APRIL 2008 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Ireland, 2008

Summary

The Irish economy has performed remarkably well over the past decade, propelling per capita income to above the EU average. Though the period of rapid catch-up has ended and productivity growth has slowed in recent years, the economic fundamentals remain strong. Economic activity has been fuelled by strong domestic demand but is now easing. In the short run, wage restraint and labour market flexibility will be important to continue to attract foreign direct investment and to crowd in foreign demand to offset slowing domestic activity. In the longer run, stronger productivity growth and continued increases in participation rates will be needed to sustain a fast pace of real income growth.

The easing of activity has led to a slowdown in government revenues and a sharp drop in the fiscal surplus. At the same time, the government is committed to a large infrastructure investment programme, and there is strong demand for better public services. Over the long term, the public finances face serious pressures from the ageing of the population.

Maintaining strong growth. Productivity has faltered, partly due to the buoyancy of the lower-productivity construction sector in recent years. Better performance will hinge on boosting competition in sheltered sectors and the network industries, on improving the innovation framework and raising education standards further. Moreover, female participation, while rising quickly, could be assisted by further increasing the supply of childcare places. The design of child benefits does little to encourage women to join the workforce.

This Policy Brief presents the executive summary of the 2008 OECD Economic Survey of Ireland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, discussed this Assessment. 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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Reforming the taxation of housing. Much of the past large rise in house prices was justified by economic fundamentals and rates of home ownership are high. But the unusually favourable tax treatment increases the role of housing in the economy and adds to volatility in the housing market. There should be a gradual move towards a more neutral system of housing taxation.

Containing risks to the financial system. The risks associated with the sharp run-up in domestic indebtedness have so far been contained. Irish banks are well-capitalised and profitable, so they should have considerable shock-absorption capacity. However, turmoil in the international markets continues to impact on the Irish financial system. Transparency in financial markets worldwide needs to be improved to restore confidence. It is important to prepare for downside risks and, in conjunction with international efforts, Ireland should consider its own arrangements.

Public spending needs to slow. Fiscal performance has been strong in recent years but revenue growth has moderated as the economy, particularly the housing market, has weakened. Public expenditure is set to slow but it is important to avoid locking-in expensive commitments, particularly on public sector pay. As spending rises more slowly, improving public services will have to rely more on undertaking further reforms to public sector management and getting better value for money.

Ageing will put pressure on government spending in the long term. Ireland faces the same, although more distant, pressures from ageing as other countries. A long-term framework needs to be put in place now to ensure decent incomes in retirement and fiscal sustainability. The recent Green Paper on Pensions sets out a comprehensive range of options for reform. A future package of measures should include linking the standard retirement age to longevity and ensuring that private pension savings are adequate. The current system of tax incentives for pension saving is very generous but needs to be better targeted.

Improving the integration of immigrants. The scale of inward migration has been remarkable in recent years. Most migrants are young, well educated and work, but are often in basic jobs. Integration policy should continue to focus on language training of adults as well as children, and the recognition of professional qualifications. The uncertainties about future migration flows pose a challenge to planning public services and infrastructure investment. Flexibility needs to be built into the planning of major projects. ■

What can be done to maintain strong growth?

The Irish economy expanded rapidly in recent years, driven by domestic demand, but activity is now easing. In particular, the housing market has cooled: house prices are falling and fewer houses are being built. Despite the slowdown, growth could remain above the euro area average, although downside risks prevail in the short run. Economic fundamentals remain strong, however, with a skilled workforce, a flexible labour market, moderate taxation, a business-friendly regulatory environment and a still sound fiscal position.

Following many years of a booming economy, slowing economic activity will test the resilience of the drivers of economic growth, and the fiscal, financial and macroeconomic frameworks. At the same time, the physical infrastructure and public services need to be improved further. Ireland should also ensure that social progress is sustainable in the long term, particularly as the population ages.

Labour productivity levels are high in international comparison in the manufacturing sector but the previously rapid productivity growth has slowed. Performance is less impressive in the services sector. The buoyancy in construction and in lower-productivity services sectors has weighed on overall productivity growth in recent years. Ireland remains a favoured destination for foreign direct investment (FDI) and is successful in attracting investment in higher valued-added activities such as pharmaceuticals, biotechnology, finance and software. But the real exchange rate has appreciated and competiveness has been eroded. There has been some loss of export market share, although strong performance in financial and business services has partly mitigated these effects.

