TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

An tAcht um Thithe an Oireachtais
(Fiosrúcháin, Pribhléidí agus Nósanna Imeachta), 2013

REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
(Inquiries, Privileges and Procedures) Act, 2013

Volume 1: Report
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Dept. of Finance
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THEME: R6

Relationship with and oversight by international stakeholders

LINE OF INQUIRY: R6a

Adequacy and impact of international organisation's oversight on banking regulation and supervision activity

220. Deputy Micheál Martin asked the **Minister for Finance** if he will make a statement on the recent request from the OECD for the extension of Europe's firewall beyond the €700 billion acceptable to Germany. **[19798/12]**

Minister for Finance (Deputy Michael Noonan): On 27 March 2012 while presenting the OECD's Economic Surveys of the Euro Area and the European Union in Brussels, OECD Secretary-General Angel Gurría said the Euro Area Finance Ministers meeting, taking place that week, needed to boost the firepower of the European stability funds to at least one trillion euros. He said that a credible financial firewall would provide governments with the breathing space they needed to focus crucially on revitalising Europe's economic growth and competitiveness. In order to further improve market confidence and in accordance with the agreement reached at the Euro Area Heads of State or Government (HoSG) meeting on 9 December [171]2011 and reiterated on 2 March 2012, the HoSG have reassessed the adequacy of the overall EFSF/ESM lending ceiling of €500 billion.

The Eurogroup concluded its review of the ESM capacity on 30 March and agreed in principle the following:

That the ESM will be the main instrument to finance new programmes as from July 2012. The EFSF will, as a rule, only remain active in financing programmes that have started before that date. For a transitional period until mid-2013, it may engage in new programmes in order to ensure a full fresh lending capacity of €500 billion.

The current overall ceiling for ESM/EFSF lending, as defined in the ESM Treaty, will be raised to €700 billion such that the ESM and the EFSF will be able to operate, if needed, as described above. As of mid-2013, the maximum lending volume of ESM will be €500 billion. The combined lending ceiling of the ESM and the EFSF will continue to be set at €700 billion.

In addition €49 billion out of the EFSM and €53 billion out of the bilateral Greek loan facility have already been paid out to support current programme countries. All together the euro area is mobilising an overall firewall of approximately €800 billion, equivalent to over $1 trillion. On 2 April, OECD Secretary-General Angel Gurría welcomed the measures announced by Eurogroup Finance Ministers meeting in Copenhagen to protect the euro area economies.

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EXECUTIVE 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. [redacted]. 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 deterioration in the fiscal balance. 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 boom in the lower-productivity construction sector. 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, [redacted]. The design of child benefits does little to encourage women to join the workforce.

Reforming the taxation of housing. Much of the past boom in house prices was justified by economic fundamentals but the unusually favourable tax treatment ~~increases~~ the role of housing in the economy and adds to volatility in the housing market. The move towards a more neutral system of housing taxation should begin as soon as the housing market [redacted].

Financial stability risks remain. Financial stability risks, which have arisen from the sharp run-up in indebtedness and turmoil in international markets, have so far been contained and Irish banks are well-capitalised. However, risks remain. Transparency in financial markets needs to be improved to restore confidence, while some features of the ~~deposit insurance scheme should be reconsidered~~ and a special, swift procedure for closing failing banks should be [redacted].

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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 overdue 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. This package 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. Immigration has soared in recent years. Most migrants are young, well educated and work, but often work in basic jobs. Better integration should focus on language training of adults as well as ~~children, and the better~~ recognition of professional qualifications.

[redacted]

[redacted]

[redacted]

Is this not true for all societies

Efficiency Review

The uncertainties about future migration flows pose a challenge to planning public services and infrastructure investment, which needs to be taken into account in the planning of major [redacted].

[redacted]

ASSESSMENT AND RECOMMENDATIONS

Growth has slowed, testing the resilience of the economy

1. 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, slower economic growth will test the resilience of the drivers of economic growth, the fiscal and macroeconomic framework, and financial stability. 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.

Raising productivity growth is the key long-term challenge

2. 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 boom in construction and strong growth of lower-productivity services sectors have 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 and public resources should be allocated more effectively.*

Improving

Banking

Greater female participation would boost labour supply

3. Growth has been boosted by rising employment of women and net inward migration. The female participation rate is rising rapidly but has been held back by a lack of childcare [redacted]. *The National Childcare Strategy is helping to address this but progress remains slow for out-of-school-hours care. The bias in the tax-benefit system against mothers at work should be removed and incentives for second earners to work full time be sharpened. Moreover, child support should be tied to the actual use of childcare.* Recent plans to move to a mutual obligations approach for single parents are welcome. Implementing them would raise employment and reduce child poverty.

[redacted]

The housing market cycle has turned

4. The housing boom 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 [redacted] is now over. 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. Further falls in house prices are likely 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 will be short-lived and that house-building will 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. 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.

Where's the evidence

5. 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 and keeping the private rental market small. *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* [redacted] *or capital gains tax.* While this makes economic sense, in the Irish context where over 80% of the population owns the 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.

Financial stability risks have been contained but remain

6. The housing boom was accompanied by a lending boom, not only for housing, 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. This gap is covered by the issuance of securities and by borrowing from other financial institutions and is proportionally the largest in the European Union. The Financial Regulator had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. To reduce vulnerabilities, it implemented a new Consumer Protection Code, which limits the scope for predatory lending practices, and introduced a forward-looking liquidity regime just before the financial market

global

boom → activity

Not clear

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.

7. The international financial market turmoil has so far raised funding costs 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 financial market turmoil has brought new policy issues to the forefront. The liquidity squeeze is partly due to a lack of transparency. *The Financial Regulator has moved quickly in this respect. A survey of the major banks shows that they have little exposure to the sub-prime market, hedge funds and the private equity sector. This initiative is welcome and should become a regular feature.* Prior to the weakening in the property market and the recent financial market turmoil, the Irish banks were highly profitable and well-capitalised, which will help to absorb the shock. *But it would also seem important to be prepared for the worst. In this context, pay-outs from the bank deposit insurance scheme should be available more rapidly and the scheme better funded to reduce liquidity concerns in case a bank comes under pressure. Enacting an insolvency process specifically adapted to banks should also be* [redacted] In Europe, bank failures are covered by general bankruptcy procedures, which can drag on for years. In the United States, a separate regime ensures a quick legal closure so that losses are usually confined to shareholders, while the bank is kept open physically, either by bringing in another bank or by operating a bridge bank. This has helped avoid bank runs, while minimising the pay-out from the deposit insurance scheme.

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Public expenditure growth needs to slow and efficiency must be increased

8. 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 largely due to lower property-related receipts. Expenditure needs to increase more slowly than in the past. The budgeted slowdown of spending over the coming years is welcome and maintains infrastructure as a priority. However, the budget still plans to raise current expenditure by 7½ per cent in 2008 and the budget is likely to show a deficit of close to 1% of GNI in 2008. *It will be important that spending growth slows further in subsequent years as planned. In particular, it will be crucial to avoid expensive commitments. This includes restraint in setting public sector wages following the recent public service pay benchmarking exercise.*

9. 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, some gaps remain in the framework: the budget constraint on spending departments needs to be tighter to focus efforts on delivering services more efficiently and directing resources to where they are most* [redacted]. *More complete budgetary information should be provided, for instance concerning off-balance sheet liabilities.* – Removed because this report will be published before the Review of the Public Service

It suggests to shift the focus ~~of expenditure~~ management from further control of inputs to specification of outputs, ~~and to~~ tighten ~~the link~~ between analysis and decision-making.

[redacted]

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Deleted: and their greater importance than in the past as a share of overall revenues poses new risks for both the short and long term

[redacted]

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The pension system should be put on the right track

10. 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. 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 set out a long-term plan 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. But combined [redacted], 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 up-rating of public sector pensions in payment in line with earnings 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. Following up on it is an opportunity to adopt a coherent package of measures that would put the system on the right track for the long term.

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[redacted]

11. 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. Should pension reform not succeed in raising pension saving, a compulsory scheme may become necessary. The private pension system should also be made more efficient. In particular, the requirement to purchase annuities under some private pension arrangements should be relaxed so that pensioners have greater choice and do not have to rely so heavily on Ireland's small annuity market. Furthermore, 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.

Migration has helped the economy grow rapidly but more should be done to integrate migrants

12. 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. [redacted] Immigration has

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, there is little the government can do to control migration. The focus should thus be on better integration.

[redacted]

13. 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 is not getting the most out of its immigrant workforce. *Language training for adult immigrants should be stepped up as weaker literacy 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, but more should be done to train existing [redacted]. *Apart from language issues, job matching can be difficult, if immigrants have trouble getting* [redacted] *their foreign qualifications recognised. Despite efforts at harmonisation at the EU level, to which the Irish National Qualification Authority 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.*

The infrastructure programme needs to cope with large uncertainties about future migration flows

14. 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 drop cannot be ruled out. International experience suggests that inward migration on the scale seen in Ireland in recent years is seldom sustained for a prolonged [redacted]. Uncertainties about population growth pose a challenge [redacted] for infrastructure planning: uncertainty relates to the extent and type of demand as well its geographic location. *In this context, it will be important to extend the use of 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 or reversibility. Planning should also seek to take other margins of adjustment into account.* For instance, more university students could study abroad, some countries have started to send patients for treatment abroad and more electricity could be imported from [redacted] other [redacted].

CHAPTER 1. KEY CHALLENGES

15. Ireland has maintained a very strong economic performance in recent years (Figure 1.1). Growth in income per capita has been among the highest in the OECD, unemployment is low and the country remains an attractive place to do business. It is receiving more than its fair share of foreign investment in high value added sectors and, by opening its borders and having a flexible labour market; it has been a magnet for an astonishingly large number of migrants from Eastern Europe.

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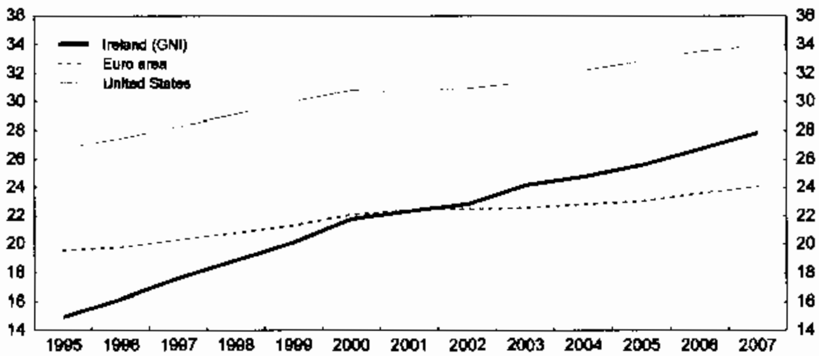
Figure 1.1. **Real GDP per capita**
Thousand euros, at 2000 purchasing power parities



Source: OECD (2007), *Economic Outlook 82 database*; IMF(2007), *World Economic Outlook*, October.

16. The economy is beginning to adjust to the end of the long housing expansion that saw construction and house prices overshoot their equilibrium levels. Residential investment has declined and a substantial number of construction workers needs to find jobs elsewhere. Dealing with the short-term adjustment will require labour market flexibility, wage restraint and a prudent fiscal policy.

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17. Over the longer term, the government has ambitious objectives for economic growth and social progress over the next five years, as set out in the 2007 Agreed Programme for Government, and beyond ([redacted], 2007). Sustaining economic growth requires efforts to boost productivity and labour market participation. Further action is needed to remove bottlenecks of physical and human capital as well as to strengthen competition to ensure that Ireland does not price itself out of the global market. In a number of areas, there is the opportunity to set policies on the right path to limit instability and ensure long-term sustainability. This includes housing policy, financial stability issues, fiscal policy, pension reform and the integration of immigrants. This chapter provides an overview of these challenges.

