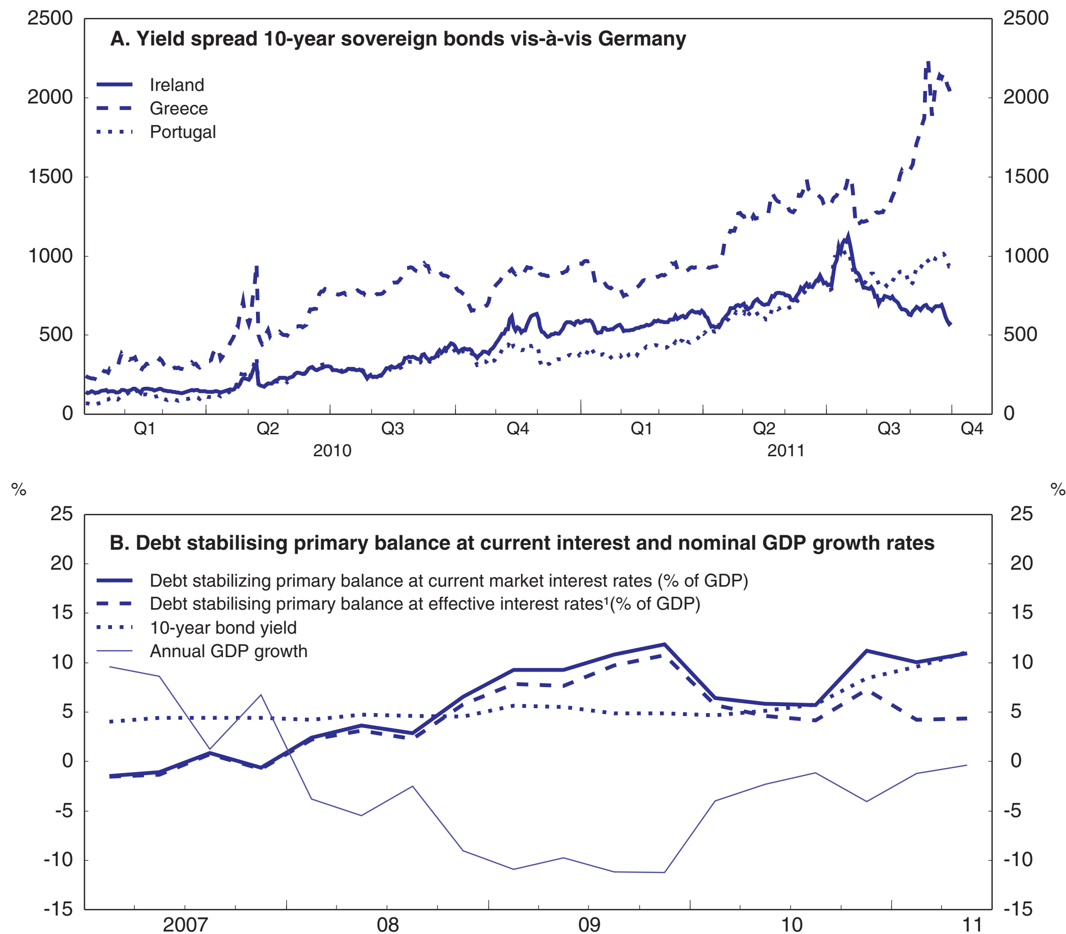
Figure 2. Ten year bond yield spreads and the debt-stabilising primary balance



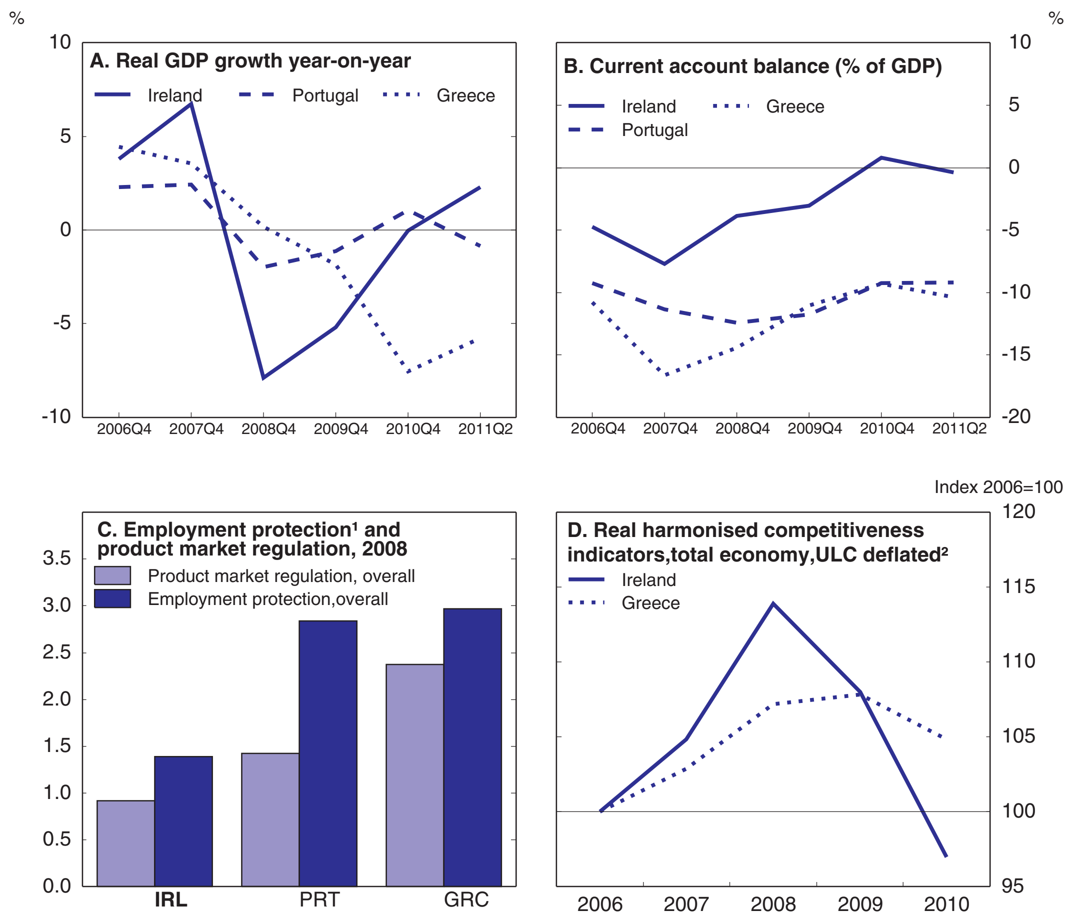
1. The effective interest rate is calculated by dividing interest payments by gross debt. This differs from the current market interest rate because funds are borrowed at varying points in time at different interest rates.

Source: Datastream; OECD Economic Outlook database and Secretariat calculations.

Long-term prospects are better than in some other crisis countries

From a long-term growth perspective, Ireland has a number of advantages relative to Greece and, to a lesser degree, Portugal: a more sophisticated and larger export sector (exports of goods and services exceed 100% of GDP in Ireland, compared with 31% in Portugal and 21% in Greece); a better qualified workforce; a friendlier environment to do business; a more efficient tax system with a lower tax wedge on labour and stable and lower corporate taxes; and more flexible and well regulated product and labour markets. Cost-competitiveness has improved more to date (Figure 3) and Ireland has continued to attract substantial flows of FDI despite the global recession. Ireland's structural strengths are reflected in relatively few structural reform conditions in its financial assistance programme, compared with Greece or Portugal.

Figure 3. Comparing Greece, Ireland and Portugal



Note: Greece has taken several measures since 2008, as described in the OECD Economic Survey of Greece 2011, which have improved the Greek indicators somewhat.

1. Strictness of employment protection, overall. Employment protection indicator for Portugal is for 2009.

2. ECB-EER: 20 group of currencies and Euro area 17 country currencies.

Source: European Central Bank (ECB) and OECD Economic Outlook database.

Despite these strengths, Ireland faces challenging fiscal prospects. These challenges would be added to by weaker-than-projected global growth. Participants in financial markets are not yet fully convinced that Ireland will be able to return to a path of fiscal sustainability, as reflected by high sovereign risk spreads, though sentiment became more favourable during the summer, aided by the decisions taken by the euro area heads of state and government on 21 July (Table 2). Gross public debt is projected to peak at around 117% of GDP in 2013 and, notwithstanding sharp fiscal consolidation, the deficit will remain large for some time. Returning to a sound fiscal position will be a long drawn-out, but achievable process.

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Table 2. EU-IMF Financial Assistance Programme

	Amount	Indicative Interest Rates
	billions of euro	Per cent
IMF[1.]	22.5	4.8
EU	45	
of which: EFSM[2.]	22.5	2.9
EFSF[3.]	17.7	3.1
Bilateral loans[4.]	4.8	
Total external support	67.5	
Ireland's own resources[5.]	17.5	NA
Total package	85	

Note: The July 21, 2011 EU summit and subsequent decisions lowered the interest rate on loans from the EFSF and EFSM to the borrowing costs of the EFSM and EFSF respectively. This lowered the interest rate charged on loans made through these facilities by around 290 basis points. The United Kingdom agreed to lower the interest rate charged on its bilateral loan to match the EFSF and EFSM rates.

1. Including hedging costs.
2. European Financial Stability Mechanism. Interest rate is indicative only and is the borrowing cost of the EFSM in its bond issues in January and March 2011.
3. European Financial Stability Fund. Interest rate is indicative only and is the average borrowing cost of the EFSF in its bond issues in January and June 2011.
4. Funds from the United Kingdom (EUR 3.8 billion), Sweden (EUR 0.6 billion) and Denmark (EUR 0.4 billion).
5. EUR 7.5 billion in cash and the remainder from the National Pension Reserve Fund.

Source: European Commission (2011), Secretariat calculations and Department of Finance, Ireland.

The adjustment programme is beginning to bear fruit and must be maintained

Progress is being made in rebalancing the economy

The adjustment programme supported by the Troika aims to revive economic growth and job creation by restoring the banking system to health, returning the public finances to a sustainable path and reversing past losses in external competitiveness. Good progress has already been made under the programme and all targets have been met, allowing the timely completion of the programme's reviews. By the end of 2011, around two-thirds of the fiscal consolidation envisaged by the government will have already been completed (Table 3). The adjustment of the housing market is well underway, households and firms are rebuilding their savings, unit labour costs are declining, competitiveness is improving and the economy is stabilizing. The recovery is expected to continue in 2012 although it will take years to reverse the sharp rise in unemployment, giving rise to concern for social cohesion that requires a change of focus for labour and social policies.