Wage and price moderation are needed to avoid a more serious weakening of export performance. Indeed, gaining competiveness would crowd in foreign demand, offsetting slowing domestic demand. Stronger competition would help to raise productivity and reduce costs.

The abolition of the Groceries Order has lowered prices and shows what can be achieved from increasing competitive pressures. Some progress has been made to increase competition in other areas but more remains to be done, especially in network industries and sheltered professions. Innovation capacity in the Irish-owned sector is weak. Spending on research and development (R&D) is relatively low, despite rapid increases, and public resources in this area should be allocated more effectively.

Growth has been boosted by rising employment of women and net inward migration. The female participation rate is rising rapidly and will increase further with additional childcare places coming through investment in the National Childcare Strategy. Another area to be addressed is increased out-of-school-hours care. More should be done to help lone parents participate in the labour market. Incentives for second earners to work full time should be sharpened further. Moreover, child support should be tied to the actual use of childcare. Effective implementation of recent plans to move to a mutual obligations approach for single parents would raise employment and reduce child poverty. ■

What is the economic impact of the housing market?

The buoyant housing market helped to sustain strong economic growth in recent years as housing investment reached almost 16% of gross national income (GNI), the highest in the OECD. But the market has turned since 2006. Much of the exceptionally large increase in house prices can be justified by Ireland's strong income growth, population expansion and the rising share of younger households. However, house prices appeared to have overshot their long-run equilibrium level and a rebalancing of demand and supply in the housing market was necessary. Some further easing in house prices is possible and there is a risk that prices could fall below their long-run level before recovering.

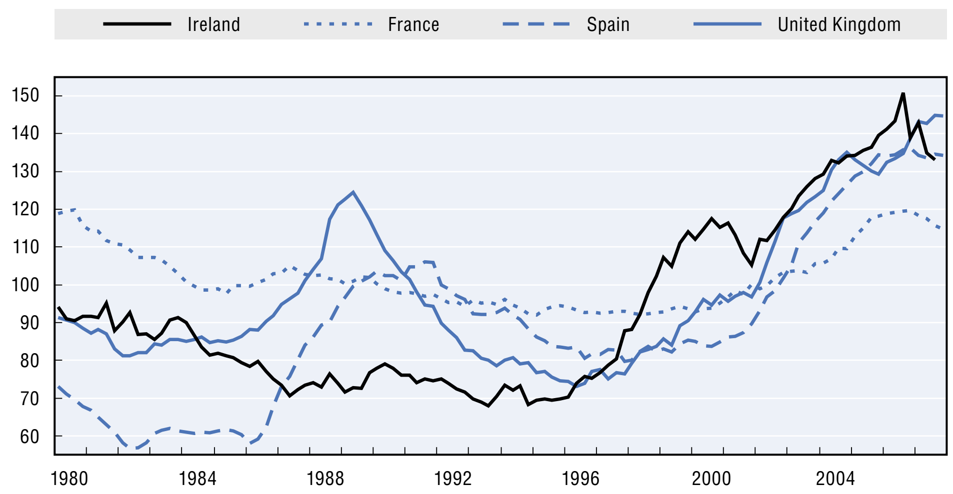
Housing investment has fallen sharply and indicators of future activity, such as building permits, are much weaker than in recent years. In line with international experience of housing construction cycles, it is anticipated that this downswing in activity could soon be over and that house-building would fairly quickly return to the rate needed to meet the growing demand for housing.

On this basis, GNI growth is projected to decline from 5% in 2007 to 3% in 2008, before recovering again in 2009, while unemployment could rise to 5½ per cent. Downside risks to growth prevail. The slowdown in the housing market could be sharper and more protracted, with greater implications for employment and the wider economy.

Figure 1.

HOUSE PRICES ROSE FASTER THAN INCOME BUT HAVE EASED

Average 1990 Q1 – 2007 Q2 = 100



Source: OECD (2005), *OECD Economic Outlook*, No. 78, updated data.

Risks of lower growth also stem from economic weakness in the United States and the United Kingdom, and the strength of the euro against the dollar. Ireland is particularly sensitive to such developments due to the direction of its trade flows and the important role played by US firms in FDI.