[redacted]

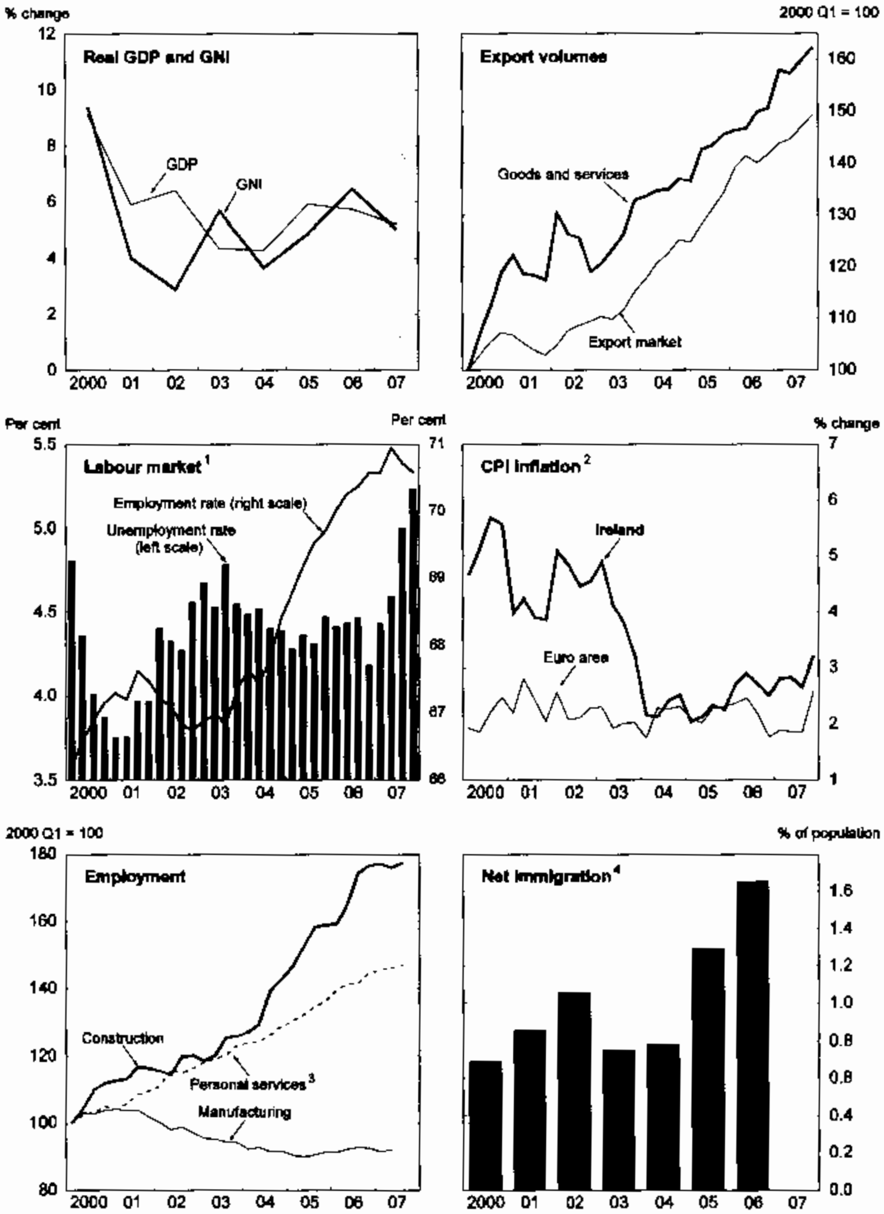
Short-term economic adjustment

The economy is slowing sharply as house-building falls

18. Growth picked up and the economy grew strongly in recent years (Figure 1.2). Activity was largely driven by domestic demand rather than by exports as in the Celtic Tiger era of the late 1990s.

Demand was supported by strong consumption, large increases in government spending and a buoyant housing market.

Figure 1.2. **The 2000s so far**



1. Unemployment in per cent of labour force, employment in per cent of working-age population.
2. Harmonised consumer price index, per cent growth over the same quarter of previous year.
3. Public administration and defence, education, health and other services.
4. Estimates from the Central Statistics Office.

Source: OECD (2007), *Economic Outlook 82 database* and Central Statistics Office.

19. The rapid increase in output during recent years was facilitated by rising employment due to higher rates of labour force participation and strong inward migration, particularly from the new member states of the European Union. Despite these favourable improvements in supply capacity, the booming housing market and strong domestic demand led to inflation that was above the euro area as a whole in 2006 and [redacted]: the annual rate of inflation on the harmonised measure, which excludes mortgage interest payments, was almost a percentage point higher in 2007 and the national consumer price index (CPI) measure of inflation peaked at above 5% as rising interest payments added to domestic cost pressures. Despite this, the impact on relative unit labour costs of manufactured goods and Ireland's share of world trade has been relatively modest so far.

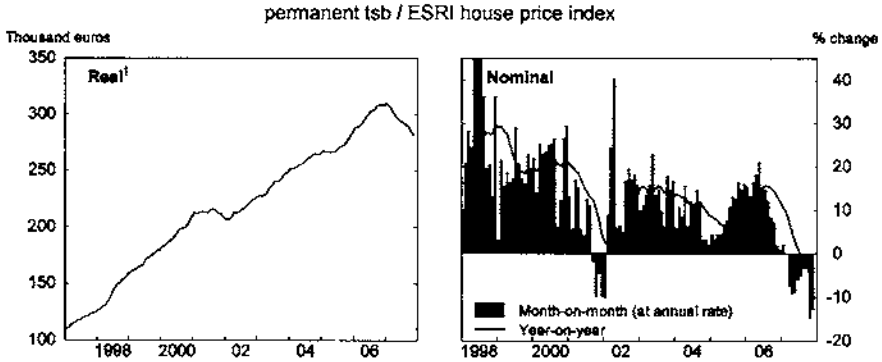
20. The strong activity in the housing market that sustained strong economic growth is over (Chapter 2). House prices are falling (Figure 1.3), housing market activity has dropped and loan approvals are down by one fifth on a year ago. In the short run, higher interest rates did much to cool demand but this slowdown was needed to bring down house price inflation and housing activity to more sustainable [redacted]. It remains likely that the housing market as a whole will not make a hard landing but there is a risk of a larger and more sustained [redacted]

21. The pace of economic growth slowed in the second half of 2007 and is likely to remain well below potential in 2008 (Table 1.1). Residential investment, which accounted for more than a seventh of gross national income (GNI) in 2006, is falling very sharply. This will continue to have a substantial impact on the growth of output and employment in the coming year. Unemployment is forecast to reach around 5½ per cent. Although growth will be low by Irish standards, it will still be stronger than in many other OECD countries. With the decline in housing projected to bottom out during 2008, growth could strengthen again in 2009.

22. There is a risk that the fall in housing construction will be greater or more sustained than anticipated. Larger falls in house prices or tighter credit conditions could also slow growth. There is a further downside risk to activity from economic weakness in the United States and the United Kingdom, and the strength of the euro against the dollar and the pound. Ireland is particularly sensitive to these factors due to the direction of its trade flows and the very important role played by foreign investment by US firms.

Figure 1.3. **House prices have begun to fall**

permanent tsb / ESRI house price index



1. In 2006 prices, deflated using the harmonised consumer price index.

Source: permanent tsb, *www.permanenttsb.ie/house-price-index/*.

[redacted]

Table 1.1. **Short-term outlook**[1]
Percentage change

	Outcomes				Projections	
	2004	2005	2006	2007[2]	2008	2009
Real gross domestic product (GDP)	**4.3**	**5.9**	**5.7**	**5.2**	**2.9**	**4.2**
Private consumption	4.0	7.4	5.3	6.4	4.7	3.8
Government consumption	2.3	4.1	6.4	6.3	5.2	4.5
Gross fixed investment	6.9	12.0	3.0	3.5	-1.8	4.2
Total domestic demand	3.8	7.9	5.7	3.4	2.7	4.1
Net exports[3]	0.4	-0.9	0.6	2.2	0.8	0.6
Real gross national income (GNI)	3.7	4.9	6.4	5.0	3.0	4.6
Memorandum items						
Inflation: harmonised CPI	2.3	2.2	2.7	2.8	2.5	2.0
Inflation: harmonised underlying[4]	2.1	1.8	2.5	2.3	2.1	2.0
Employment	3.0	4.7	4.4	3.3	1.5	2.3
Unemployment rate (% of labour force)	4.4	4.4	4.4	4.8	5.6	5.4
Current account balance (% of GNI)	-0.7	-4.2	-5.0	-5.0	-3.8	-3.6
Government net lending (% of GNI)	1.6	1.4	3.4	0.6	-1.2	-1.3

1. Projections are those published in *Economic Outlook* No. 82. Government net lending projections were updated to include later information on the fiscal position.
2. Estimate.
3. Contribution to GDP growth.
4. Excluding energy, food, alcohol and tobacco.

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

Sustaining robust long-term growth

23. Long-term growth potential remains high relative to the OECD average. Although gross domestic product (GDP) growth is well below the rates of the Celtic tiger era of the second half of the 1990s, it has nevertheless averaged over 5% per year since 2001 (Table 1.2). In recent years, activity was fuelled by a substantial rise in the working-age population, reflecting both domestic demographic factors and inward migration, while labour productivity growth has slowed.

24. It is, however, difficult to disentangle the underlying productivity trend from special factors such as the contribution from the "modern" sector and structural shifts in activity. For instance, between 2000 and 2006, the shift in employment away from high-tech manufacturing and towards the relatively low-productivity construction and non-market service sectors has reduced measured productivity growth by nearly 1 percentage point per annum. Some of this will unwind as employment in the building industry falls.

Table 1.2. **Decomposition of GDP growth**
Average annual growth rates, per cent

	1989-95	1995-2001	2001-07
GDP	5.3	9.1	5.3
Total hours worked	1.3	3.6	2.4
Of which:			
Working-age population	1.3	1.9	2.4
Employment rate	1.1	3.3	0.8
Average hours	-1.1	-1.5	-0.7
Labour productivity	3.9	5.3	2.9
Of which:			
Capital intensity[1]	0.0	1.5	0.9
Multi-factor productivity	3.9	3.8	2.0

1. Capital intensity defined residually as labour productivity less multi-factor productivity growth.

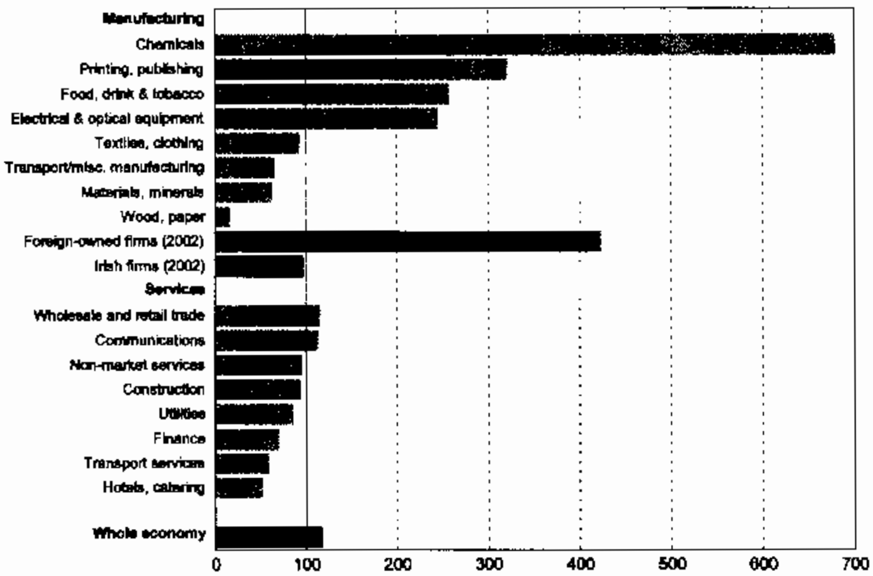
Source: OECD (2007), *Economic Outlook 82* database, and OECD calculations.

Maintaining productivity growth is the key longer-term challenge

25. Labour productivity levels in manufacturing are high by international standards. Output per worker is close to or above the EU15 average in most manufacturing industries (Figure 1.4). Foreign multinationals have much higher (measured) productivity than local firms and have generated the lion's share of growth over the past decade, but it would be misleading to regard the Irish success story as exclusively driven by the multinational sector as labour productivity in Irish-owned manufacturing firms is respectable in its own right: in level terms, it is close to the European average and has grown relatively quickly over the past decade (OECD, 2006).

Figure 1.4. **Productivity levels relative to EU15**

Gross value added per hour in 2003, EU15 = 100



Source: Cassidy, M. and D. O'Brien (2007), "Ireland's Competitiveness Performance" *Quarterly Bulletin*, No. 2, Central Bank and Financial Services Authority of Ireland, Dublin (based on Groningen 60-industry database).