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Table 3. Consolidation targets and measures

% of GDP

	% of GDP					
	2008-2010[1]	**2011**	**2012**	**2013**	**2014**	**2015**
Headline fiscal balance target[2]	-11.9	-10.0	-8.6	-7.2	-4.7	-2.8
Consolidation measures required[3]				2.0		
Consolidation measures implemented and planned	9.3	3.8	2.2			
Expenditure	5.7	2.5	1.3			
Current	4.4	1.3	1.1			
Capital	1.4	1.1	0.2			
Revenue	3.5	0.9	0.9			
Other[4]	-	0.4	-	-	-	-

Note: Consolidation measures planned for 2012 are consistent with those contained in the Stability Programme Update 2011 and the Joint EU-IMF programme Memorandum of Understanding. The Government will set out a medium-term fiscal consolidation plan for the period 2012-2015 in the Pre-Budget Outlook in October. OECD projections for GDP are used. Totals do not always add due to rounding.

1. Measured as impact of 2008-10 measures on 2010.
2. For 2010, actual fiscal balance excluding bank support measures of 20.1% of GDP. The headline general government financial balance targets are the government's. The EU-IMF programme requires that the general government deficit not exceed 10.6% of GDP in 2011, 8.6% of GDP in 2012 and 7.5% of GDP in 2013.
3. Secretariat projection of requirement to meet headline target measured as the change in the underlying primary balance.
4. Includes asset sales, increased dividends and interest cost savings.

Source: Stability Programme Update 2011, 2011 Budget and Secretariat calculations.

The housing sector and consumers are adjusting

Encouraged by lax bank lending standards and unsustainable surges in property prices, the economy became overly reliant on housing and household consumption during 2000-06. This resulted in outsized construction sector, a rapid fall in the household savings rate and a leap in household debt (Figure 4). House prices peaked in 2007 and by July 2011, real house prices had declined by 43%, thus bringing them back to a level last seen ten years ago. Even so, price-to-rent and price-to-income ratios still appear high, suggesting a risk of further price decline.

The private sector and in particular the household sector over-extended itself during the boom and as a whole was spending more than it was earning. Since the onset of the recession there has been a sharp adjustment with declines from their peaks of 13% in real consumption and 71% in private investment. The household savings rate has increased sharply, reflecting in part the need for over-indebtedness to be reduced, which remains a problem as is apparent from high levels of non-performing loans (Figure 4).

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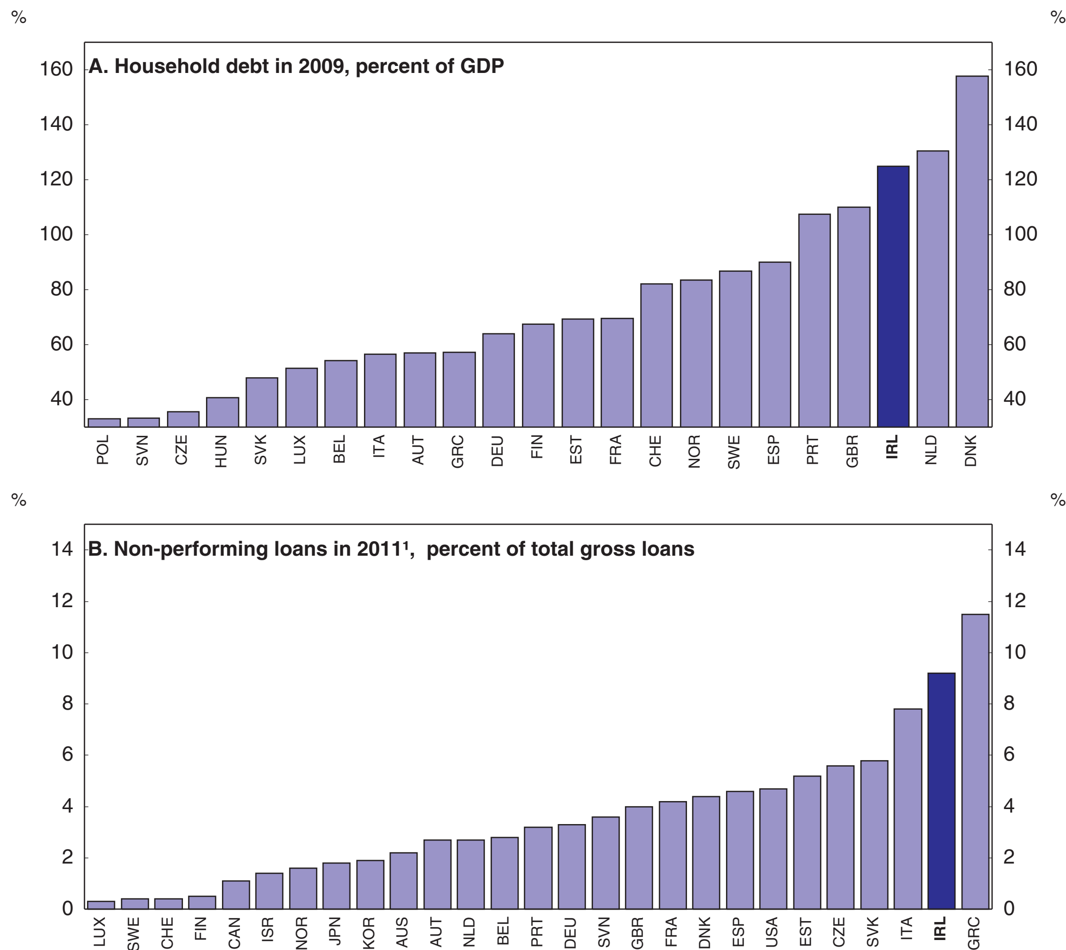
Figure 4. Household debt and non-performing loans



Note: Loans overdue more than 90 days.

1. Or latest year available. The year 2011 refers to various quarters.

Source: Eurostat and International Monetary Fund (IMF), Global Financial Stability Report Financial Soundness Indicators Tables September 2011.

The economy is returning to growth

After the painful correction of 2008-10, there are encouraging signs that the economy is stabilising. Exports have returned to robust growth, underpinned by ongoing inflows of foreign investment, which held up well during the crisis, better cost-competitiveness and growth in trading partners up to now. After an extremely sharp decline, overall investment has almost certainly undershot longer-term sustainable levels. The fading drag from the construction sector and domestic demand more generally should boost GDP growth in 2012. However, as is typical in recoveries from financial crises, the reduction of household debt, the deleveraging of bank balance sheets and prolonged fiscal consolidation will all temper growth in Ireland for some time to come (Cerra and Saxena, 2008; Reinhart and Rogoff, 2009; Furceri and Mourougane, 2009).

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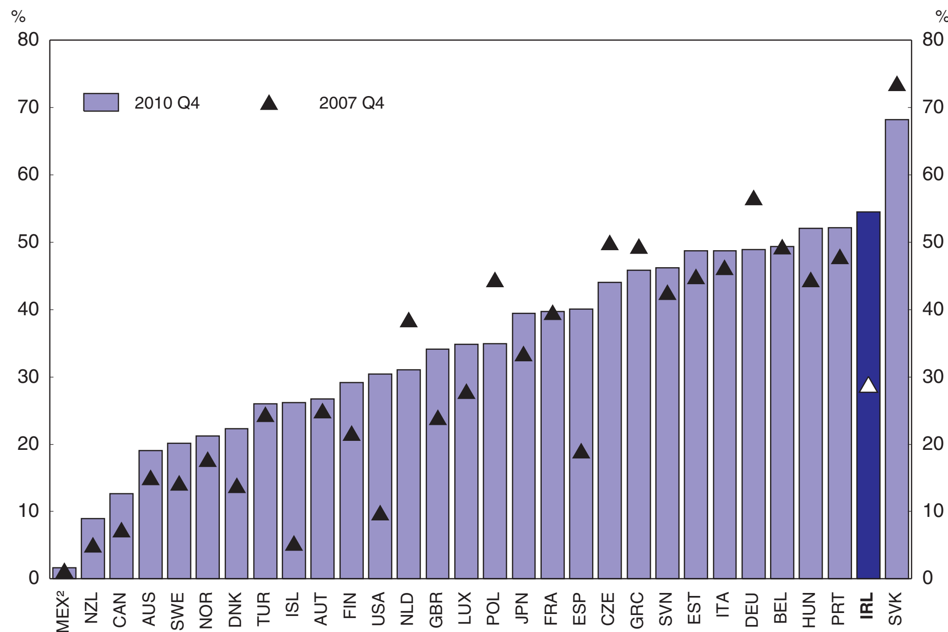
Unemployment will remain high

The unemployment rate rose from 4.6% in 2007 to 14.2% in the second quarter of 2011. In addition, labour-market participation has declined significantly, particularly among youth, and there has been a sharp increase in emigration. These developments reflect the large employment losses that occurred during the Irish recession, a pattern typical of countries having been affected by the burst of a property bubble, such as Estonia, Spain and the United States. Long-term unemployment has risen significantly (Figure 5) and, as discussed below, there are weaknesses in Ireland's activation policies. In this environment, there is a risk of structural unemployment remaining high, as the skills of job seekers are not matched by the job offers and human capital erodes (Manchin and Manning, 1998).

Figure 5. The share of long-term unemployment has risen sharply

Share of people unemployed for more than 12 months in total unemployment[1]



1. Series smoothed using a three-quarter centred moving average.
2. 2010 Q3.

Source: OECD Employment Outlook, 2010.

The difficult fiscal situation is being dealt with using tough but fair measures

The government aims to reduce the budget deficit to below 3% of GDP in 2015

During the boom years Ireland's tax base became excessively reliant on housing, increasing vulnerability to the large economic and financial shock that eventually hit. The sudden collapse of housing, a contraction of nominal GDP by 18% during 2007-10 and the huge cost of rescuing the banking system transformed what had appeared to be a sound fiscal position into an unsustainable one. The headline fiscal balance shifted from a surplus of 2.9% of GDP in 2006 to a deficit of 11.9% in 2010 (32% including one-off banking measures) and public debt rose sharply (Figure 6).