The Irish housing tax system is among the most favourable in the OECD. This generosity has generally contributed to the volatility of the housing market, although the recent reforms to stamp duty were well-timed to support the housing market during the current slowdown. Such instability is particularly costly as Ireland is a small member of a much larger monetary union. It can no longer use monetary policy to slow house price growth or cushion the broader effects of a sharp slowdown in the housing market. Tax breaks favouring owner-occupation also contribute to making housing expensive.

These effects should be reduced either by limiting mortgage-interest tax relief with the aim of phasing it out over time, or by introducing a property or capital gains tax. While this makes economic sense, in the Irish context where over 80% of households own their home, a profound tax reform of the housing sector is unlikely to be implemented any time soon. However, the experience of other countries shows that these reforms can be made and that a gradual approach is likely to be successful. ■

What issues are raised by international financial market turmoil?

Lending has been strong, not only for residential mortgages but also for commercial property and the construction industry. Property-related lending now accounts for more than half of the stock of bank lending. Deposit growth was much weaker than lending growth, leading to a widening funding gap, which is proportionally the largest in the European Union. This gap is mainly covered by the issuance of securities as well as by borrowing from other financial institutions.

The Central Bank and Financial Services Authority of Ireland (CBFSAI) had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. To reduce such vulnerabilities, the CBFSAI implemented a new Consumer Protection Code, which limits the scope for predatory lending practices, and introduced a forward-looking liquidity regime just before the international financial market turmoil struck. It also took regulatory action to reduce risks by increasing the risk-weighting for high loan-to-value mortgages for owner-occupiers and speculative commercial real estate lending.

The international financial market turmoil has so far raised funding costs for Irish banks to some extent, while lending standards have tightened. Both are likely to reduce banks' willingness to supply loans and bank lending has decelerated sharply, though weaker demand has clearly also played a role. The global financial market turmoil has brought new policy issues to the forefront. The liquidity squeeze is partly due to a lack of transparency internationally. The CBFSAI has moved quickly in this respect.

A survey of the major banks in Ireland shows that they have little exposure to the sub-prime market, hedge funds and the private equity sector. This publication initiative is welcome and should be made a regular feature. The Irish banks are highly profitable and well-capitalised, so they should have considerable shock-absorption capacity. But it would also seem important to be prepared to deal with downside risks. In this context, the EU Deposit Guarantee Schemes Directive is being reviewed and Ireland should consider the efficacy of its own arrangements in the light of this. ■

What are the main challenges for fiscal policy?

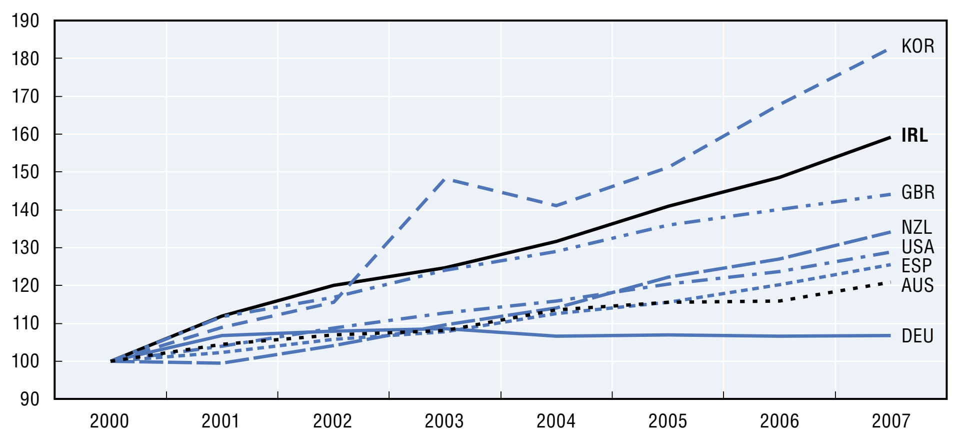
Ireland enjoyed spectacular growth in tax revenues over the past five years. This allowed real public spending to increase faster than in any other OECD country except Korea, while the government also paid down public debt and started to build a fund to pay for future pension liabilities. This left the public finances in a healthy position. Revenue growth has, however, decelerated sharply as the economy has slowed and the government surplus shrank from 3½ per cent of GNI in 2006 to ½ per cent in 2007. Over the coming years the growth in tax revenues will be lower than that seen in recent years, partly due to lower property-related receipts.