26. In contrast, productivity in several service sectors appears to be less impressive (bearing in mind the difficulties in measuring and comparing service sector productivity across countries). Productivity is below the EU15 average in most service sectors, the exceptions being communications and distributive trades.

Ireland remains highly dependent on foreign trade and investment

27. As a financial and production intermediary, Ireland has one of the OECD's most open economies. While this has contributed to its impressive economic performance, it has also left it exposed to

shocks originating abroad not just because of the scale of its financial and trade linkages but also because these links are concentrated on a small number of partner countries. Total foreign assets and liabilities amount to more than 1 300% of GNI each (Table 1.3). Much of this is portfolio investment through the International Financial Services Centre (IFSC), but even non-IFSC assets and liabilities are large relative to GNI. Approximately half of all liabilities are owed to the United States.[1] On the trade side, exports amounted to 94% of GNI in 2006 while imports were 81%. Two industries – chemicals and ICT – account for three-quarters of goods exports. These industries are almost entirely US-owned and they sell mainly to Europe.

Table 1.3. **Ireland's international investment position**

Per cent of GNI

	In 2002			In 2006		
	Total	IFSC[1]	non-IFSC	Total	IFSC[1]	non-IFSC
Assets						
Direct investment abroad	53	13	39	63	15	48
Portfolio investment	514	438	76	812	693	111
Total[2]	871	680	191	1 345	1 089	256
Liabilities						
Direct investment in Ireland	164	71	92	80	37	43
Portfolio investment	420	351	69	822	698	123
Total[2]	893	635	257	1 352	1 049	303
Net position						
Direct investment	-111	-58	-53	-17	-22	5
Portfolio investment	94	87	7	-9	-6	-4
Total[2]	-22	44	-66	-7	40	-47

1. International Financial Services Centre.
2. Total does not equal the sum of the preceding rows because it includes other investments not shown in the table.
Source: Central Statistics Office.

28. While swings in foreign direct investment (FDI) have been large, this mainly represents financial transactions rather than tangible projects (Table 1.4).[2] A better gauge of Ireland's attractiveness to foreign investors is the number of people employed by firms supported by the Irish Development Agency. While there have been some high-profile closures of plants by foreign multinationals, the rate of job losses has declined since 2002 and the entry of new firms means that net job creation returned to positive territory in 2005-06 (Figure 1.5). The type of FDI projects that Ireland attracts continues to change. Currently only around 5% of new projects are in manufacturing, down from a quarter four years ago.[3] Instead, FDI in the life sciences, including pharmaceuticals, healthcare and biotechnology, are becoming more common: Ireland received a quarter of all the FDI into Europe in the life sciences area in the year to June 2007.

Table 1.4. **Foreign direct investment**

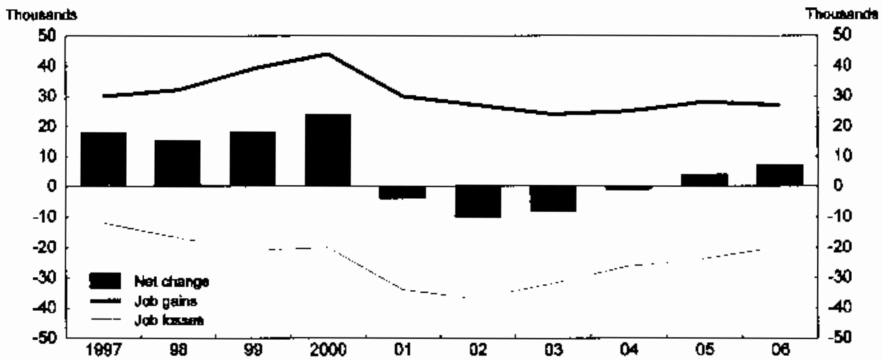
Per cent of GNI

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Investment in Ireland	11.6	22.4	31.4	11.0	29.4	17.2	-6.9	-18.8	-0.5
Investment abroad	5.1	7.5	5.6	4.6	11.0	4.2	11.7	8.5	7.8
Net investment	6.5	14.9	25.8	6.4	18.3	13.0	-18.6	-27.2	-8.3

Source: Central Statistics Office.

Figure 1.5. **Employment in firms supported by the Irish Development Agency**

Full-time employment in manufacturing and internationally traded financial services

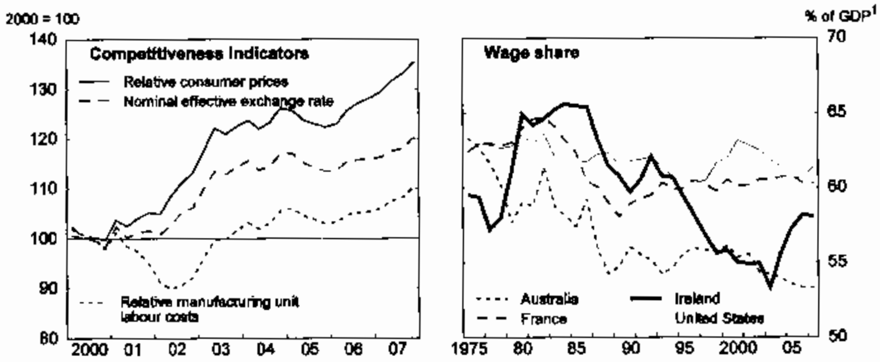


Source: Forfás, *Annual Employment Survey.*

Competitiveness needs to improve to boost exports

29. Long-run growth prospects depend heavily on export performance as the Irish economy is particularly open. More immediately, higher net exports would boost demand and ease the adjustment process following the end of the construction boom. Ireland has been losing competitiveness since the year 2000 as measured by relative consumer prices (Figure 1.6). The nominal exchange rate has appreciated, and wages and consumer prices have been growing faster than in its trading partners. But unit labour costs in the more export-orientated manufacturing sector have risen less sharply since 2000, initially falling, as wages in that sector have kept more in line with productivity growth. As a result of the developments in competitiveness, the improvement in Ireland's share of world exports has stalled and even fallen back modestly since 2002. The contribution of net exports to growth has been small or negative in recent years (Figure 1.7). But even maintaining market share is a reasonable performance given the growing weight of emerging economies in world trade. Since the late 1990s, Ireland has gained market share in financial and business services and has more or less maintained the share in most other categories except information and communication technology (ICT) manufactures and recorded media.

Figure 1.6. **Indicators of competitiveness**

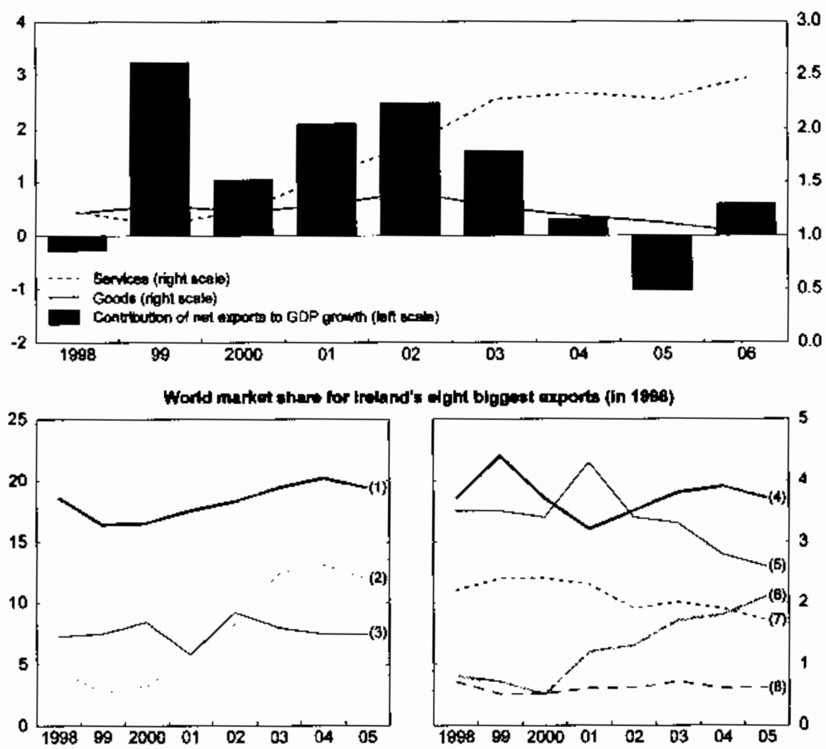


1. GDP at factor cost. GNI for Ireland. Wage share excludes self-employment income.

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

Figure 1.7. **Ireland's share of world export markets**

Per cent



(1) Computer services; (2) Financial services (including insurance); (3) Chemicals and pharmaceuticals; (4) Meat products; (5) ICT manufactures; (6) Business services (other); (7) Recorded media; (8) Transport and travel services.

Source: UN, *Comtrade database* and OECD calculations.

30. The dilemma now facing Ireland is that improved competitiveness would help macroeconomic adjustment in the short run, but there are signs that exports are becoming *less* competitive: relative manufacturing unit labour costs have risen by 7% over the past two years and the share of national income going to wages has been rising sharply since 2003 (Figure 1.6, right-hand panel). The rise in the wage share is even more striking considering that it goes against the international trend. These indicators suggest that the loss of competitiveness may be starting to become a serious problem. Although it is natural that wages in Ireland should rise in line with productivity growth, these natural or equilibrium forces may have been overtaken by disequilibrium effects. Wage growth does not appear to have responded quickly enough to the slow-down in productivity growth; the housing boom has put additional pressures on demand; and there are concerns about whether the increase in public expenditure and wages has been fully justified in terms of efficiency (Chapter 2). Unless wage and price inflation are reined in, the export sector will not be able contribute either to short-term adjustment or the long-run improvement in living standards. Real wage growth needs to be limited to increase in line with productivity or by even less in the short term. Competitiveness problems are exacerbated by rapid increases in non-wage labour costs as diverse as electricity prices, insurance premiums, office rents and local authority charges.

Policies to underpin growth

31. Ireland faces policy challenges to maintain strong growth. These include boosting competition, upgrading infrastructure, generating more innovation, raising human capital and increasing labour market participation. These issues were covered extensively in the previous *Survey* and are the policy priorities identified in the OECD's *Going for Growth* study (OECD, 2007). There remains scope for progress in these areas. This section provides an update on policy actions and highlights outstanding weaknesses that need to be addressed.

Stronger competition would boost productivity and reduce costs

32. Ireland compares well with other OECD countries when it comes to the regulatory environment. Overall regulation of the business sector is relatively light-handed and competition-friendly. Nonetheless, there are still too many sheltered sectors where competition is restricted and where the interests of producers and suppliers are favoured over the interests of consumers (Table 1.5). Boosting competition in these sectors would help to reduce prices, make Irish firms more competitive and raise productivity.

33. The need to increase competitive pressures remains in some of the network industries:

- In the *electricity sector*, the main problem continues to be the market power of the state-owned Electricity Supply Board (ESB). It owns the transmission network and has a large share of the generation capacity. Its dominance contributes to higher prices: one study estimates that 30% of the gap in electricity prices between Ireland and the average EU country can be explained by inefficiencies in the Irish market.[4] The previous *Survey* and the *Review of Energy Policy* conducted by the International Energy Agency (IEA, 2007) recommended a range of measures to reduce ESB's dominance.

- In the *telecoms sector*, the main issue is the slow rollout of broadband. Eircom, the telephone incumbent, dominates the market and the regulator (ComReg) has persistently criticised Eircom for dragging its feet over local loop unbundling.[5]

- The *bus market* is also relatively sheltered as private companies are restricted from competing with the state-owned bus firm on certain routes, and the regulator is not independent.

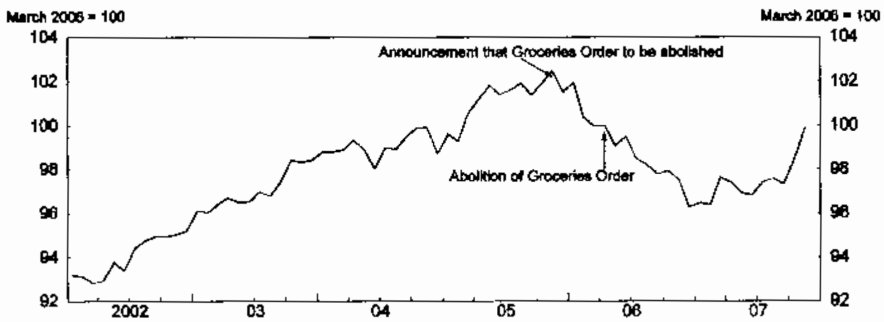
34. Unnecessary restrictions crop up in other sectors including the *licensed trades* such as the legal, medical, dental and veterinary professions. These rules are sometimes put in place to protect the public but they can be out of all proportion to their objectives. All EU countries are currently doing a stock-take of restrictions in the service sector as part of implementing the services directive. This provides a good opportunity for Ireland to clear away these barriers to competition and trade.