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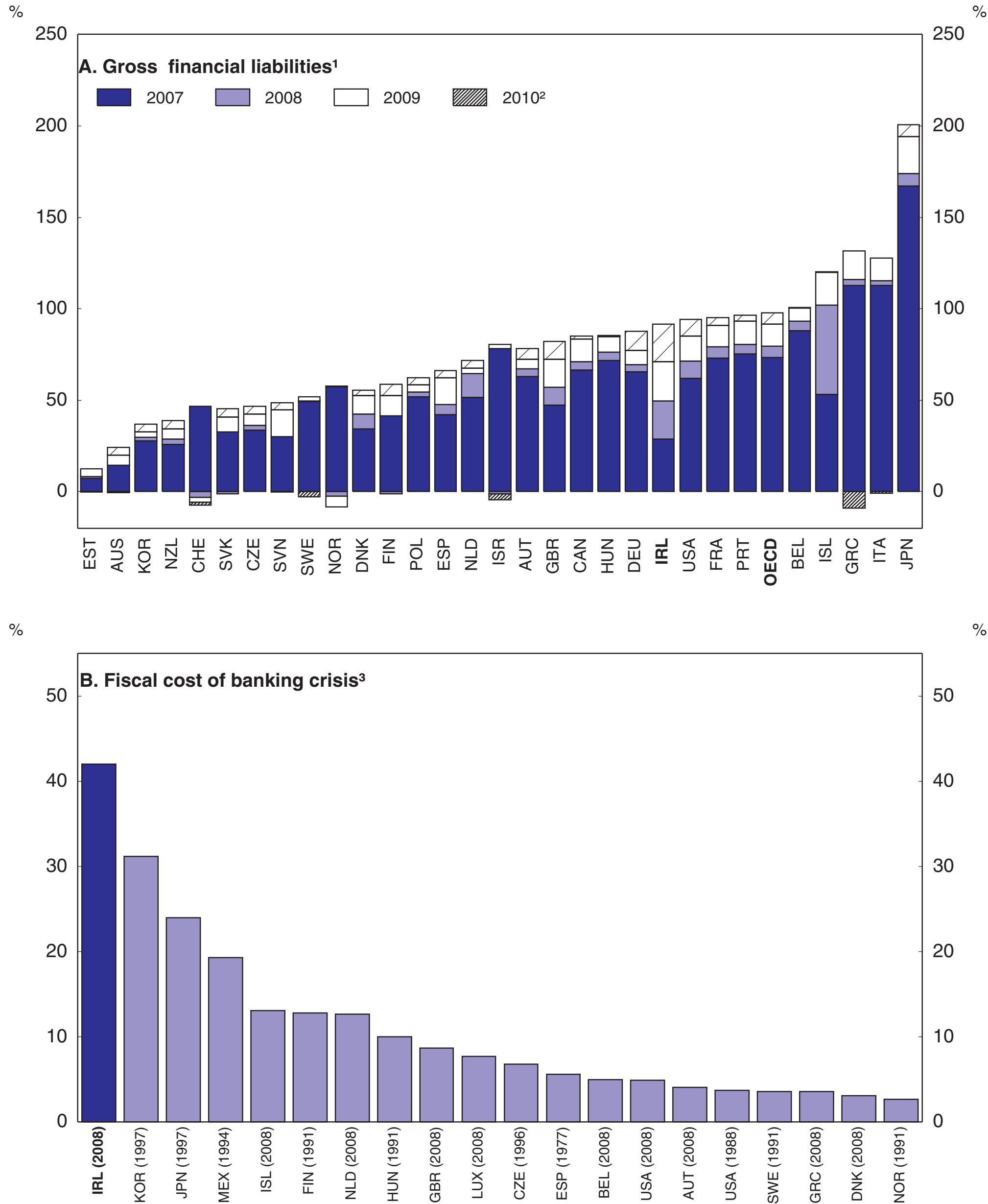
Figure 6. General government gross assets and fiscal cost of banking crisis

% of GDP



1. System of National Accounts (SNA) definition.
2. For Greece, Ireland and Portugal the 2010 change in SNA government debt has been approximated by the change in the Maastricht definition of government debt to make it independent from strong temporary fluctuations in debt levels due to revaluations.
3. Dates refer to year in which the banking crisis started. Gross fiscal costs excluding recovery proceeds computed over the first five years following the start of the crisis.

Source: European Central Bank (ECB); International Monetary Fund (IMF) and OECD Economic Outlook database.

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The principal fiscal target is to reduce the general government deficit every year to bring it below 3% of GDP in 2015. Around 9% of GDP in consolidation measures had been taken before the inception of the Troika-supported programme. A further 2.2% of GDP in discretionary fiscal measures will be implemented in 2012. To gain market confidence, slippage relative to the programme must be avoided. Indeed, providing that growth allows, the authorities should reduce the deficit faster than required by the programme. Ireland's very open economy means the fiscal multiplier is relatively small, which reduces the drag on the economy from greater consolidation.

Expenditure measures adopted by the government include cutting public sector wages, social welfare and capital spending. Although around 60% of the consolidation measures being implemented from 2008 to 2012 are on the expenditure side, consideration should be given to further tilting the balance towards cutting spending over raising revenue, as international experience shows that expenditure-based fiscal consolidations tend to be more successful (Guichard *et al.,* 2007). Keeping tight control of public sector wages and employee headcount should remain a priority as this has the triple benefit of assisting consolidation, contributing to social cohesion by spreading the adjustment burden more widely and demonstrating wage restraint to the wider economy. Infrastructure spending should be deferred, as investment during the boom means that there are now few bottlenecks. Welfare expenditure, at close to 40% of current spending, should be scaled back through tightening eligibility as well as reducing rates to keep social payment replacement rates from rising against a background of nominal wage cuts. Lowering the overall expenditure envelopes as part of the new fiscal framework would encourage greater public sector efficiency.

On the revenue side, the government has focussed its efforts on the introduction of an income levy and increases in social security and health levies in the 2011 Budget. Revenue is being further increased in 2011 and 2012 by broadening the income tax base, reducing the tax relief on pension contributions, cutting other tax expenditures, introducing an interim property (site value) tax, increasing the carbon tax and reforming capital gain taxes. These measures will not leave Ireland's overall revenue to GDP ratio high by OECD standards and in view of high government debt levels, Ireland could consider using further revenue measures, should it become apparent that cuts in spending are insufficient to balance the budget. These measures are also broadly in line with OECD advice on fiscal consolidation (OECD, 2010). In particular, revenue measures are focused on base broadening rather than raising tax rates. In addition, greater reliance is being placed on taxes that are least harmful to growth, such as taxes on residential property and green taxes, such as carbon taxes and water charges. It is important to put a priority on the structural changes that are required to ensure these are viable long-term revenue sources. For fairness and administrative reasons, water charges for domestic users and the proposed property (site value) tax need, respectively, water metering and a property valuation system that is updated on a regular basis. The decision to maintain the corporate tax rate at 12.5% is prudent as a sudden increase in tax rates would create uncertainty about Irish tax policy that could undermine investor sentiment. In addition, high corporation taxes tend to be the most harmful to growth (Arnold, 2008) and have serious negative effects on foreign investment (OECD, 2008, Djankov *et al.,* 2010). Ireland's corporate tax revenue to GDP ratio is around the OECD median. The effective corporate tax rate is close to the statutory tax rate indicating an already broad tax base. It is important that the low corporate income tax rate continues to be accompanied by a further broadening of the tax base and by a strict implementation of OECD guidelines on transfer pricing to prevent artificial profit shifting.

Adjustment should be spread fairly, so as to ensure social cohesion and political support

The recession has not fallen evenly across society and, in particular, those who lost their jobs have been amongst the hardest hit. Making sure that the costs and benefits of adjustment are spread fairly will be important for sustained public support. The government has taken measures that put a greater burden on those with a larger capacity to pay by avoiding cutting the basic pension and smaller public sector pensions. In addition, pay cuts have been proportionally greater

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for higher-paid public-sector employees and more use has been made of reducing pay rates rather than cutting employment, thereby spreading the burden more widely. The Public-Sector Agreement signed with the public service unions (the Croke Park agreement) has contributed to social cohesion by providing a collectively agreed basis for reform in the sector. Despite the recession, Ireland remains at the top of the international league of living standards, as measured by per capita GDP, and displays several above-average indicators of well-being, notably in terms of life satisfaction. However, high unemployment is likely to endure for several years which will put pressure on Ireland's traditional model of social cohesion.

There are many opportunities to improve public spending efficiency

The government has recently completed a comprehensive review of spending. This will be used to determine what spending items could be abandoned completely and how to get more out of existing spending. To increase value for money, consideration should be given to making service provision to or on behalf of government more contestable by the private sector. This can provide cost benchmarks for the public sector as well as saving money. Obtaining maximum efficiency gains from reducing public sector employee numbers will require mechanisms to ensure smooth redeployment of staff between departments and agencies. In addition, demands on government increasingly require specialised skills. Reform should facilitate the hiring of more specialists and enhance the fluid movement of employees both within and between the public and private sectors, which is especially important in a small labour market. This will require greater flexibility in contract types and a less costly redundancy regime for the public service. Changes to lift public-sector efficiency will include rationalising non-commercial state agencies through mergers and reducing staff. To improve performance monitoring performance statements for agencies and departments should have a few key output and outcome indicators that can be monitored over time against benchmarks.

The fiscal framework should be strengthened

During the previous boom, public expenditure was allowed to grow too fast and the tax base was excessively narrowed through reducing the proportion of wage and salary earners not subject to income tax and increased reliance on capital taxes, thus contributing to the large deterioration in the fiscal position when the recession struck. A stronger fiscal framework can help to prevent this occurring in the future and to tackle Ireland's high sovereign debt burden in the wake of the crisis. The government will introduce legislation for a new fiscal framework by the end of the year. This will take account of international best practice, including new developments at the EU level. In addition to the Fiscal Council that was established mid-year with participation of international experts, as recommended by previous Economic Surveys, the main elements of the overall fiscal framework will be a medium-term budget plan, a set of fiscal rules including requirements for the fiscal balance and expenditure ceilings as well as performance budgeting (Department of Finance, 2011).