Current expenditure needs to increase more slowly than in the past. The budgeted slowdown of spending over the coming years is welcome and maintains infrastructure investment as a priority. However, the budget still plans to raise current expenditure by 7.7% in 2008 and the budget is likely

Figure 2.

REAL GOVERNMENT EXPENDITURE HAS EXPANDED RAPIDLY

Cumulative growth since 2000



Source: OECD (2007), *Economic Outlook 82 database.*

to show a deficit of close to 1% of GNI in 2008. It will be important that current spending growth slows further in subsequent years as planned. In particular, it will be crucial to avoid expensive commitments. The recent public service pay benchmarking exercise showed that public and private sector wages are broadly in line and pay restraint will be necessary in the upcoming national pay negotiation under the "*Towards 2016*" social partnership agreement.

Expectations for improvements in public services will remain high even as government spending slows. Achieving value for money will become increasingly important if higher standards of service are to be delivered. A wide range of improvements has been made to the management of public spending: a unified budget has been introduced; a multi-year framework for capital expenditure has been implemented; Value for Money reviews are being undertaken in all government departments; the Management Information Framework (MIF) has been rolled out across government; and a new Efficiency Review of public expenditure has been launched.

However, the framework needs to be consolidated: the budget constraint on spending departments needs to be tighter, in line with the more top-down approach to expenditure management introduced by the new unified budget framework, to focus efforts on delivering services more efficiently and directing resources to where they are most effective.

The multiannual budget framework for current spending should be strengthened along the lines of the models introduced in other countries, to avoid sharp changes from year-to-year and excessive spending growth at times of buoyant revenues. The focus of expenditure management should continue to shift from control of inputs to specification of outputs, and the link between analysis and decision-making should be tightened. ■

Is the pension system prepared for population ageing?

Ireland faces similar long-term fiscal sustainability pressures from ageing as other OECD countries; although its relatively young population today means that the problem is more distant, there is no room for complacency and it is important to act early so as to be able to deal with later pressures in a gradual way. It is well-placed to tackle these issues as taxation and government debt are low, some pre-funding of public pensions is being undertaken, and the sizeable investment programme will be scaled back well before ageing pressures peak. Yet, public spending on pensions is set to rise by more than 6 percentage points of gross domestic product (GDP) by 2050, more than in most other EU countries, while health and elderly care spending is also likely to rise rapidly.

It is important to develop a long-term framework now to ensure the sustainability of public finances and adequate retirement incomes. Substantial increases in the effectively flat-rate state pension have reduced pensioner poverty. The current system will become unsustainable as the population ages, even with the resources in the National Pension Reserve Fund. This will eventually require substantial changes in the overall composition of public spending, in taxation or in the pension system. The standard retirement age should be indexed to longevity and an explicit target for the value of the state pension adopted.

The current approach to up-rating public service pensions in payment should be reconsidered. Action should be taken to ensure that disability is not used as a route into effective early retirement and that those with some work capacity remain in the labour market. The recent Green Paper on Pensions has outlined options for reform. This should be used as an opportunity to implement a coherent package of measures that would put the system on the right track for the long term.

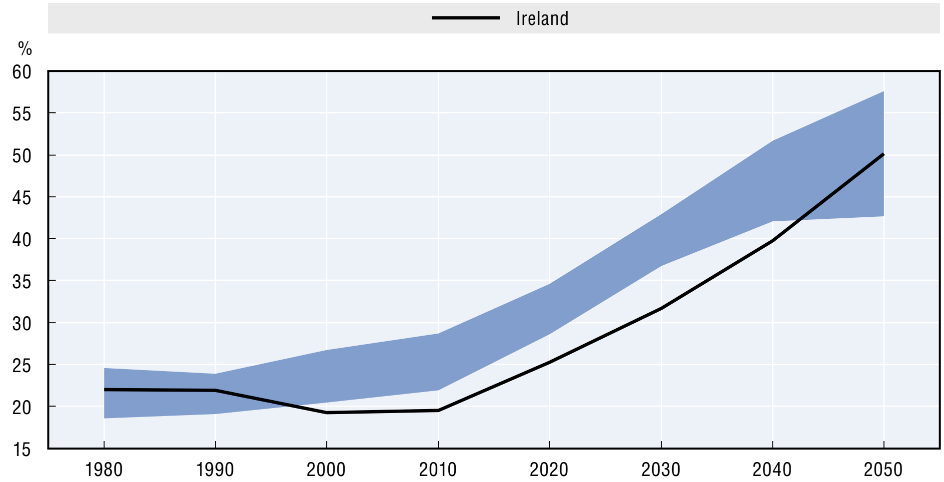
Despite increases in the pension level, there is still a large gap for most people between the state pension and an adequate replacement income in retirement. Private pension provision is therefore very important. Many people have good private coverage, particularly through employer defined-benefit (DB) schemes, but there is a substantial group without adequate private coverage.