35. A reduction in *state ownership* could also improve economic efficiency. Today, government-owned firms have a monopoly or dominant position in the postal, energy, transport, health insurance, television and forestry industries. The government also has interests in airlines and hotels. Even if there are no explicit rules that favour them, state-owned enterprises can enjoy a competitive advantage through more gentle regulatory oversight, a lower cost of capital due to implicit guarantees, implicit subsidies or cross-subsidies and the dominant position they may have inherited from their days as protected monopolies.

36. A general problem with the *competition framework* is that enforcement can be difficult because it has to use criminal law processes and meet criminal law standards of proof. However, progress has been made recently with the Irish Competition Agency securing 18 criminal convictions in a cartel case and this is encouraging for the strategy of using the criminal law: the Irish competition authorities are the first in Europe to get a custodial sentence for a breach of competition law. The Competition Act is under review. It may be useful to include clearer guidance regarding fines since the penalties handed down so far have typically been light.

37. Despite these weaknesses, there has been solid progress in several areas since the previous *Survey*. First, the Groceries Order, which prevented price competition for basic foodstuffs, was abolished. This has been a notable success for competition policy: since the Order was abolished, the relative price of those items has fallen sharply (Figure 1.8). Second, restrictions on foreign-trained pharmacists, which were a major barrier to competition in the sector, will shortly be removed. Third, the powers of the telecoms regulator were greatly strengthened in April 2007. Just one month later, it reached agreement with Eircom to resolve all substantial matters holding back the local loop unbundling process. Fourth, the electricity regulator ordered ESB to sell some of its generation plants to reduce its market share. In addition, an all-island wholesale electricity and gas market was implemented in November 2007. It will have an independent market operator and ESB will no longer own the grid.

Figure 1.8. **Relative price of items covered by Groceries Order**
Relative to similar items not covered by the Order[1]



1. Groceries Order items included elements of food and non-alcoholic beverages, off-licence alcohol and household non-durable goods. Non-Groceries Order items included elements of foods and non-alcoholic beverages and household non-durable goods.

Source: Central Statistics Office, *CPI release*, *www.cso.ie/releasespublications/documents/prices/current/pic.pdf.*

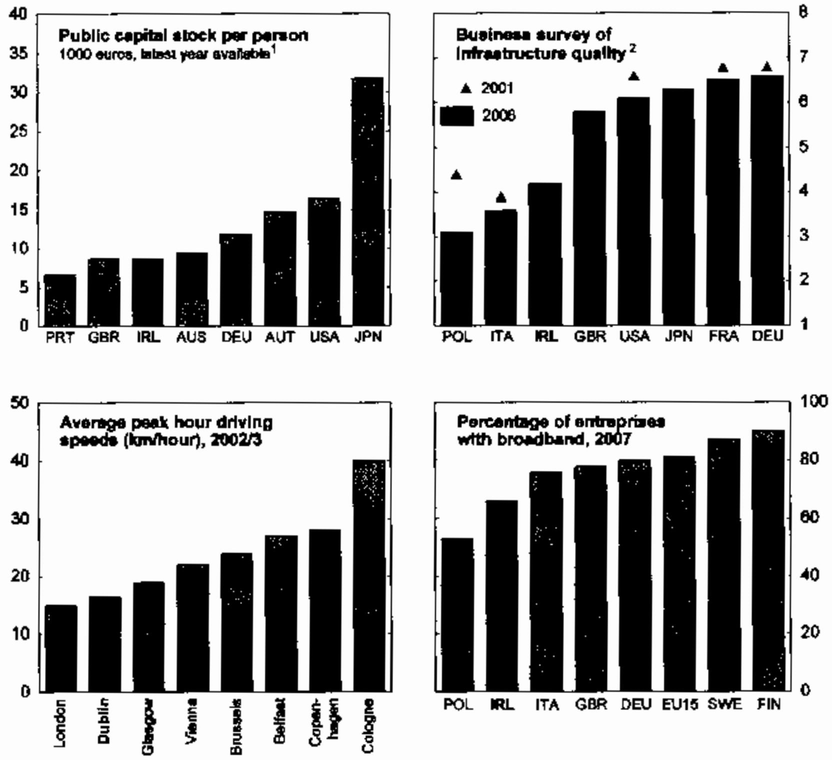
Table 1.5. **Progress in structural reform: competition policy**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Consider giving the Competition Authority power to impose sanctions. Review the Authority's staffing. Reduce the costs and delays of court proceedings.	No progress, but the Competition Act 2002 is under review.
Abolish the Groceries Order. Revise the retail planning guide to allow bigger stores.	The Groceries Order was abolished in 2006 leading to a noticeable drop in (relative) prices.
For pharmacies, replace the 50% retail mark-up with a flat dispensing fee, auction the right to run a pharmacy and abolish the "three year" rule for pharmacists who were not trained in Ireland.	The pharmacies sector was reformed in 2007. The government intends to abolish the three-year rule at an unspecified future date once other regulatory reforms are bedded in.
Remove the ceiling on the number of pub licenses.	No progress but the alcohol legislation is up for review in 2008.
Remove unnecessary restrictions in the legal profession including abolishing the bar council's monopoly on legal training. Speed up the registration process for foreign professionals.	There have been some minor reforms regarding barristers but other competition restrictions remain in place. The government has not responded to the Competition Authority's recommendation for an independent regulator.
Integrate the electricity market with Northern Ireland and the rest of the United Kingdom. Split up ESB by separating the transmission grid from the generation capacity. Consider splitting generation into competing firms.	An all-island wholesale electricity and gas market took effect in November 2007. By the end of 2008, ownership of the transmission network will be transferred from ESB to EirGrid. The regulator has ordered ESB to sell some generation plants to reduce its market share to 40% by 2010.
Liberalise the bus market. Appoint an independent regulator and remove restrictions on the number of bus routes that can be operated by private firms.	Only 15% of *growth* in the Dublin market has been opened to private operators. The European Commission is investigating whether state aid to its bus companies is legal.
Reduce state ownership.	No progress.

Infrastructure bottlenecks may be holding back growth

38. Soaring activity and rapid population growth have created a number of infrastructure bottlenecks. Major pressures are evident in roads, airports, electricity transmission, landfill, waste water treatment and broadband internet (Figure 1.9). In 2007 a global business survey ranked Ireland 25th in the OECD for the quality of its infrastructure, one place better than its 2002 ranking. These bottlenecks can have direct economic consequences, especially since foreign investors put a high weight on the quality of infrastructure when deciding where to locate. They can also have environmental and social consequences, such as pollution and long commuting times. While Ireland has one of the lowest levels of public capital in the OECD, it has one of the highest rates of public investment – higher even than some transition economies such as Hungary and Poland. So far this decade public investment has averaged 4½ per cent of GNI, and under the latest National Development Plan (NDP) is expected to remain that high at least until 2013. This includes the ten-year *Transport 21* plan that covers some large-scale public transport and road and rail projects. But even with this amount of spending, it will take until 2020 before the level of public capital per person reaches the OECD average and policy action is needed to speed up infrastructure projects, improve infrastructure planning and to allow for a better use of infrastructure services (Table 1.6).[6]

Figure 1.9. **Indicators of infrastructure**



1. At 1995 prices, using 2000 purchasing power parities. Data cover 2004 for Ireland, 2000 for other countries.
2. A high score indicates a high quality of infrastructure.

Source: OECD (2006), *OECD Economic Surveys: Ireland*; World Economic Forum (2002, 2007), *The Global Competitiveness Report* 2001-2002 (resp. 2006-2007); National Competitiveness Council (2007), *Annual Competitiveness Report* 2006, Vol. 1; Eurostat (2008), *Information Society Statistics*, online database (January).

Table 1.6. **Progress in structural reform: upgrading infrastructure**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Reduce the length and uncertainty of challenges during the planning process. To guarantee a balance between giving due regard to the concerns of people affected by projects and the need to ensure that public goods be delivered timely and efficiently:	53 major infrastructural projects have been submitted directly to the Planning Board for fast-track planning permission.
• Restrict the possibility of challenging planning decisions to persons whose financial interests would be affected by the project.	No change.
• Introduce a "silence is consent" rule to give the planning board greater incentive to comply with its statutory deadlines.	No change.
Ensure that projects deliver benefits greater than costs. To this end:	
• Suppress the possibility of avoiding a cost-benefit analysis.	No [redacted]
• Create an independent central unit responsible for the oversight and quality control of cost-benefit analyses.	A unit has been set up in the Department of Finance to promote best practice
Avoid over-investment in infrastructure and ensure its efficient use by generalising user charges. For example:	
• Charge the full cost of providing drinking water and collecting and treating sewage.	Meters for most non-domestic users will be in place by end 2007. Households continue to receive free water.
• Introduce a congestion charge in central Dublin when public transport alternatives improve.	Action will not be required until more of the Transport 21 plan has been completed.

[redacted]

[redacted]

The innovation system should be enhanced

39. Maintaining strong rates of productivity growth will require a greater focus on research and innovation. A key challenge is to increase innovation capacity in Irish-owned firms. Having a stronger domestic research base would make it easier to deliver home-grown innovation and to capitalise on advances made abroad. While business expenditure on research and development (R&D) has increased in recent years, it remains low by OECD standards. Most of the research in the private sector is undertaken by foreign multinationals, but even then they do most of their research at home. Ireland needs to improve its framework conditions and ensure a ready supply of skilled researchers in order to capture a greater share of this research. At the government level, Ireland has been a late starter in investing in research. Funding for R&D has more than doubled since the late 1990s, but when measured as a share of GNI it remains on the low side compared with other countries. Staffing bottlenecks are among the factors that have limited the growth of R&D expenditure until now. With an underfunded university [redacted], the number of people graduating with a PhD each year is below the OECD average, so progress depends on being able to attract enough skilled researchers from abroad.

[redacted]

40. The previous *Survey* put forward some suggestions for refining the science framework in order to get the most out of the relatively limited innovation budget (Table 1.7). For example, there are many funding streams that overlap to some extent, and a tidy-up may be helpful. As in many countries, universities could make greater efforts to commercialise their research and build links with industry. Finally, funding may be spread too thinly. It might be better to focus on a small number of centres of excellence rather than promoting research centres in regions that may not be able to attain critical mass. Greater amalgamation and specialisation among institutions may therefore be useful.

Table 1.7. **Progress in structural reform: research and innovation**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Improve economy-wide framework conditions as they are the most important determinant of R&D.	[redacted]
Consider rebalancing the science budget by making more use of market-led measures and scaling back direct grants. Evaluate the new tax incentive, and if successful channel more funding through it.	A new Science, Technology and Innovation (STI) strategy puts more emphasis on industry led initiatives. The tax credit was made more generous in 2006.
Consider whether public funding is being spread too thinly and whether Ireland would be better off concentrating its resources in a small number of world-class centres of excellence.	No [redacted].
Improve co-ordination among the different players. In particular, infrastructure spending needs to be better aligned with programme funding and with the investment being made in human capital. Review the structure of the innovation system to see whether combining some of the agencies would be the best way to improve coherence. There may be a need for fewer but more specialised business incubators.	Ongoing through various bodies and [redacted].