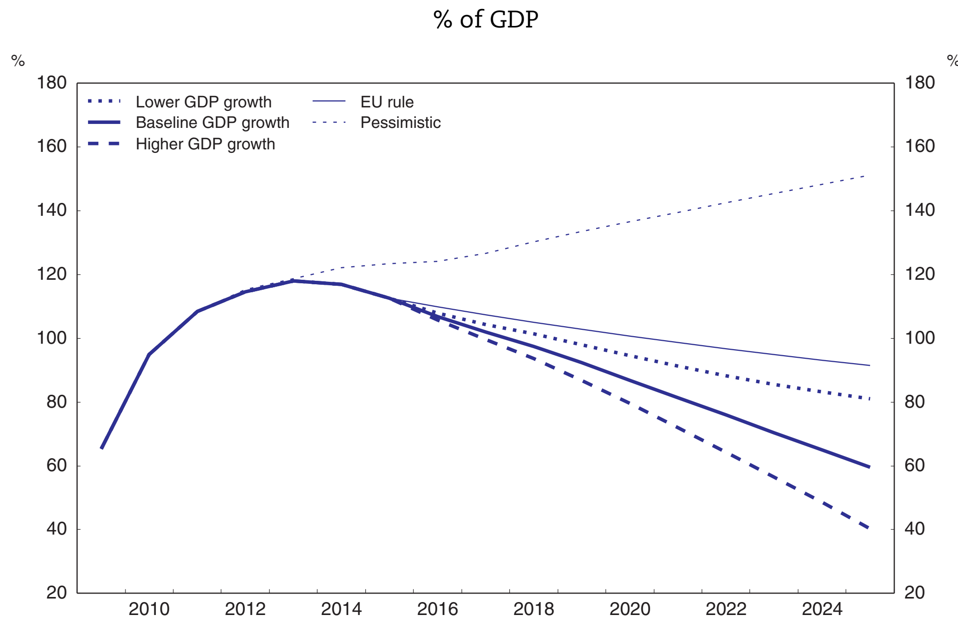
Together these framework elements can help to create a mutually-reinforcing system to help meet the government's medium-term fiscal policy goals and eventually lower borrowing costs by fostering credibility. The budget plan should be operationalised through a commitment to a fiscal rule that can be easily understood and monitored by the parliament and public. The proposed fiscal rules provide constraints for fiscal policy in 'stormy weather' (a non-cyclically-adjusted correction path), 'bad weather' (a cyclically-adjusted path) and 'good weather' (an expenditure rule). It can be argued that such a framework is overly complex as the rules are situation contingent and sometimes specified in terms (the cyclically-adjusted primary balance) that are not easily verified. The government should consider using a commitment to a nominal expenditure ceiling for each year as the main practical commitment to budget prudence for putting the budget plan into action. The Fiscal Council can help to ensure the budget plan is effective by strengthening independent analysis of the fiscal position and assessing whether the government's targets are appropriate and its proposed actions likely to achieve its goals as well as

critiquing the government's macroeconomic projections. Appointing international fiscal policy expertise to the Council is welcome. This helps to broaden the range of independent perspectives that the government would have access to in determining policy which is one of the important potential benefits to be derived from such a body.

Ireland's heavy debt burden puts a premium on reversing the debt trajectory. Therefore, the government should focus on a target debt-to-GDP ratio to be achieved by a specified date. A debt target provides a visible medium-term policy anchor, and a simple and transparent way to communicate the government's fiscal policy messages and commitments. In the longer-term, a debt target will help to deal with the upcoming pressures of ageing on public health and pension spending, which is projected to have an above-average impact on Ireland (OECD, 2011). The choice of target and speed of approach would depend on among other things, the assumptions about future growth and interest rates. The debt trajectory is sensitive to medium-term growth prospects; structural reforms to raise growth (discussed below) thus have strong potential returns as regards fiscal sustainability. For example, all else equal, an increase in average real GDP growth of around 1% compared with the baseline would cut the debt ratio to below 60% of GDP by 2023 instead of 2025 (Figure 7).

Figure 7. Gross general government liabilities[1]

% of GDP



Note: In the baseline, low and high growth scenarios the government is assumed to meet its headline deficit targets through to 2015. Nominal trend GDP growth is assumed to average 4.8% in the baseline scenario (2.8% real growth). Nominal trend GDP growth is expected to average 0.8% higher/lower in the high growth/low growth scenarios from 2016 through to 2025. In the baseline scenario the primary balance increases from 3% in 2015 to around 5% in 2020 where it remains through to 2025. In the high growth scenario real spending remains at the baseline level and all the revenue gain from higher growth is added to the primary balance, which increases to 6.2% of GDP by 2020. In the low growth scenario, real spending is held at the baseline level and all of the revenue loss from lower growth is subtracted from the underlying primary balance, which rises from 3% of GDP in 2015 to 3.7% of GDP in 2020 before declining to 2.4% of GDP by 2025.The EU rule fiscal policy scenario uses the baseline assumptions for growth and from 2016 onwards requires debt to decline each year by 1/20 of the difference between the current year debt level and 60% of GDP required by the Maastricht Treaty. The implicit interest rate on government debt averages 5.2% from 2016 to 2025 equivalent to a 125 basis point spread versus Germany). In the pessimistic scenario real growth averages 1% per annum and the headline deficit averages 7.3% from 2011 to 2025 and interest rates average 6.8% in 2016-25.

1. Maastricht Treaty definition.

Source: OECD Economic Outlook database and Secretariat calculations.

Box 1. Summary of recommendations for restoring fiscal debt sustainability

- Continue to implement the EU-IMF financial assistance programme to reduce the deficit to below 3% of GDP by 2015. Provided that growth allows, reduce the deficit faster than required by the programme so as to gain greater credibility in financial markets. Focus the consolidation effort more on reducing spending. Broaden the tax base.

- Proceed with the implementation of a new fiscal framework. As part of the framework produce a multi-year budget. Focus on a debt-to-GDP target to be achieved by a specified date to anchor the fiscal framework. Use a ceiling for nominal expenditure broadly defined in each year of the medium-term framework to help achieve the debt target.

The banking sector collapse has required a costly recapitalisation

Progress has been achieved in stabilising the banking system, reflecting efforts by the government, as shown by early signs of improved market confidence. In order to contain the crisis, the authorities initially issued an extensive guarantee of bank liabilities amounting to EUR 375 billion (240% of GDP), which was more comprehensive than the approaches adopted by many other countries (Schich, 2009). The government guaranteed bank deposits (including corporate and interbank), covered bonds, senior debt and certain subordinated debt. This broad coverage complicated loss allocation and resolution options and increased the cost for taxpayers. Crucially, as elsewhere, the guarantee was not accompanied by a resolution mechanism to deal with the situation where an initial liquidity problem turned out to be one of solvency. In the short-run, the guarantee prevented bank runs and brought some calm to markets. However, the guarantee period was initially not used to restructure banks, and the ultimate costs in terms of the deterioration of the fiscal position proved very high.

The exit strategy involves recapitalisation, deleveraging and withdrawing from guarantees

As financial market confidence returns, the guarantee scheme needs to be narrowed to a more restricted range of liabilities, but the timing and speed is a fine balancing act. An early exit when the financial system is still fragile could revive concerns about the health of the sector, but too slow an exit could increase the distortion to incentives and competition. The Eligible Liabilities Guarantee (ELG) Scheme that has prevailed following the expiry of the initial guarantee is much more targeted and restricted, and it charges higher fees. In the design for normal times, an even more restricted guarantee scheme should be implemented. It should continue to have a fee structure that takes account of risk and well defined types of liabilities to be covered, in order to minimize moral hazard and the cost to the taxpayer.

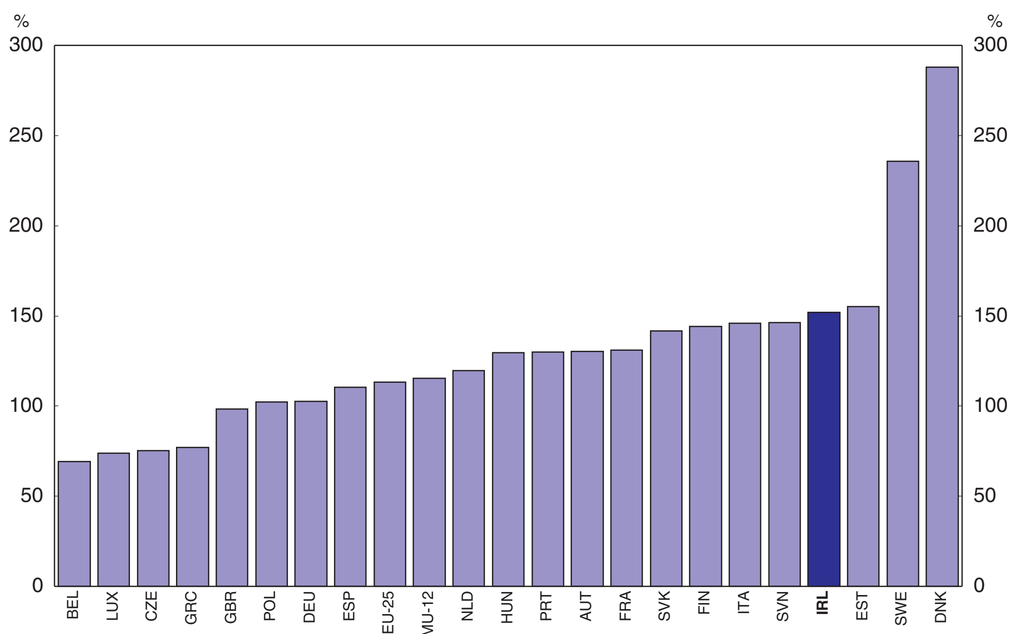
Private shareholders and subordinated bondholders suffered equity losses of EUR 60 billion and EUR 10 billion, respectively, these massive losses left the domestic banking system severely under-capitalised. In response, the government has injected public funds of around EUR 63 billion (40% of GDP) by end July 2011. The government initially had insufficient access to information about the scale of the banking losses, which made it difficult to identify the extent of restructuring and the need for capital, leading to incomplete measures that undermined market confidence in the health of the banking system.

A turning point came when the Central Bank of Ireland published its Prudential Capital Assessment Review (PCAR) and Prudential Liquidity Assessment Review (PLAR) in March 2011. These stress tests provided a transparent and stringent assessment of the capital and liquidity needs of the banks, and were based on conservative assumptions on the loan losses and strict parameters (high capital ratio thresholds, 3 year periods of stress). Their publication immediately

improved market confidence as evidenced by the sharp, though temporary drop in the sovereign spread. Following the tests, the banks have raised a total of EUR 24 billion in capital, of which EUR 16.5 billion came from the state. The subsequent 2011 stress tests conducted by the European Banking Authority (EBA) show that the participating Irish banks meet the EBA stress test requirements and do not require additional capital beyond the requirement set by PCAR. The EBA tests were designed to gauge the resilience of European banks against a set of adverse circumstances, whereas PCAR was tailored to the Irish banks` need to reduce their reliance on external funding (CBI, 2011).

The domestic Irish banking system is too large and has become over-reliant on Euro-system financing (EUR 122 billion in August 2011) due to a loss of deposits and private wholesale funding. To deal with this issue, the results of the PLAR require a reduction in the loan-to-deposit ratio to 122.5% by the end of 2013 (Figure 8). Deleveraging, which is underway, will help to bring the size of the banking system to one that is more in line with the Irish economy, reduce the amount of assets that need to be funded by wholesale funding, which is generally less stable than deposits, and decrease reliance on Euro-system financing. However, the pace of asset reduction needs to be one that avoids fire sales and allows the banks to still issue new credit, an important condition for the economic recovery, especially for the SMEs that will generate new employment growth. The government is restructuring the sector around two domestic universal core pillar banks (Bank of Ireland and Allied Irish Bank), which will return eventually to full private ownership. This is being complemented by competition from domestic and the existing foreign-owned banks and possible entry of other institutions.