The current tax incentives to encourage private pensions are very costly and poorly targeted. These incentives should be reduced and better targeted. A system of capped matching payments, for instance, would be more effective. Alternatively, some degree of compulsion could be considered to raise pension saving, for instance by moving from "opt in" to "opt out" private pensions. If this approach does not succeed in raising pension saving, a fully compulsory scheme may become necessary.

Figure 3.

OLD-AGE DEPENDENCY WILL EVENTUALLY MATCH OTHER OECD COUNTRIES

Population aged over 65 relative to working-age population



Note: The shaded area indicates interquartile range of OECD countries.

Source: OECD, *Demographic and Labour Force Statistics databases.*

The private pension system should be made more efficient. Improvements to the funding standard for DB company pension schemes should be considered. The current emphasis on a "wind-up" test, that requires schemes to be able to buy annuities if the scheme were to close immediately, does not adequately reflect the future funding needs of pension funds and may encourage investment in low-yielding assets. ■

What can be done to make sure immigration is a continued success?

Ireland turned from being a traditional emigration country to an immigration country in the mid-1990s. The economic boom has spurred immigration, which got another massive boost after 2004 when Ireland opened its door to the new members of the European Union. Currently, around 15% of people living in Ireland were born outside the country and this share has doubled in just ten years.

Immigration has boosted growth, alleviated labour market bottlenecks and kept Ireland attractive for multinational companies. As the majority of migrants are young and employed, they have not put major demands on public services or the welfare system. On the other hand, the rapid population growth has added to infrastructure bottlenecks and fuelled housing demand. With the free movement of people across Europe, the focus should be on better integration.

Immigrants tend to have a higher education level than the native Irish. Yet, they often work in basic jobs and their wages are considerably below average. This suggests that Ireland may not be getting the most out of its immigrant workforce. Language training for adult immigrants should be stepped up as weaker linguistic skills are probably important in explaining the wage gap and international experience suggests that language training on arrival significantly improves future employability. Language support for migrant children is also important to avoid social disadvantages being perpetuated into the future. The number of special language training teachers is rising rapidly.

Apart from language issues, job matching can be difficult, if immigrants have trouble getting their foreign qualifications recognised. Despite efforts at harmonisation at the EU level, to which the National Qualifications Authority of Ireland is contributing, certain regulated professions still have licensing requirements, which can be onerous, and the introduction of an on-the-job skill assessment programme for cases where qualifications are difficult to assess should be considered.

In recent years, inward migration was well above the rates assumed in the official population projections. If high levels of inward migration are sustained, they will add to existing pressures on the physical and social infrastructure. On the other hand, lower inward migration or even a net outflow cannot be ruled out.

Uncertainties about population growth pose a challenge for prioritising public spending and infrastructure planning: this relates to the extent and type of demand, as well as its geographic location. In this context, it will be important to extend user charges for infrastructure services. This would restrain demand, result in a more efficient use of infrastructure and help to signal where new investment is warranted. Project evaluation should include an analysis of the optimal timing of projects and choose projects that have the appropriate life span and flexibility. Planning should also seek to take other margins of adjustment into account. For instance, more electricity could be imported from other countries. ■

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Economic Outlook No. 82, December 2007.
More information about this publication can be found on the OECD's website at *www.oecd.org/eco/Economic_Outlook*.

Economic Policy Reforms: Going for Growth, 2008 edition.
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