Education policy should aim to match the best countries

41. The sharp increase in educational attainment of the adult population has been an important factor behind Ireland's success. Even so, Ireland is well below the OECD's best performers in terms of the quantity and quality of education. Its economic structure and its ambitious target for R&D both require a more skilled workforce than the average country.[7] There is room for improvement at all levels of the education system (Table 1.8). For example:

- Pre-school attendance is low while classes are large and of short duration. The recent expansion of childcare places gives a good opportunity to move towards an integrated system that combines pre-primary education with crèche-based day-care at the same location. International experience has shown that this is best for children and provides greater parental satisfaction.
- In secondary schools, the OECD's PISA study shows that Irish 15-year olds do well at reading while their performance in mathematics and science is average. One issue is insufficient help for pupils who are struggling. Targeting special assistance programmes on children who have [redacted] learning is more efficient than simply focussing help on children who come from disadvantaged backgrounds. More intensive and better targeted catch-up programmes will become increasingly important as the children of migrants, many of whom do not speak English at home, start to enter the school system.
- Tertiary institutions are under-funded, constraining their ability to expand and attract high quality [redacted] from abroad. The funding squeeze is partly because undergraduate tuition fees were abolished in 1995. This was done to improve equality of access but the goal has not been achieved. The economic and equity arguments for students paying a greater share towards the cost of their tertiary education are strong. Ireland should consider the system in Australia, New Zealand and the United Kingdom with upfront tuition fees that can be covered by a loan, repaid later when the individual begins to earn above a certain threshold. Aside from bringing more funding into the system, this type of scheme can make education institutions more innovative and more geared to the needs of students. It can also raise efficiency by encouraging students to choose more useful courses and not waste time in their studies. Some structural re-organisation may also help to obtain better quality and value for money at the tertiary level. The OECD's *Review of Higher Education in Ireland* in 2005 made several suggestions, such as greater management autonomy and more specialisation and amalgamation among the smaller institutions in order to reach critical mass. Greater flexibility, such as evening and weekend courses, will become more important to help working adults up-skill without dropping out of the workforce.

[redacted]

Table 1.8. **Progress in structural reform: education**

Recommendations from previous *Surveys*	**Action taken since the March 2006 *Survey***
Invest more in pre-primary schooling by:	
• Generalising pre-primary education from the age of three.	No [redacted]
• Avoiding infant classes of more than thirty children.	Average class sizes at *primary* level have fallen, but this level has not been [redacted]
• Expanding the duration of daily classes.	No progress.
Improve outcomes in primary and secondary education by targeting efforts on children with learning difficulties rather than on those from disadvantaged backgrounds.	No [redacted].
Give universities the means to increase their resources and the incentive to be more responsive to students' needs by levying fees that students (including part-time students) repay from their subsequent earnings. Public funding should not be cut back as fees increase.	No [redacted]

[redacted]

Participation can be raised further

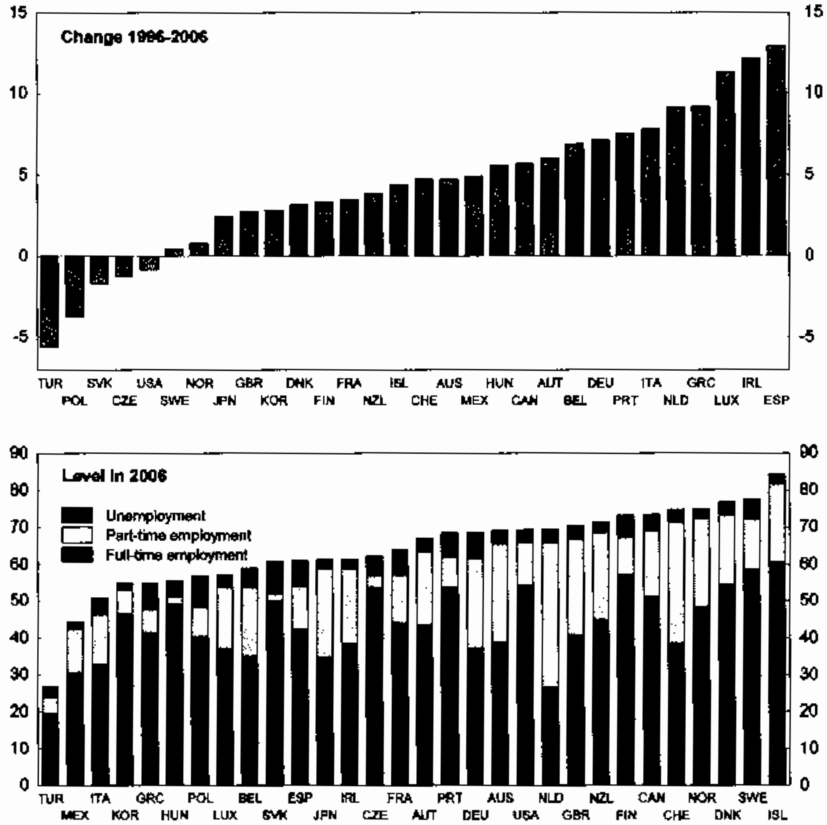
42. While immigration has been a main source of labour supply growth in recent years, there are areas where indigenous labour supply can be raised substantially such as the participation of women. To some extent this will happen naturally as cohort effects and changing cultural attitudes work their way through, but the increase could be stronger with some help from policy reforms (Table 1.9).

Table 1.9. **Progress in structural reform: female participation**

Recommendations from previous *Surveys*	**Action taken since the March 2006 *Survey***
Encourage more out-of-school-hours care where school facilities are suitable.	Recent budgets have allocated funding in this area, and school boards are becoming more willing to offer their facilities.
Implement plans to increase the supply of training places for childminders.	No progress yet, but there is a target of 17 000 new training places by 2010.
Over time, link childcare support such as the Early Childcare Supplement to employment status or to the use of formal childcare.	The government moved in the opposite direction by raising the universal Child Benefit by 7% in the budget for 2007 without making it more targeted. It also changed the subsidy system for childcare support so that recipients of social welfare get substantially more than working parents.
Phase out the Home Carer's Tax Credit.	No progress.
Give priority access to community childcare to working parents, especially lone parents.	Priority is given to disadvantaged parents, especially those on welfare.
In order to reduce child poverty, provide job-search assistance and childcare support to lone parents. In return, boost job search requirements for lone parents on income support whose children are of school age. Consider allowing lone parents to keep some of their benefit for a limited time after going back to work. Raise the threshold from which the One Parent Family Payment starts being withdrawn and reduce its phase-out rate.	A substantial reform of lone parent support is being prepared. It proposes a mutual obligations approach, including some job search requirements. The upper income threshold for entitlement to the one parent benefit was raised in the budget for 2007.
Continue reducing average and marginal effective tax rates on second earners. Consider moving to individual taxation.	The top rate of income tax has been reduced to 41% and average rates reduced through higher thresholds and allowances.
Introduce fines for employers found in breach of Equal Pay legislation.	No progress.

43. While the female participation rate has increased enormously over the past decade, it started from such a low base that it is still below the OECD average (Figure 1.10). Part-time employment is more common in Ireland than elsewhere, so the effective female labour supply is well below average. Women with children have a very low participation rate by OECD standards. As argued in *Going for Growth* (2007), raising pre-school attendance by children is also important for developing Ireland's human capital.

Figure 1.10. **Female participation has risen a lot but is still low**
Percentage of women aged 15-64 in the labour force



Source: OECD (2007), *Labour Force Statistics - online database*, September.

44. Part of the problem is that there are not currently enough childcare places, though the National Childcare Strategy is helping to fix that. It includes the construction of childcare facilities and aims for 50 000 extra places by 2010. When fully up and running, it will bring the coverage rate of formal childcare close to the current OECD average. But childcare is also expensive by international standards as public support towards the costs of childcare services is among the lowest in the OECD.[8] Rather than concentrating on expanding supply, a more balanced policy would put greater focus on the demand side by providing income support to make childcare more affordable.[9] The government already spends a considerable amount on child benefits and child benefits have been raised by 85% since 2005.[10] But this expenditure is poorly targeted as the Child Benefit and the Early Childcare Supplement are cash transfers that are paid whether parents are working or not and regardless of whether they are actually using childcare services. Ireland could get significantly greater value for money if support was linked to employment, job search or the use of formal childcare services (OECD, 2003). It has chosen not to go down this route because of a perception that it would discriminate against mothers at home. However, it is important to convince the public that the tax-benefit system is already biased against mothers at work, so a more targeted approach would not only deliver better value for money but would make the system fairer as well.

45. There is also a scarcity of out-of-school-hours care. In the past, school boards have been reluctant to open up their facilities for after-school programmes, but a few trail-blazers have succeeded in changing the attitude of some of the more hesitant boards. There is a target of 5 000 new out-of-school-hours places by 2010 and, while this seems achievable, it would cover less than 1½ per cent of the population aged 6-12. The government should ensure that public investment in school buildings also benefits communities after school-hours, which would help to raise after-school provision of childcare, improve value for money and avoid the need to ferry children from one location to another.

46. The country also suffers from having a large number of single parents whose employment rate is low by OECD standards. This has clear economic costs, but the social costs associated with child poverty are far more important. The best way to reduce child poverty is to help parents return to work. The problem in the past has been a hands-off welfare system that does not encourage lone parents to work even part-time combined with a high effective marginal tax rate if they shift from a part-time to a full-time job. This is changing for the better. The government plans to move towards a mutual obligations approach for single parents. The details have not yet been worked out, but the proposal is to provide greater support for training, job search and childcare combined with a work requirement after the youngest child reaches a certain age. It is essential for these activation initiatives to be successful that the public employment service (FÁS) has sufficient resources to activate people effectively and meet additional demands as more people are covered.[11]

47. The income tax system also contributes to reducing the incentives for second-earners to work full time, though the problem is less severe in Ireland than in some other European countries. Ireland has a hybrid income tax system that is somewhere between individual and joint taxation of household members, with the consequence that second earners can pay the highest marginal tax rate (48%, including social contributions) at a relatively low income level.[12]

Setting policies to underpin stability and sustainability

48. In the short run, the major challenge is to keep the economy on a stable path; in the long run, the sustainability of economic and social progress needs to be ensured. This *Survey* discusses these issues in depth. The functioning of the housing market should be improved and gradual change needs to start soon, before the next boom begins. The downturn in the housing market and international financial market turmoil have highlighted the need to be prepared for shocks to financial stability. Slower revenue growth will put a premium on maintaining fiscal prudence and progressing in the on-going efforts to improve value for money from government spending. Ageing will pose fiscal challenges in the long term. The special chapter focuses on how to ensure that the recent boom in migration results in the successful longer-term integration of migrants.

Support for housing should be more efficient and promote stability

49. Over the past decade, Ireland has enjoyed the largest increase in house prices in the OECD, though prices started at a low level. The increase was propelled by the large rise in disposable income and low real interest rates. Demographic changes also spurred the market, with strong growth of the population at the age where people tend to buy a house, while the average number of people per dwelling has fallen. And there has been significant immigration. However, house prices have overshot and are now declining. The most likely scenario is a rapid adjustment in house-building to a more sustainable level and some further decline in house prices. To avoid future booms in the housing market, which are difficult to cope with in a monetary union, the government should review the taxation of housing (Chapter 2).

50. Ireland has a high rate of owner occupation of housing. Although this may have some benefits, it is partly the result of costly and inefficient policies that distort the housing market and increase the role of housing in the economy as a whole. The tax treatment of housing is very favourable and the value of mortgage interest tax relief has been increased. Support should be reduced and better targeted. This would lead to a better use of resources and could help to dampen future housing cycles. A well-designed property tax would help achieve both. The abolition of stamp duty on housing transactions for first-time buyers and rationalisation of the regime for others, leading to lower payments for most buyers, will help to make the housing market more efficient and flexible. Housing support for those with low incomes is focussed on building new houses. This approach is costly and only provides immediate help to a small number of people. It would be more effective to provide means-tested housing benefits or vouchers that could be used to pay either a mortgage or rent.

The property boom and financial market turmoil have raised financial stability issues

51. As well as the booming housing market, the commercial property market and the construction industry have also expanded very rapidly. This has raised bank lending substantially in the context of very low real interest rates and easing lending conditions. The private sector debt-to-income ratio now exceeds 200%, up from 100% in the late 1990s, with a heavy concentration of lending in the property and construction sector. The Financial Regulator clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. In addition, Irish banks are funded to a considerable extent by issuing securities and borrowing in the interbank market, which has also raised [redacted]

[redacted]

52. The Financial Regulator has taken action to reduce risks, including higher risk weightings on some assets, an improved regime to monitor liquidity and the implementation of a new Consumer Protection Code to avoid predatory lending practices. The slowing in house prices and subsequent decline since mid-2007 has eased a key concern, as it brings house prices closer to fundamentals, raises housing affordability and helps to stabilise repayment burdens for new borrowers. However, financial market turmoil has led to a liquidity squeeze, higher funding costs for banks and a tightening in lending standards. It has raised transparency issues about banks' exposure to the sub-prime market and credit lines extended to structured investment vehicles, hedge funds and private equity. Prior to the financial market turmoil and the slowdown in bank lending, Irish banks were very profitable and well-capitalised, so that they should have considerable shock-absorption capacity. But the financial system should also be prepared for the worst. In this context, it would be useful to revisit the features of the deposit insurance scheme, while a special insolvency procedure that ensures the smooth exit of a failing bank would help underpin the soundness of the financial system (Chapter 3).