Figure 8. Stocks of loans to deposits ratio, 2009



Source: European Central Bank (ECB).

NAMA should concentrate on resolving bad loans

The National Asset Management Agency (NAMA), a state bank restructuring agency established as part of the crisis resolution, acquired 11 500 property development-related loans, with a nominal value of EUR 72.3 billion (46% of GDP) at an average haircut of 58%, in return for NAMA bonds which the banks were able to use as collateral at the ECB. This was an important part of cleaning up the banking system as it forced banks to recognise their losses and transfer bad assets off their balance sheets, thereby allowing them to concentrate on new lending.

NAMA aims to manage its assets in a way that results in the best possible return for the taxpayer over a timeframe of 7-10 years. However, in response to low activity in the residential housing market, NAMA has proposed a small-scale pilot programme to stimulate interest in the purchase of residential property by providing some protection against possible additional price declines. In implementing this programme, care must be taken to avoid directly exposing the government to further house price risk. If not, this would distort the property market and expose the government to asset price risk that should rest with the house buyer. In order to prevent this, it is important that this NAMA pilot programme remains transparent and of a small size.

Financial supervision and oversight is being extensively overhauled

A wide range of governance and supervision failures contributed to the banking crisis in Ireland. Failures included a lack of adequate disclosure standards, poor loan evaluation procedures, weak risk assessment systems and too few checks and balances on management, including on remuneration schemes that encouraged risk taking. Supervision failures were in the fields of: *i)* micro-prudential policy, such as the non-intrusive style of supervision that depended on the internal risk assessments of banks, and the inadequacy of staff resources to supervise an ever growing banking system; *ii)* macro-prudential policy, such as the failure to address the rapid increase in mortgage lending by imposing additional capital requirements, caps on sectoral lending, or loan-to-value ratios; and *iii)* financial stability policy, such as the dependence on expectations of a soft landing to the housing bubble in stress tests and external and internal evaluations.

The Irish authorities have taken many measures to address these weaknesses. Financial regulation and supervision have been merged into the Central Bank again, after having been carved off to a separate financial regulator in 2003. The Central Bank will be responsible for regulation of the banking system at micro and macro-prudential levels so that attention can be paid to macro-financial linkages. The main objectives set out in the Central Bank Reform Act of 2010 are to create a new fully-integrated structure for financial regulation and the introduction of a fitness and probity regime for the financial sector. The goal of promoting of the growth of the Irish financial sector, which had hindered the financial regulator from appropriate supervision of the growth in credit during the boom years, has been dropped. As recommended in the previous OECD Economic Survey, the government is also moving to introduce a special resolution regime for banks consistent with the EU framework. This should go hand in hand with the deposit insurance scheme.

There have also been significant changes to banking supervision with a switch from the light-handed approach of the pre-crisis period to a more intrusive style. In order to effectively supervise institutions, including via more frequent onsite surveillance, the numbers and skills of the staff are being strengthened. The Financial Stability Committee, chaired by the Central Bank Governor, has been altered to include senior staff from regulatory and macroeconomic departments and meets more frequently. The Central Bank (Supervision and Enforcement) Bill was published in July 2011. This strengthens the ability of the Central Bank to impose and supervise compliance with regulatory requirements and to undertake timely interventions. The Bill also provides the Central Bank with greater access to information and analysis and will

underpin the credible enforcement of Irish financial services legislation in line with international best practice.

The financial crisis also exposed weaknesses in the regulation of equity capital under Basel I and Basel II rules, which provided an insufficient buffer against losses and meant that a costly recapitalisation had to be made by the government. In order to help prevent this from recurring, the Central Bank should adopt a set of indicators covering the many dimensions of banks' risk taking. Ireland should as soon as feasible adopt the Basel III standards. In addition, using a simple overall leverage ratio (total un-risk-weighted assets over capital) should be considered as a backstop to the capital ratio. The large role of property loans in the financial crisis also suggests that more rule-based regulation, such as caps on the ratio of loans to values (LTV) or incomes (LTI), should be considered. Capital ratios that increase with bank size would help deal with the particular difficulties posed by systemically important financial institutions and a credit register to prevent excessive exposures to certain sectors and borrowers should be considered.

Another problem highlighted by the financial crisis has been the gap between financial stability assessments and effective policy action. The vagueness of enforcement mechanisms and the unclear mandates in terms of supervision led to inaction in the face of warnings and regulatory forbearance was observed in some cases (Nyberg, 2011). The financial regulator should consider setting up thresholds for a few indicators that can be used to gauge the riskiness of a financial institution. Departures from these benchmarks can prompt a series of actions, starting from more intense supervision of the institution to imposition of higher capital requirements and asking the financial institution to scale down its business. For example, the bank-specific "Supervisory Diamond" introduced in Denmark in 2010 has identified large exposures, lending growth, funding ratio, concentration on commercial property exposures and liquidity ratios as potential risk areas to be monitored. The financial regulator in Ireland could use a similar tool. Starting a dialogue at an earlier stage can help avoid larger problems in the future. Making these thresholds transparent and giving the financial regulator power to make banks comply in the face of breaches can lead to better supervision and prevent regulatory forbearance.

The household debt resolution framework needs upgrading

The size of bad household debt is large. According to a household survey conducted by the Central Statistics Office, a quarter of all households were in arrears with at least one bill or loan on at least one occasion in 2009, compared to 10% in 2008. In the period ended March 2011, 6.3% of private residential mortgage accounts were in arrears for more than 90 days. If current non-performing loan (NPL) problems are not resolved in an efficient and fair way for both creditors and debtors it would likely discourage both the future demand and supply for credit. The relevant legal regime will thus be integral to the resolution of bad debts and restoring the Irish financial system to health. In this light, current bankruptcy laws and debt resolution procedures could be improved. The government is preparing draft legislation to reform personal insolvency with the aim of balancing moral hazard concerns against efficient and effective proceedings. The government's plans to introduce a new structured non-judicial debt settlement and enforcement system as an alternative to court proceedings is welcome. This move can potentially make a large contribution to fairly and efficiently resolving the large overhang of bad household debt. In the meantime, some emergency measures have been taken to address the urgent restructuring needs of the financial system. The CBI has published a Code of Conduct on Mortgage Arrears to prevent costly and unnecessary defaults and a similar Code of Conduct on Loans to SMEs.

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Box 2. Main recommendations for exiting the banking crisis and establishing a healthy banking system

- NAMA should remain focused on its long term mission of managing its assets to achieve the best possible return for the taxpayer and refrain from activities that increase the contingent liabilities of the government.

- As financial market confidence returns, the bank liability guarantee scheme should be narrowed to a more restricted range of liabilities, with fees that are commensurate with risk so as to minimize moral hazard and taxpayer costs.

- To help prevent future crises, adopt the standards envisaged by Basel III as soon as feasible. Also, consider using a leverage ratio (total un-risk-weighted assets over capital) as a backstop to capital ratios. In addition to the loan to deposits (LD) ratio already in place, consider using further rule-based regulation, such as caps on the ratio of loans to values (LTV) or incomes (LTI), capital requirements linked to the size of the bank to address systemic risks. Consider a credit register to prevent excessive exposures to certain sectors and borrowers. To prevent the recurrence of problems with regulatory forbearance, consideration should be given to having a well-defined process where the breach of identified benchmarks on a few indicators, such as excessive growth in overall lending, would accelerate a formal assessment of what, if any, corrective action may be required.

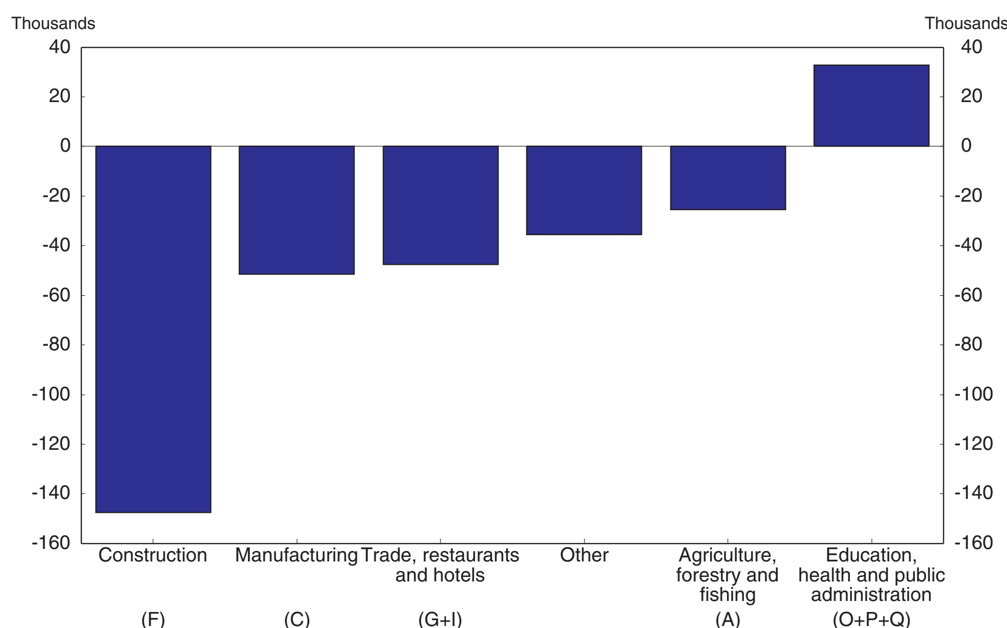
Labour and social policies need to focus on workers most severely hit by the recession

The economic recession had a severe impact on the labour market, especially on those who were employed in the construction sector (Figure 9). Ireland's unemployment rate is now among the highest in the OECD area. Though unemployment numbers have soared for all age groups and levels of educational attainment, most newly unemployed people are young workers – especially males – with low or intermediate qualifications. Those under 35 without tertiary education accounted for 42% of total unemployment (against 23% of the total labour force) at the end of 2010. The severe deterioration of the labour market could result in a persistent problem of under-employment, as Ireland experienced between the mid-1970s to the mid-1990s, and could pose a threat to social cohesion. Irish poverty rates, measured before all social transfers and relative to a 60% of median income threshold, increased the most in the EU (6 percentage points) during 2007-09. Social transfers have contained the problem, with poverty rates after transfers continuing the decline that had started earlier in the decade. However, fighting poverty through welfare benefits alone places a heavy burden on public finances and is ultimately a cause of poverty persistence, brought about by long term dependence on social transfers (Department of Social Protection, 2010).