Fiscal policy should adapt to lower revenue growth

53. The fiscal position was strong in the years up to 2006, despite one of the largest increases in public spending in the OECD, owing to the rapid expansion in revenues (Chapter 4). The general government account has been close to balance or in surplus since 1995 and public debt has become very low (Figure 1.11). The level of public savings (current revenue minus current expenditure) was one of the highest in the OECD and this has left ample room to fund longer-term capital investment. Around 4% of GNI is being spent on new infrastructure and other public assets. By law, 1% of GNP is put into a pension reserve fund in order to partly pre-fund future pension liabilities.

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54. Revenue growth, however, slowed sharply in 2007 and the fiscal balance fell to around 0.5% of GNI [redacted] 3.4% the previous year. Stamp duty and corporation tax receipts were lower in 2007 than the previous year (CT was expected to be lower due to negative cash flow implications of bring forward the

[redacted]

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payment date for preliminary CT). Stamp Duty receipts are expected to decelerate further in 2008. This weakness in revenues, alongside the planned slowdown in expenditure growth, is anticipated to lead to a deficit of around 1¼ per cent of GNI for 2008 and 2009. In the longer term, distortionary and costly tax expenditure should be eliminated where these cannot be shown to be effective. A Tax Commission has been established to consider these issues, as well as others such as the financing of local government and a carbon tax. Cuts in taxation or employee social security contributions should only be considered if medium-term circumstances [redacted].

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of tax revenue (Chapter 4). Since 2000, between a quarter and a third of the increase in total tax revenues was related to the property boom. This amounts to more than 4% of GNI, and the total contribution is

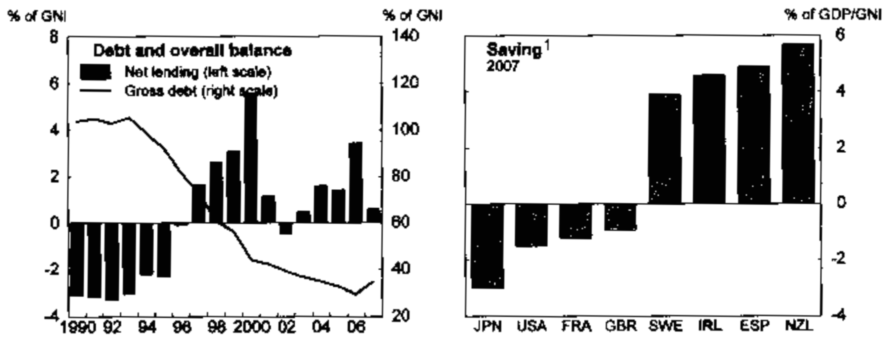
effects to the wider economy are taken into account. A further 1.5% of GNI now comes from corporation tax on the multinational sector. All in all, a substantial share of revenues is vulnerable to structural changes in the economy such as the current correction in the housing market or a shift in sentiment by foreign investors that could occur at any time

[redacted]

55. Spending growth is planned to slow in the coming years but will continue to be fairly rapid in 2008. Implementation of the NDP and infrastructure investment has been given priority and fiscal plans remain prudent overall. However, it is important to avoid locking in generous long-term social expenditure and public sector wage commitments at this point of the revenue cycle.

Figure 1.11. **Fiscal performance has weakened**

General government sector



1. OECD estimates; current revenue less current expenditure. Ireland in per cent of GNI. *Outlook* projections for Ireland updated to include later information on the fiscal position.

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

56. With revenue growth likely to be constrained over the next few years, the public sector will need to give more emphasis to boosting efficiency and effectiveness. Steps have already been taken in this direction but more needs to done. The OECD *Review of the Irish Public Service* (OECD, 2008) identifies many areas where further progress could be achieved including better use of human resources, more focus on inputs rather than [redacted], [redacted] attention to decision making and collection of data to evaluate performance, and improved governance, particularly of agencies. E-government should be used more effectively, greater efficiency is required by local government and the challenges posed by the decentralisation process need to be managed.

[redacted]

57. Going forward, it is important that additional expenditure leads to increased volume and quality of public services rather than being absorbed in wages and prices. The second Public Sector Benchmarking Body report has shown that wages in the public sector compare well with those in private firms, in part due to more generous pension entitlements, and that no substantial increase in public sector wages is necessary. Pay levels in some sectors such as healthcare workers are already substantially higher than in comparable countries. It is important that this is taken into account in the next pay deal under the social partnership arrangement.

Population ageing will put substantial pressure on public finances in the long-term

58. Looking to the longer term, Ireland faces one of the sharpest increases in age-related public spending in Europe, largely because its young population means that it is starting from a low base. Currently it has one of the youngest populations in Europe. It has some time on its hands: it will not be before 2025 that the old-age dependency ratio rises to the level that the EU25 faces today (Figure 1.12). But this should not be seen as an excuse to put off some needed expenditure reforms such as a redesign of the pension system (Chapter 5). Many other European countries have left it too late, while Ireland has the luxury of being able to start early and therefore spread the adjustment over a longer time period. As the population ages, it will become increasingly difficult to provide an adequate retirement income for older people and maintain a fiscally sustainable pension system. Increases in benefits have reduced old-age poverty but there is gap for most households between the state pension and a reasonable replacement income in old age. Ireland relies heavily on private savings to close this gap but many people are not saving enough. The challenge is to provide a long-term framework that achieves an adequate level of private saving.

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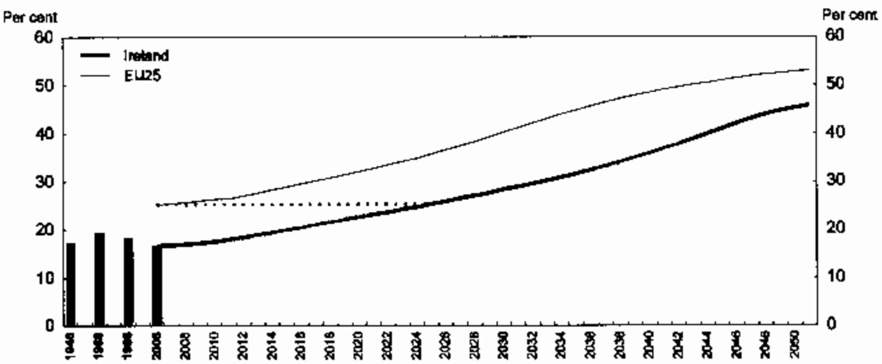
Figure 1.12. **Old-age dependency ratio**

Population aged over 65 relative to working-age population



Source: Eurostat and Central Statistics Office.

59. The effective retirement age is now 65 and it is not uncommon to work beyond this age, but there remain obstacles to the participation of older workers. The phasing out of the Pre-Retirement Allowance (PRETA) and extension of the preventive process of unemployment assistance have removed incentives for those aged above 55 to leave the workforce. It is, however, important to ensure that other effective early retirement pathways do not open up through disability benefits.

Better integration is needed to get the most out of immigrants

60. The surge in immigration over the past decade, and especially since the European Union was enlarged in 2004, means that around 15% of the workforce was born in another country. Immigrants who arrived in the 1990s were predominantly British, American or had Irish nationality through their parents. This cohort has integrated easily into society and the job market. Since 2004, the inflow has been dominated by Eastern European migrants, mainly from Poland and Lithuania. They are well educated on average and have a very high employment rate, but they tend to work in jobs well below their skill level. In this sense, they are not fully integrated into the workforce and their talents are not being put to their best use. There is a third group of immigrants, from outside Europe. This covers a diverse range of people,

some of whom face significant integration problems. Apart from the economic and labour market issues, the public sector will be facing new challenges over the next few years as more migrants settle permanently and bring over their spouses and children. Integration policy is only just getting off the ground. Policies for better integrating migrants are discussed in depth in Chapter 6 as well as the challenges that uncertainty about future migration flows poses for infrastructure planning.

NOTES

1. This figure applies to 2001-03 and is based on ultimate beneficial ownership (if a US company channels funds through the Cayman Islands, for example, the statistics look through this and attribute it to the US rather than the intermediary). The estimates are based on CSO statistics reported in Lane and Ruane (2006).

2. For example, the cumulative net FDI outflow of 35% of GNI in 2005 and 2006 was mainly due to loans from IFSC companies to their affiliates abroad.

3. Figures based on a study by OCO Consulting reported in the *Irish Post*, 7 October 2007.

4. The rest is due to a different fuel mix. See Deloitte and Touche (2005).

5. See the regular *Status Reports on Local Loop Unbundling*, published by ComReg.

6. See Chapter 5 of OECD (2006).

7. For a discussion of future skills needs, see Expert Group on Future Skills Needs (2007).

8. See Chapter 6 of the previous *Survey* for further details.

9. There are limits to how quickly this could be done because if demand grows more quickly than supply, it is likely to simply raise costs in the sector.

10. This figure is for the first and second child and includes the Early Childcare Supplement that was introduced in the budget for 2006.

11. € 50 million has been allocated under the National Development Plan (NDP) for the Department of Social and Family Affairs to provide an activation programme that engages with all social welfare recipients, but this covers a wide range of people including lone parents, people with a disability and the unemployed.

12. Using a model based on micro-economic data for Ireland, Callan *et al.* (2007) show that changing the tax treatment of couples would have a substantially greater impact on participation by married women than would a general tax cut that costs the Exchequer the same amount.

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[redacted]

Market cycle has turned

CHAPTER 2. THE HOUSING [redacted]

After booming for many years, the housing market has slowed: house prices are falling and there has been a sharp reduction in the number of new homes being built. The exceptional rise in property values in recent years was largely driven by higher income and demographics, but did appear to overshoot the sustainable level. House prices may fall further and could even fall below their medium-term sustainable value. Residential investment is experiencing a [redacted]. *This will have some effect on wider economic activity. Furthermore, the housing market poses risks for the economy and financial stability if a more severe slowdown occurs. Phasing out policies that distort the housing market could help to dampen future housing cycles and maintain the competitiveness of the* [redacted].

[redacted]

61. Although housing markets boomed in most OECD countries over the past decade, the increase in real house prices in Ireland has been exceptional: house prices are more than 2.5 times higher in real terms than 10 years ago. This partly reflects the same factors that have driven housing markets elsewhere, such as a period of relatively low nominal interest rates, but also the "catch up" in Ireland following the Celtic Tiger years, strong inward migration and the starting position of relatively cheap housing. This boom is now over. Indeed, house prices have begun to fall while they are still rising in many other countries, even if at a slowing rate. The main consequence for wider economic activity so far has come from the sharp slowdown in housing construction, although there are risks of a stronger impact and for financial stability (Chapter 3). This housing cycle, the first since Ireland joined Economic and Monetary Union (EMU), raises a number of structural policy issues that should be addressed before the next cycle begins.

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The housing market slowdown

[redacted]

62. House prices are falling as measured by the mix-adjusted permanent tsb/ESRI House Price Index and the price for second-hand houses recorded by the Department of the Environment (Table 2.1). This follows a sustained deceleration in prices since the second half of 2006. Some further fall in house prices is likely. The weakness in house prices has been matched by a sharp fall in the number of transactions. As demand slows and prices fall, owner-occupiers are less likely to trade-up or down and fewer new households try to get onto the housing ladder. Although houses are becoming more affordable, potential buyers are likely to wait until prices appear to have stopped falling.

63. A housing market slowdown had been widely anticipated, although the exact timing was difficult to predict, and activity in the early part of 2007 was depressed in the short term by expectations in the run up to the general election that changes to stamp duty would occur. In 2005, probit analysis by the OECD suggested that the likelihood of being at a peak in real house prices in Ireland was then around the mid-point of the countries considered (van den Noord, 2006). The subsequent increase in the real value of houses, however, made it more likely that the market would soon reach a peak given past experience of how housing cycles evolve. The doubling of ECB's policy rate from 2% to 4% since December 2005 had a strong cooling effect on the housing market, even if the rate rises did not bite immediately. Econometric analysis suggests that house prices in Ireland are more sensitive to short-term interest rates than in many other countries, consistent with the popularity of variable-rate mortgages (Rae and van den Noord, 2006).

Table 2.1. Housing market indicators show a slowdown
Year-on-year growth rate

	2006				2007		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
House prices							
permanent tsb/ESRI series	11.1	14.3	15.3	13.0	9.2	2.9	-1.8
New houses	11.4	11.9	12.1	9.0	9.0	7.7	3.2
Second-hand houses	14.4	14.1	18.9	6.8	9.0	2.1	-4.0
Loan approvals (number, all agencies)	28.6	7.8	-23.3	-24.5	-21.9	-28.4	-18.3
Planning permissions	-4.5	-16.8	-6.9	-11.8	-3.1	0.7	-2.6
Construction volume	16.8	-2.6	-12.3	5.5	-19.8	-6.2	
Quarterly house completions	24.3[1]	n.a.	18.3	1.5	-8.6	-13.8	-22.8
New house registrations	15.0	12.5	13.6	-14.0	-28.0	-40.7	-52.2

1. Data for 2006 Q1 and Q2 were not published separately.

Source: Central Statistics Office; Department of the Environment, Heritage and Local Government; permanent tsb.

[redacted]

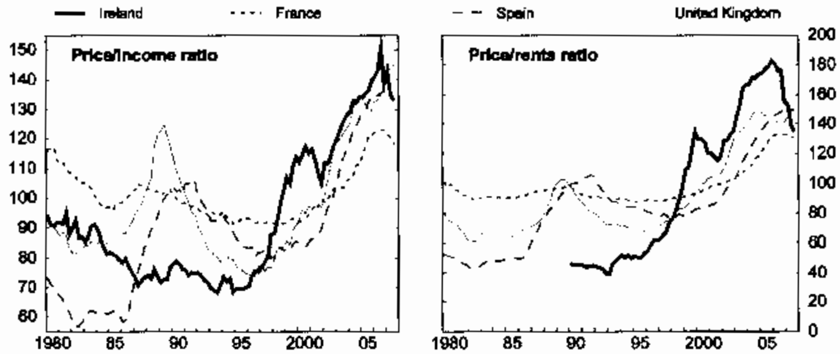
64. The outlook for house prices is highly uncertain but the falls to date have been relatively small compared with the massive rise over recent years. The dynamics of house prices are hard to predict. Housing cycle corrections often occur through small falls in prices followed by long periods of flat prices as homeowners are reluctant to sell at a nominal loss, waiting until the equilibrium level of prices catches up to actual prices. However, past experience cannot rule out that prices fall more sharply and overshoot the sustainable level on the downside. The medium-term sustainable level of house prices, however, is likely to be much higher than in the past and prices may not be far from their fundamental level; the exceptional increase in house prices in Ireland relative to other OECD countries partly reflects the very strong economic performance of Ireland, rapid inward migration and its unusual demographic position. The sharp rise in employment and incomes, together with a rising population and a high rate of formation of new households, is likely to have increased the sustainable level of house prices considerably. The number of housing units relative to the population has caught up from a low level by European standards to 417 per thousand inhabitants, close to the EU average but still below the stock in France and Germany.

65. There are a number of ways of assessing the balance between demand and supply in the housing market and hence the sustainable level of house prices. The ratio of house prices to incomes has fallen sharply, as nominal house price inflation has eased and incomes have continued to increase rapidly (Figure 2.1). The ratio of house prices to rents has also fallen. By bringing the cost of buying and renting more into line, this is likely to stimulate demand for owner-occupation. Furthermore, rents have accelerated and rose by 12% over the past [redacted]. The strong current demand for rental accommodation partly reflects first-time buyers being unable to afford to buy a house and thus renting for longer. Migration is likely to have increased demand for rental property too. As rents rise and house prices fall, some of first-time buyers households will return to purchase housing although the impact is likely to be initially concentrated on the lower end of the housing market. Despite the rebalancing of the housing market, the value of houses in Ireland remains high compared with historical experience on these measures.

66. Evidence from an economic model suggests that house prices were below their fundamental level in the early part of the decade but then overshot as the housing market boomed (Figure 2.2). The sustainable level of both new and second-hand house prices has continued to rise at a relatively fast rate of 5-10% annually, which would be high in international comparison but is well below the rate of increase in the late 1990s. The recent rise has been driven by higher incomes and demographic factors. This may overstate the effect on prices of demographic effects given that the large number of migrants who arrived in the past two years are more likely to rent and live in high density [redacted]. For second-hand houses, the

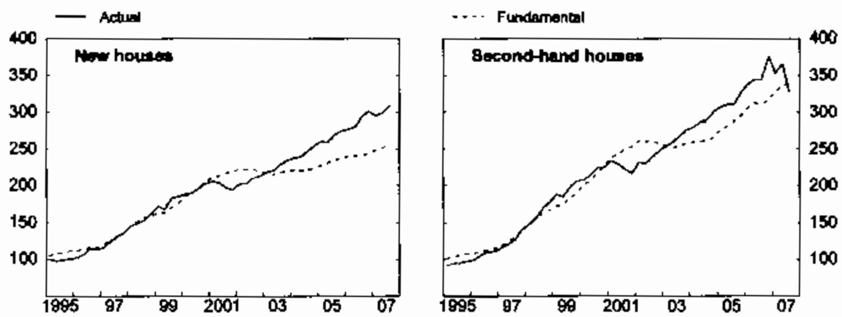
fall in house prices appears to have eliminated the gap with the fundamental level, although such estimates are highly uncertain. For prices of new houses, a large gap has opened up with the long-run level of house prices and there has been little adjustment to new house prices to date.

Figure 2.1. **House prices in relation to income and rents**
Average 1990 Q1 - 2007 Q2 = 100



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

Figure 2.2. **Actual and fundamental house prices**
In thousand euros, real prices[1]



1. Nominal prices deflated using the harmonised consumer price index.

Source: Rae, D. and P. van den Noord (2006), "Ireland's housing boom: What has driven it and have prices overshot?", *OECD Economics Department Working Papers*, No. 492, June, updated data.

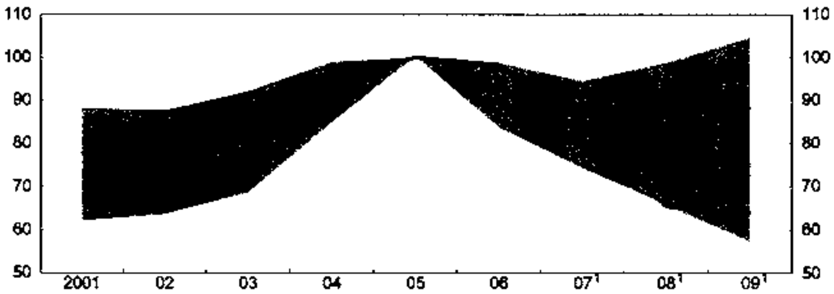
The sharp fall in residential construction

67. Housing investment was 12% lower in the first half of 2007 than a year earlier. This ends the boom in house-building that began in 1993. Over this period, housing investment more than doubled as a share of GNI to reach a peak of 16%, the highest share in the OECD. Residential investment is characterised by pronounced boom-bust cycles. Compared with the experience of 46 house-building booms

in 23 countries between 1960 and 2004, the recent expansion in Ireland was big and the current slowdown is consequently likely to be relatively severe (Figure 2.3). The OECD projects a fall in completions from around 90 000 in 2006 to 50 000-60 000 in 2008, which is close to the level regarded as sustainable given rising incomes and demographic effects. But the cutback in investment could be even sharper. International experience suggests that the correction in house-building is usually relatively quick with sharp falls in the first two years, followed by a couple of years of stagnation. Some slumps, however, last longer and this remains a risk, especially if immigration were to recede.

Figure 2.3. **Residential investment per capita**

Index, peak = 100



Note: The shaded area indicates the 10th to 90th percentile of the distribution of residential investment per capita in 46 booms in 23 countries between 1960 and 2004, where the peak is normalised at 100 and set at 2005.

1. OECD forecasts.

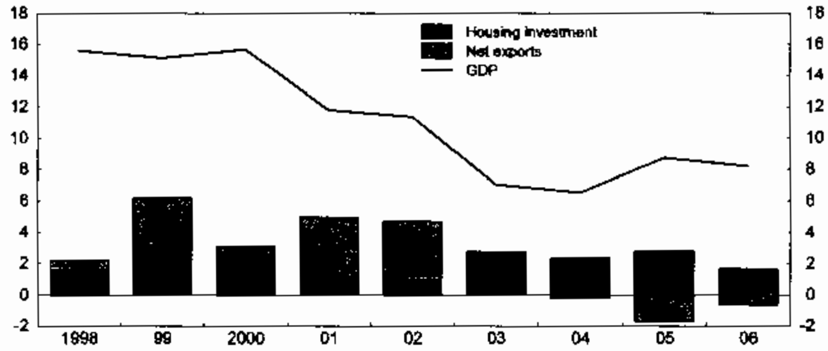
Source: OECD (2007), *Economic Outlook 82 database.*

68. Given the large share of economic activity, the fall in housing construction will have a substantial impact on overall economic activity. Construction, including commercial and civil engineering, accounts for 12% of employment but the housing component is relatively labour intensive. Furthermore, construction accounted for one quarter of the increase in employment over the past five years. Much of this increased supply of labour has been provided by migrants (Chapter 6), often working through various forms of self-employment rather than being directly employed.

The macroeconomic impact of the housing market cycle

69. Housing demand has had a major impact on the economy in recent years. Residential investment has constituted around a seventh of value added. Moreover, as the strong contribution of net exports to the growth of demand in the late 1990s receded, house-building made a major contribution to nominal growth (Figure 2.4). The strength of consumption growth is also likely to have been supported by rising house prices. People tend to purchase big-ticket durable goods when they move. There may also be more general wealth and confidence effects. These could fade as house prices fall. Many studies have failed to find a strong effect of housing wealth on consumption in Ireland: the strong growth of consumption in recent years could be explained by rising incomes and employment rather than housing. Evidence from a cross-country study, however, suggests that consumption in Ireland is relatively sensitive to the housing market as there is a high rate of home ownership, loan-to-value ratios on new mortgages are high and short-term interest rate loans are popular (Catte *et al.*, 2004). Consumer confidence has already fallen to its lowest level since 2003.

Figure 2.4. **Housing investment and net exports**
Contribution to nominal GDP growth, per cent



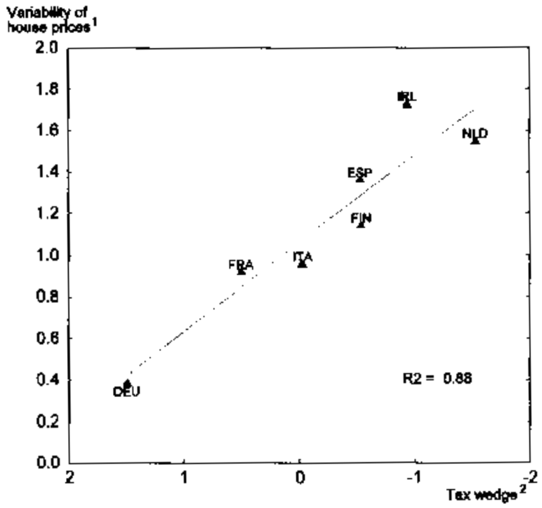
Source: OECD (2007), *Economic Outlook 82 database.*

70. The slowdown will have a wide range of effects including putting pressure on the financial system (Chapter 3) and lowering tax revenues (Chapter 4). Simulations of the OECD's macroeconomic model for the *2006 Survey* suggested that a one-third decline in housing investment from the level at that time would reduce GNI by 2% and raise unemployment by as much as 2 percentage points. Although the current *Economic Outlook* projections paint a less severe picture, the housing market nevertheless weighs heavily on growth in 2008. The effect on overall construction activity of lower house-building is partly offset by government infrastructure construction and more spending on home improvements facilitated by the greater availability of builders. There will also be effects on the supply capacity of the economy. The reduced demand for workers in the construction industry is likely to reduce the number of migrant workers, but average productivity will increase as resources are redirected towards more productive sectors of the economy.