After more than a decade of strong contributions to demographic growth, net migration turned negative, with an estimated cumulative outflow of 76 000 (around 1.7% of the total population) from April 2008 to April 2011. Arrivals to Ireland have gone back to the early nineties levels, and emigration has increased markedly, especially among Irish nationals, where it has tripled. Short-term migration can play an adjustment role in increasingly integrated European labour markets. However, close to 90% of emigrants are youths and prime-age workers, and anecdotal evidence suggests a growing share are highly-skilled people, some of whom are young graduates choosing to enter the labour market abroad. Their permanent departure would take a high toll on economic performance in areas as distinct as innovative capacity, pension systems and housing market prospects.

Figure 9. Change in employment by sector

Change 2007 to 2010



Note: letters in brackets refer to NACE Rev.2 classifications.
Source: Central Statistics Office (CSO) and Secretariat calculations.

A coherent strategy to foster return to work

The government has acted to address the challenge of unemployment, including with the Jobs Initiative launched in May 2011. Further measures, underpinned by a broad social consensus, would foster return to work and thus stave off rising social exclusion. The three pillars of such a plan should be: *i)* welfare reform, *ii)* better activation policies, and *iii)* a sustained reduction in unit labour costs. The latter, essential to further improve competitiveness, requires medium-term wage restraint, with the public sector setting the tone for the rest of the economy. Cuts in employers' social contributions for low-skilled workers can also provide a short-term boost to labour demand, and thus speed up labour market adjustment.

High replacement rates may result in inactivity traps

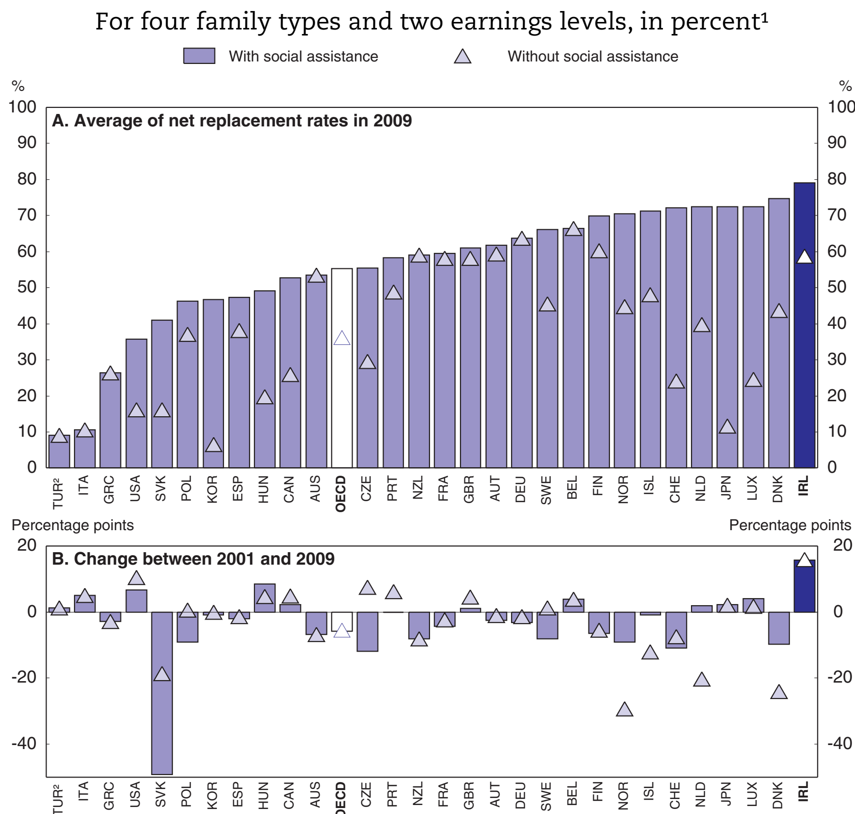
After very substantial increases up to 2009, long-term average unemployment benefit (UB) replacement rates in Ireland stand among the highest in the OECD (Figure 10). Although nominal UB levels for prime-age workers were reduced by around 4% in both 2010 and 2011, they are still marginally above 2007 levels in real terms and, account taken of declining wages and personal income tax hikes, replacement rates fell by only 1 or 2 percentage points in 2010, and probably even less in 2011. Other benefits, such as rent supplements, tend to further increase replacement rates. Though the level of income replacement upon becoming unemployed is below average, the flat-rate nature and unlimited duration of Irish unemployment benefits implies higher replacement rates at low wages and (in international comparison) as unemployment duration rises. Disincentive effects are therefore stronger for low-skilled workers and the long-term unemployed, adding to the risk of entrenching high structural unemployment. Part-time workers, who are generally eligible for unemployment benefit, often face high disincentives to move to a full-time job. Benefit cuts have not addressed one of the system's main shortcomings, notably

non-tapering replacement rates. Reducing rates with unemployment duration would mitigate hysteresis effects and lower fiscal costs (OECD, 2011).

A review of other welfare benefits is also essential to make Irish social protection more coherent, incentive-compatible and simpler to administer. Safety-net payments (basic supplementary welfare allowance) should be reformed in tandem with unemployment benefits, so as to ensure that the former never exceed the value of the latter. Another case in point is rent supplement, a means-tested benefit paid to those renting from a private landlord. Its impact on replacement rates can be substantial (see Figure 10), as gaining a full-time job (30 or more hours per week) generally implies total loss of benefit. To reduce disincentive effects, the authorities should implement plans to transfer households from rent supplement to other social housing models, such as the Rental Accommodation Scheme (RAS). Under the latter (which involves a three-way relationship between landlord, tenant, and a local authority), a full-time job does not in general determine loss of eligibility, but rather a larger household contribution towards the total cost of rent. In this context, the current RAS eligibility requirement of an 18-month period of rent supplement receipt should be reconsidered.

Figure 10. Average of net replacement rates over 60 months of unemployment, 2009

For four family types and two earnings levels, in percent[1]



Note: Ranked in ascending order of average of net replacement rates with social assistance. For Ireland, the difference between net replacement rates with and without social assistance is accounted for by housing benefit (Rent Supplement).

1. Unweighted averages, for earnings levels of 67% and 100% of Average Worker. Family types are: single person with no children, one-earner married couple with no children, lone parent with two children and one-earner married couple with two children. Any income taxes payable on unemployment benefits are determined in relation to annualised benefit values (i.e. monthly values multiplied by 12) even if the maximum benefit duration is shorter than 12 months. For married couples the percentage of AW relates to one spouse only; the second spouse is assumed to be 'inactive' with no earnings. Children are aged four and six and neither childcare benefits nor childcare costs are considered.
2. Calculations are based on Average Production Worker (ISIC D). Data refer to 2005-09.

Source: OECD, Tax-Benefit Models.

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The matching of jobs and job seekers could be improved

Effective job search assistance increases the efficiency of jobs matching and hence leads to higher outflows from joblessness. However, Irish performance in this area has suffered from both a lack of resources and weaknesses in the procedures of the Department of Social Protection (DSP), responsible for welfare benefits, and the Training and Employment Authority (FÁS), the public employment service. DSP referrals of UB claimants to FÁS for an activation interview have had too restrictive rules, in particular excluding individuals in their second or subsequent unemployment spells, and a quarter of those eligible have never been referred (McGuinness *et al.,* 2011). When referrals have taken place, interaction with jobseekers has often been limited, and penalties for insufficient cooperation with FÁS have been seldom applied (Grubb *et al.,* 2009), which helps to explain why the activation interview did not seem to increase the chances of gaining employment (McGuinness *et al.,* 2011).

Recent efficiency-enhancing steps include bringing together benefit provision and activation through the transfer of FÁS' employment and community services to DSP (giving rise to a new National Employment and Entitlements Service), the implementation by DSP of a profiling system for the unemployed, enabling a more targeted use of resources on those facing higher risks of long-term unemployment, and reinforced sanctions for refusal to engage in active labour market programmes. These reforms are welcome, and the results should be closely monitored so that further corrections can be made as needed.

Training programmes should be more aligned with labour market needs

Irish activation policy has traditionally and appropriately placed a strong emphasis on training programmes, which are essential to re-skill the unemployed into new jobs. Training courses that are closely coordinated with the labour market and provide occupational-specific training have been found generally effective. However, programmes geared at the most disadvantaged and mainly aiming at progression to further education or training often have over-qualified participants (Forfás, 2010), and thus low cost-efficiency. The response to the crisis has largely relied on scaling up and further diversifying training and work experience offers, which is appropriate given the lower payoff from job search in a recession. However, short courses, which were expanded the most, will not suffice to retrain former construction workers. Programmes should be focused on re-skilling the jobless for employment in new sectors, and provide them with specific skills which match labour market needs, or with general skills training if their background so requires.

The fact that FÁS has both run the public employment service and provided training has arguably reduced incentives for cost-efficiency and labour market responsiveness of the training portfolio. The ongoing integration of the public employment service into DSP, hence making placement separate from training, should be taken advantage of to evolve towards greater contestability in training provision, with DSP referring jobseekers – when appropriate – to the most suitable training programmes, which could be supplied by public or private providers (McGuinness *et al.,* 2011).

Opportunities such as apprenticeships and internships are particularly important for facilitating the entry of youth into employment (OECD, 2009a), and should also play a role in facilitating labour reallocation across sectors. Vocational training in Ireland largely relies on an apprenticeship system, whereby apprentices, hired by firms, follow a pre-determined sequence of on-the-job and off-the-job phases, generally lasting for four years (Kis, 2010). The system offers training in mostly traditional, male-dominated trades and has become overly reliant on the construction sector. The crisis has resulted in fewer new apprentice registrations, of which construction trades still account for a sizeable share (20% in 2010), and has given rise to a growing problem of redundant apprentices. The policy response has been guided by the overriding aim of training completion – for instance, by subsidising employers who engage redundant apprentices

to complete on-the-job phases. The authorities should stop subsidising completion for apprentices in the early phases of construction trades and temporarily close new registrations in those trades. There is a case for enlarging the set of trades covered according to labour market needs and for making programme duration more flexible, such as shortening it for less technically-demanding trades. As was the case with training schemes, post-secondary vocational education programmes, such as Post Leaving Certificate (PLC) courses, have also been expanded in response to the crisis. However, their effectiveness is hampered by the very limited amount of workplace training provided, generally as short as 3 weeks (Kis, 2010), and for these programmes workplace training periods should be extended.

Compared with other OECD countries, Irish spending on ALMPs has been heavily tilted towards direct job creation programmes. The largest one is the Community Employment (CE) scheme, which gave part-time occupation in the provision of non-market services for local communities to over 23 000 participants at end-2010 (more than 1% of the labour force). The result, after rather long participation spells (3 years on average, more for older workers), is often a return to long-term unemployment (McGuinness *et al.*, 2011). The authorities have nonetheless created new CE places during the crisis, and are rolling out a new job creation programme, the Community Work Placement Initiative (Tús). Irish job creation schemes can help boost social inclusion but are not an effective pathway to employment and should therefore be used as a last resort activation policy. Participation periods should be shortened, with possible exceptions for workers with severe impediments to employment.

Tax wedge reductions could favour employment of the low skilled

The authorities have decided to temporarily halve the 8.5% rate of employers' social security contributions (Pay Related Social Insurance, PRSI) on weekly wages up to EUR 356, a threshold only 5.5% above the national minimum wage. This should favour employment of the low skilled, and hotels and restaurants will benefit the most, thus boosting the cost competitiveness of tourism. For the full amount of weekly wages above EUR 356 a higher PRSI rate (10.75%) continues to apply. Far more broad-based than previous job subsidies (such as those under the Employer Job Incentive Scheme, which targeted new net hiring with additional eligibility requirements), this PRSI cut will involve higher deadweight losses, but will also be easier to monitor and administer. The authorities are advised not to withdraw the PRSI reduction by end-2013, as scheduled. They should smooth the discontinuity at 356 EUR, which distorts the wage distribution, and ensure that compensating budget measures are in place so as not to endanger fiscal consolidation targets.

Box 3. Recommendations for preventing a permanent increase in structural unemployment

- Decrease unemployment benefits with unemployment duration.
- Review the coherence and work incentive effects of other welfare benefits.
- Continue efforts to increase efficiency in public employment services and engage more actively with jobseekers, while enforcing tighter requirements for job search and participation in relevant ALMPs.
- To help reabsorb the unemployed into the labour market, improve the alignment of training programmes with participants' background and labour market skill needs, enlarge the set of trades covered by apprenticeship programmes, temporarily close apprentice admission in construction trades and increase workplace training in vocational education programmes.
- Reduce participation periods in job creation schemes, to be used as a last resort activation measure.
- Extend the duration of the recent cut in employers' social security contributions (PRSI) for low-wage workers.

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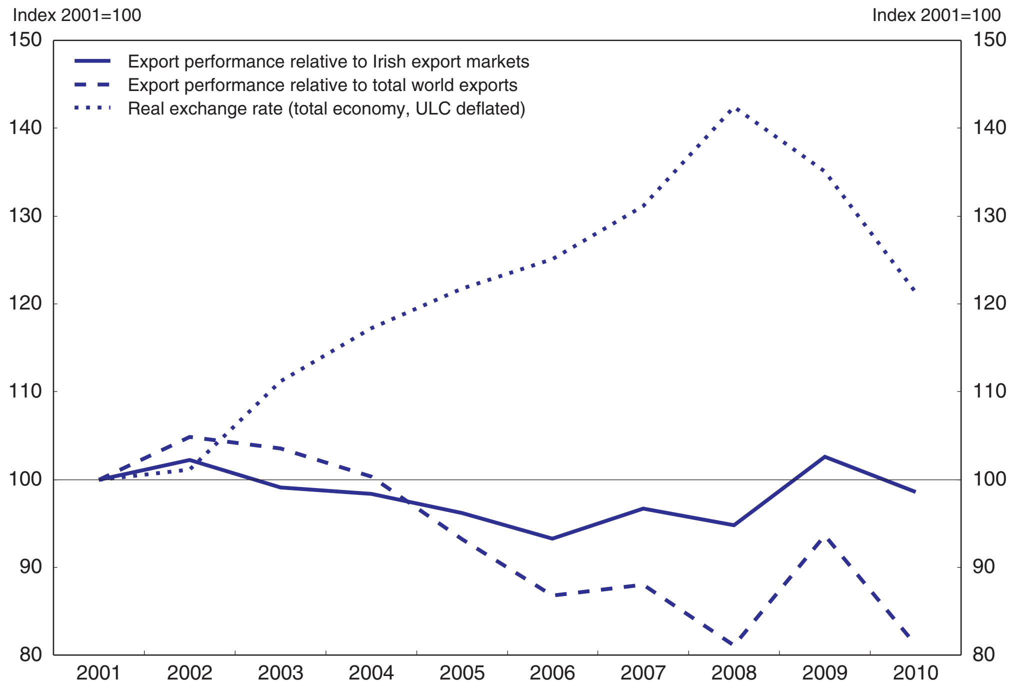
Export-led growth requires further gains in competitiveness

Productivity stalled and competitiveness deteriorated in the run-up to the crisis

After surging from the mid-nineties to the early years of the new millennium, Irish labour productivity growth decelerated markedly and fell below the OECD average during 2003-07. Part of this slowdown was compositional, stemming from structural changes, with growing employment in labour intensive activities, most prominently the construction sector. Export performance also deteriorated in the run-up to the crisis, in tandem with losses in cost competitiveness (Figure 11). Besides losing ground in its main export destinations, Ireland also suffered from a lack of significant penetration in fast-growing emerging markets.

Figure 11. Competitiveness and export performance indicators[1]



1. Export performance refers to goods and services. Irish export markets are defined with reference to an average of import volume growth in 44 economic partners, weighted according to their importance in Irish exports, and therefore attaching modest weights to emerging markets. Total world exports avoid this problem, but are defined in nominal terms, and hence are affected by price developments (e.g. of oil).

Source: European Central Bank (ECB) and OECD Economic Outlook database.

Competitiveness is improving, but further labour cost adjustment is needed

International competitiveness has improved in the past two years, and there are signs of an export-led recovery (see Figure 11). Strong performance of the chemical sector, mainly pharmaceuticals, has underpinned progress in overall export market shares, benefitting from gains in specific markets and (in 2009) from the fairly acyclical nature of the industry. More recently, food exports have also performed strongly, indicative of a broadening of the export recovery. During 2008-10, the real exchange rate (total economy unit labour costs compared to

trading partners) has depreciated by 15%, due to both productivity gains and wage restraint, and Ireland recorded the largest decrease in unit labour costs among euro area countries. Though the largest cuts in nominal wage rates have taken place in the public sector (in 2010), private firms have also trimmed average earnings per week, mainly through lower hours worked but also, in some sectors (like construction, restaurants and hotels), through a reduction in earnings per hour.

However, further gains in cost competitiveness are needed. Controlling for changes in the composition of output, which have affected aggregate productivity (O'Brien, 2011), Ireland's real exchange rate is back to 2005-06 levels, when loss of competitiveness and market shares was already well under way (see Figure 11). Further wage moderation is therefore needed, which requires support from social partners in the framework of an integrated strategy to promote a return to work. Labour costs are of particular importance to traditional, labour-intensive sectors, which have been slower to recover from the crisis and where trade tends to be more price-sensitive and more exposed to euro-sterling exchange rate developments.

Reducing non-labour costs through better regulation and enhanced competition in non-tradables

The competitiveness of tradable sectors also depends on largely non-tradable inputs. Electricity remains expensive in international comparison, and evidence suggests that the retail margin is probably too high (Devitt *et al.,* 2011). The state-owned Electricity Supply Board (ESB) owns the transmission and distribution networks, operates the latter (Eirgrid, also state-owned, operates the former), and is also a major player in generation and supply, both of which are now fully open to competition. This high degree of vertical integration should be decreased by transferring the ownership of the transmission network to Eirgrid and possibly by additional reductions of ESB's generating capacity (Review Group on State Assets and Liabilities, 2011). It is also important that the target of sourcing 40% of electricity from renewables by 2020 is achieved at least cost. A feed-in tariff scheme (REFIT), whose cost is passed on to consumers, guarantees minimum prices for electricity from onshore wind and other renewable sources, such as offshore wind, tidal or wave energy. Encouraging investment in these latter sources will risk increasing electricity costs with no net environmental gains (Fitz Gerald, 2011), as they enjoy guaranteed prices 2 to 3 times higher than those received by onshore wind generators. Furthermore, on top of guaranteed prices, REFIT also makes a fixed payment per MWh produced. REFIT should therefore be made more cost efficient by discontinuing support for offshore wind, tidal or wave electricity and suppressing fixed payments.

Enforcement of Irish competition law continues to be hampered. As in some other countries, there is an emphasis on criminal rather than civil law and the corresponding very high standard of proof implies that in practice sanctions can only be imposed in cases of flagrant cartel behaviour. To promote stronger competition, civil fines should be introduced. Further, no exemptions from competition law should be granted for collective bargaining, as has been sought by some representative bodies in medical professions. For the legal professions, setting up an independent regulator and encouraging competition should help to bring down fees, currently high by international comparison. As part of its commitments under the EU-IMF programme, the government is also exposing sheltered sectors to competition.

Domestic firms need to become more productive and export-oriented

Irish-owned firms, mostly SMEs, must lie at the heart of an integrated strategy to return to healthy growth and job creation, as they account for around 90% of private sector employment. Given macroeconomic conditions, their growth will require much greater focus on export markets, supported by further gains in cost competitiveness. Better training policies and enhanced banking sector ability to provide credit on a sound basis will also assist in increasing SME productivity. At firm level, the most productive firms are in a better position to become exporters, or even investors in foreign markets (Helpman *et al.,* 2004); in turn, exporting may also promote

productivity gains, for instance through greater investment in innovation (Siedschlag *et al.,* 2010). Hence supports to internationalisation and particularly greater SME involvement in R&D are mutually reinforcing components of a strategy for long-term growth. The former supports (in areas like consultancy expertise, trade missions or market research) are broadly in place, though there is scope for institutional streamlining among the agencies involved. As for innovation policies, more and better focused efforts to promote cooperation between industry and researchers are needed. In the long run, a high-quality and equitable education system is key to economic prosperity and social cohesion.

FDI remains of central importance

Foreign multinational corporations (MNCs) have played a central role in Irish economic growth, and it is essential that Ireland remains attractive for FDI. These firms account for over two-thirds of Irish exports and of business sector R&D, and have far higher productivity levels than their Irish-owned counterparts. FDI attractiveness is fostered by a host of factors: an open economy with flexible product and labour markets, high levels of human capital, low and stable corporate taxes, favourable geographical and cultural factors, and low regulatory burdens on business. Besides supporting domestic firms and employment, policies to further improve cost-competitiveness and increase labour productivity – in particular those focusing on labour force skills, education, R&D and more efficient product markets in non-tradables – will also help to preserve and enhance Ireland's attractiveness for FDI investors. Though input-output linkages with indigenous firms are hindered by the dominance of global supply chains, the presence of MNCs can promote valuable spillovers in the areas of human capital or R&D.

Efforts to promote R&D should be better focused at technology transfer

Despite the crisis, Ireland has managed to continue to make progress on the research and innovation front. Gross expenditure on R&D (GERD) increased from 1.3% of GDP in 2007 to 1.8% in 2009, as nominal spending kept growing at a strong pace. Progress was also substantial among companies, with business expenditure on R&D increasing from 0.8% of GDP in 2007 to the EU average of 1.2% in 2009. In the light of economic and budgetary difficulties, the target of making GERD reach 2.5% of GNP has been postponed from 2013 to the end of the decade. As envisaged by the authorities, public funding of R&D should at least be kept constant in nominal terms until 2014.

Linkages between research institutions and industry remain limited (Martin, 2009), and the overall involvement of SMEs in R&D low, despite some exceptions (such as the indigenous software sector). The authorities have been developing a range of initiatives to bring researchers and the enterprise sector into closer cooperation, often with a particular focus on SMEs, which should be expanded. Furthermore, the need remains for more concentration of resources in a smaller number of centres of excellence, informed by systematic assessment of the existing programmes and supported institutions. Fewer and larger actors in the research arena would also contribute to ease interaction with MNCs.

High-quality education helps to foster long-term growth

To preserve its strengths in human capital, Ireland needs to ensure a high quality of education. Yet serious concerns have emerged. The PISA 2009 outcomes (which measure achievement of 15-year olds) declined sharply in reading and mathematics performance (Figure 12). Irish scores now stand at average OECD levels (reading) or below (maths). At the same time, after massive increases over the past decade, Ireland caught up with the average OECD education spending levels, and then even exceeded them (by around 10% in 2007, taking PPP-adjusted cumulative expenditure per student aged 6 to 15).

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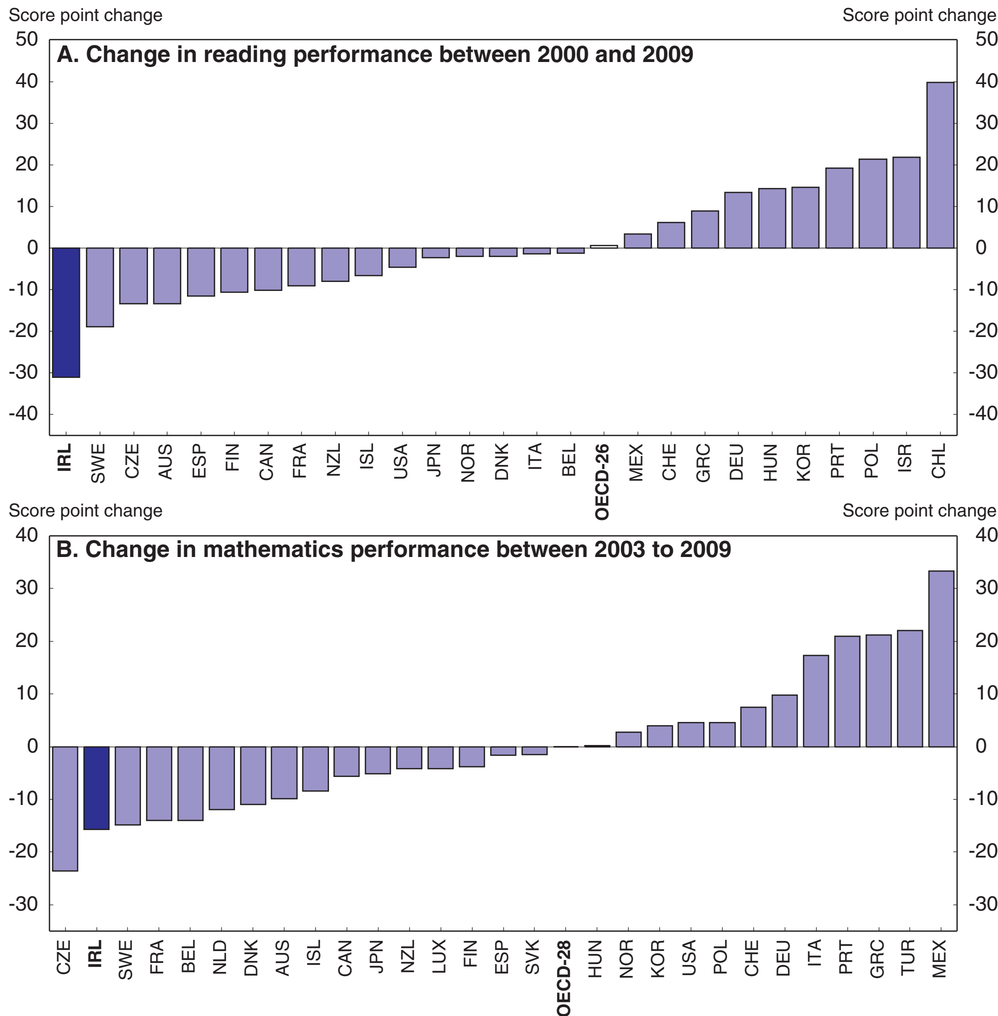
Figure 12. Changes in student performance



Note: Countries are ranked in ascending order of the score point change. Zone aggregates are unweighted averages.

Source: OECD, PISA 2009 database, Tables V.2.1 and V.3.1.

The Irish school system is characterised by limited accountability mechanisms. Results from TALIS (OECD, 2009b), a survey focussing on lower secondary education in 23 countries, show that Ireland had the 4th highest percentage of teachers not having received any appraisal or feedback in their schools (26%), and the highest share of teachers working in schools where no evaluation had been conducted over the past 5 years (39%). Inspection of the work of individual teachers falls almost exclusively on primary teachers on probation, and limited data on comparative school performance is made public. The authorities should set up mechanisms to systematically evaluate teachers' and schools' performance, and make the latter public once adjusted for socio-economic background. Evaluation results should have implications for career progression, and inform any needed corrective action in relevant areas. These include teacher training, where shortcomings have been detected at primary and secondary levels, especially in maths.

Pre-primary school attendance has both a positive impact on later educational performance and an equity-enhancing effect, reducing the persistence of educational inequality across generations (Causa and Chapuis, 2009). Ireland has long lagged other countries in this area, with a

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2009 enrolment rate for 3 and 4-year-olds of only 23%, a third of the OECD average (70%). In a welcome step, the government replaced the Early Childcare Supplement (a welfare payment) in 2010 by a free Pre-School Year, open to 3 and 4 year-olds and intended to precede the two-year infant cycle of primary schools (where children must be at least 4 at the start of the school year). However, classes last only 3 hours a day, against around 5 hours for primary school's infant cycle. The authorities should therefore reallocate budget funds to increase the duration of daily classes in the Pre-School Year.

Box 4. Summary of recommendations for further improving competitiveness

- Decrease vertical integration in electricity and reform the feed-in tariff scheme for renewables.
- Introduce civil fines in competition law.
- Increase competition in professional services.
- Devote more and better focused efforts to promote cooperation between industry and researchers.
- Systematically evaluate teachers' and schools' performance, and use the results to inform corrective action.
- Reallocate budget funds so as to increase the duration of daily classes in the Pre-School Year.

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Chapter summaries

Chapter 1. Getting back on track: restoring fiscal sustainability

Ireland's banking crisis, one of the most severe in the OECD area, and the associated economic recession have taken a heavy toll on public finances. Large public deficits have accumulated since 2008 and net public debt, which had been eliminated, has soared once again. The rapid deterioration of the fiscal accounts, together with the government guarantee of banks' liabilities, has led to Ireland losing the confidence of the sovereign bond market and requiring financial assistance from the international community. With one of the highest levels of gross public debt relative to GDP in the OECD, high bond spreads and weak nominal GDP growth, returning to a healthy fiscal position poses a significant challenge. A sustained effort will be needed to eliminate the budget deficit, regain the confidence of financial markets and to seek to increase trend growth through appropriate structural reforms. The economic adjustment programme supported by the IMF and the EU foresees a gradual consolidation of the public finances to stabilise and reduce the debt to GDP ratio and restore fiscal sustainability. The programme builds on significant progress that has already been made to contain the deterioration of fiscal accounts and the government plans to introduce further fiscal adjustment in 2012 and later years in line with the programme. The programme also foresees a strengthening of the fiscal framework, with large institutional changes intended to secure a path of fiscal sustainability in the medium-term. The consolidation effort is also underpinned by efforts to increase public sector efficiency, which provides a growth-friendly avenue for reducing the deficit in a durable way

Chapter 2. Overcoming the banking crisis

Ireland is recovering from an extremely large banking crisis born of over-exuberant property lending. The government has taken a wide range of measures to tackle the crisis over the past 3 years. Larger bad property loans have been transferred to a government controlled "bad bank", NAMA, and the associated heavy losses fully recognised by the banks. NAMA needs to focus on maximising tax payer returns from disposing of this asset portfolio. The banking system was recapitalised in mid 2011 following stringent bank "stress tests", which proved to be a crucial turning point in the crisis by helping to draw a line under losses. Restructuring of the domestic banking system around two core pillar banks is underway but the domestic banking system is still too large. Selling down the banks' large portfolio of foreign assets will help to downsize the banks. It will assist in reducing reliance on eurosystem liquidity while minimising the squeeze on domestic credit. As confidence in the financial system is regained, the authorities should further restrict the government guarantee of bank liabilities. Revamped bank regulation and supervision should utilise a wider set of indicators and rules beyond standard capital ratios and pay greater attention to macro-financial linkages.

Chapter 3. Structural reforms to reduce unemployment and restore competitiveness

After a recession of historic proportions, an export-led recovery is gaining traction in Ireland. The pace of recovery, however, varies sharply across sectors. While export-oriented manufacturing and services, led by large multinationals, have reached record-high levels of output, inward-oriented sectors, where Irish-owned SMEs predominate, are by and large still struggling to emerge from the crisis. Reflecting the weakness of this traditional sector, which is labour intensive, unemployment rates remain very high,

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particularly among young men with low or intermediate qualifications, often formerly employed in the construction sector.

To tackle high and persistent unemployment and thus stave off social exclusion, Ireland needs to further pursue an integrated three-pillar strategy: welfare reform to ensure that work pays; better activation policies to assist labour reallocation across sectors; and a sustained restraint in wages and other business costs to restore international competitiveness. In particular, often building on recent policy initiatives or commitments, this chapter recommends reforms to further enhance product-market competition, improve innovation efforts and ameliorate the quality of education, which are key to economic prosperity.

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