71. This is the first housing cycle in Ireland since EMU. In the past, many of the effects of the housing market slowdown on aggregate demand could have been offset in the short run by an accommodative monetary policy. This mechanism is unlikely to come into play this time, particularly because Ireland appears to be leading other economies in this episode. It has been fortunate for Ireland that the European Central Bank did not raise short-term interest rates in the autumn of 2007 as expected prior to the global financial market turmoil. The size and structure of the housing market makes Ireland particularly sensitive to changes in interest rates. Furthermore, the initial rise in house prices was related to low real interest rates in Ireland during the boom period brought about by low nominal interest rates reflecting sluggish euro area growth, while inflation in Ireland was relatively high. House price growth has been more rapid on average in those euro area countries with low real interest rates. This emphasises the role of other policies and the importance of Ireland maintaining external competiveness so that net exports can partly contribute to rebalancing the economy (Hoeller and Rae, 2007).

72. Housing market policies should not contribute to housing market instability, particularly as the monetary policy instrument is not available. The variability of real house prices tends to be higher where the tax wedge between after- and pre-tax real interest rates on mortgages loans is most negative (van den Noord, 2004, Figure 2.5). This is because the impact of rising house prices on the cost of purchasing a house are partly offset by the tax break so there are weaker forces in the system to slow down rising house prices. Higher house prices tend to increase the value of loans that people take out but this is partly countered by the government through the higher value of tax relief on mortgage interest payment. In addition, there is no property or capital gains tax that might curb housing demand as prices increase, although relatively high stamp duty payments have some slowing effect on housing market turnover.

Figure 2.5. **House price volatility and the tax treatment of housing**
Per cent



1. Root mean square deviation of real house price from trend, 1970-2006.
2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

Source: Van den Noord, P. (2004), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale* and OECD calculations.

More efficient policies towards housing

73. There would be long-run gains from more efficient policies towards housing, in addition to mitigating the cyclical volatility of the housing market. Table 2.2 summarises the recommendations of the previous *Survey* and subsequent policy action. Ireland remains the only country in the OECD that allows households a tax deduction for mortgage interest payments at the same time as not taxing property values, capital gains or imputed rent. Income invested in housing may therefore effectively never be taxed during a person's lifetime.

Table 2.2. **Progress in structural reform: housing**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Phase out the bias towards housing that is embedded in the tax system. Reduce the tax incentive for speculative investment on properties.	The government moved in the opposite direction by doubling the ceiling on mortgage tax relief for first-time buyers. Reforms to the stamp duty regime will reduce the transactions costs for most home buyers.
Introduce a property tax in order to fund local infrastructure and services and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.	No change.
Social housing policy should become more tenure-neutral by scaling back house-building and providing more by way of income support and/or housing vouchers.	No [redacted]. The NDP envisages large-scale investment in public housing.
Promote the supply of under-developed land.	No progress.

[redacted]

74. Other countries that previously had similar arrangements have moved towards a more efficient framework for taxing housing (Box 2.1). By contrast, the Budget for 2007 moved modestly in the other direction by raising the ceilings for mortgage-interest tax relief for first-time buyers.[13] Recent measures to exempt first-time buyers from stamp duty, reduce it for others and introduce a more incremental schedule, however, will contribute somewhat to making the housing market more flexible and efficient; the impact of these measures is relatively small for the average house and totally exempting first-time buyers is most valuable to the few buyers able to purchase the most expensive properties (those worth in excess of € 635 000).

75. Ireland has achieved very high levels of ownership relative to most other OECD countries. However, this is partly due to the tax system, which generates strong incentives towards home ownership at the expense of renting and spending money on other things. The case for a more neutral tax system was discussed in the 2006 *Survey*. The high share of the average household budget spent on housing relative to other countries is indicative of the way the current system encourages people to spend more money on it. Given that the supply of housing in desirable locations is limited, much of the extra demand pressure leads to people paying more to live in the same houses. These incentives may encourage households to invest too much of their wealth in housing and not enough in other assets such as equities or a pension. Households would face less risk if they spread their wealth more evenly across different assets. The high level of house prices could also discourage migrants, particularly where there is competition for skilled workers who can easily choose to settle in another country where housing is more affordable. High levels of stamp duty and unrecoverable costs associated with moving house may reduce the mobility of workers between different parts of the country. A deeper rental market could also ease cyclical pressures in the housing market by making it easier for households to switch at the margin between the two types of accommodation.

76. Spending on housing support for people with low incomes is largely directed towards capital expenditure and building new social housing.[14] The Affordable Housing scheme also involves building homes for those with low incomes to buy. Combined with the generosity of the Affordable Housing scheme and the tenant purchase scheme for existing social housing tenants, this policy strongly favours home ownership. Although there may be reasons for looking favourably on owner-occupation, Ireland already has one of the highest rates of home ownership in Europe and households should be free to choose the most appropriate form of housing tenure for their circumstances, rather than facing a skewed choice. Furthermore, the current system provides support to a relatively small number of people at a very high cost as it is very expensive to build houses to sell at a discount. It can also be difficult to allocate scarce new public housing to the people who need it most. Moving to a system of means-tested housing [redacted] or vouchers, that households could use either to pay a mortgage or rent, would be desirable. The low marginal tax rates in Ireland increase the scope to introduce such an element of means testing.

[redacted]

Box 2.1. **Reforming taxation of housing**

Many countries find it difficult to reform the taxation of housing but no other OECD country has kept such a range of favourable tax treatments of housing as Ireland. It is a sensitive issue because a house is for many households the most valuable asset, particularly in a country that has one of the highest rates of home ownership in the OECD. There are also benefits to home ownership as it gives people more of a stake in the areas where they live. There is an understandable reluctance by policymakers to change housing taxation at a time of weakness and instability. Tax measures introduced in Ireland in 1998, for example, led to a sudden sharp fall in house prices and were reversed in subsequent budgets. However, it would be beneficial to make tax policies towards housing more efficient both to reduce the likelihood of boom-bust cycles and to make the economy more competitive. It would be desirable to begin to act soon before another boom begins.

The least distortionary system for taxing housing, the most consistent with the way other assets are taxed, would be to tax the imputed rents on housing and treat capital gains on owner-occupied housing in the same way as for other assets, preferably using a scheme that avoids the risk of accumulating a large liability when the property is sold. Under such a system, mortgage and other costs relating to a house should be tax deductible. No OECD country applies this system. Other countries that once effectively did not tax housing like Ireland have, however, made reforms that make their tax systems less distortionary.

Some countries reformed taxation on housing by removing the tax deductibility of mortgage [redacted]. Germany (1987), France (1997/1998),[1] and the United Kingdom (2000). In the case of UK Mortgage Interest Tax Relief (MIRAS), this was scrapped in a number of separate changes over a long period of time. This limits the disruptive impact on the housing market and eases the political constraints. The first step in such a reform in Ireland could:

[redacted]

- Limit deductibility to first-time buyers in line with the stated objective of helping young people and families to buy their first home. The upper limit on relief to people who have owned a house for more than seven years is € 6 000 for a couple and € 3 000 for a single person. € 255 million was spent in 2007 on this relief to homeowners who had not purchased their house in the previous seven years.

- Reduce the number of years over which first-time buyers can claim more generous relief from the first seven years.

- Lower the annual ceiling on the generous relief for first-time buyers to € 16 000 for a couple and € 8 000 for an [redacted].

[redacted]

A useful strategy is to remove the tax deduction at a time when mortgage interest payments are set to fall, for example due to cuts in interest rates, to cushion the impact on the disposable incomes of families with mortgages. The reduction of interest deductibility could be made fiscally neutral by offsetting reductions in tax rates. At a minimum, a long-term commitment to freezing the ceiling for relief in nominal terms, as has been done in Spain, would slowly reduce the distortionary impact of the tax break.

An alternative approach is to raise other taxes on property to offset the interest deductibility. Denmark, Finland and Sweden raised or introduced property taxes on homeowners, although in some cases these taxes are rather low. This attempts to approximate a tax on imputed rents. This might also be desirable in Ireland for other reasons, such as recovering some of the gains to private property owners from the benefits of public expenditure on infrastructure that raises local property values.[2]

1. It was re-introduced in a limited way in 2007.

2. Development contributions are currently used in Ireland by local authorities to help to pay for public infrastructure servicing new developments, such as roads and sewerage. These are much more limited in scope than an effective property tax would be.

Box 2.2. **Summary of recommendations on the housing market**

- Set out a programme to eliminate gradually the bias towards home ownership in the tax system following the possible approaches identified in Box 2.1.
- Introduce a property tax to fund local infrastructure and services. This would broaden the tax base and redistribute some of the windfall gains from those who benefit from living close to public infrastructure projects.
- Social housing policy should become less reliant on direct provision of public housing and provide more assistance through housing vouchers and/or income support.

NOTES

13. The ceiling for rent relief was also raised to € 2 000 for a single person and € 4 000 for a couple aged under 55, which is one-fifth of the ceiling on mortgage interest tax relief. This illustrates how both housing in general and owner-occupation in particular are favoured by the tax system.

14. Under the National Development Plan (NDP), € 18 billion is provided for social and affordable housing programmes and only € 3 billion for rent allowance schemes.

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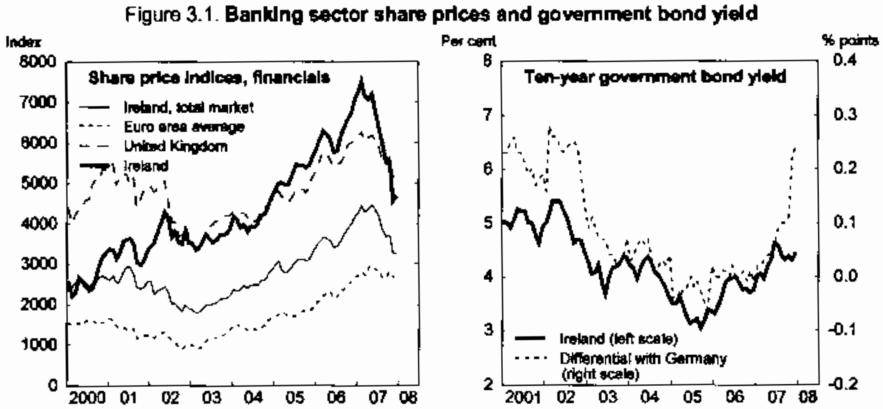
CHAPTER 3. FINANCIAL STABILITY: BANKING ON PRUDENCE

The property boom was accompanied by a lending boom, with debt ratios reaching very high levels. The Financial Regulator had clearly identified the major vulnerabilities and taken action to mitigate them. Prior to the downturn in the housing market and the international financial market turmoil, the Irish banks were well-capitalised and very profitable, which provides a cushion to weather the more difficult times ahead. This chapter reviews financial market developments, the actions by the financial market supervisor and the new policy issues that have come to the fore with the financial market turmoil.

77. The Irish financial markets have grown very fast since the turn of the century. Domestic bank lending has risen by about 25% annually, double the rate in the euro area as a whole. Stronger competition has reduced interest margins, to which banks reacted by cost cutting, while lending was spurred by the property boom. Property-related lending (residential mortgages, commercial property and lending to construction companies) now accounts for more than half of the stock of bank lending. Deposit growth has not kept up with lending growth. An increasing share of lending was funded by the issuance of securities and by borrowing from other financial institutions, with nearly half coming from UK banks. At 60% in mid-2007, Ireland is the country with the lowest deposit-to-credit ratio in the European Union.

78. Prior to the weakening in the Irish housing market and the recent international financial market turmoil, the Irish banks were in great financial shape: they had the highest rate of return on assets in the euro area, while non-performing loans to total loans had fallen to 0.7% in 2006, from 1% in 2000. Moreover, the ratings of Irish banks by rating agencies are among the highest in the euro area. The financial share price index on the Irish Stock Exchange had more than tripled between 2000 and 2006. It then fell sharply and the decline was much larger than in the euro area on average (Figure 3.1). How jittery financial markets have become with the recent financial market turmoil is illustrated by the fact that the government bond yield differential with Germany has gone up in late 2007, though Ireland's government net debt position is much better than that of Germany.

Figure 3.1. **Banking sector share prices and government bond yield**



Source: Datastream and European Central Bank.

From the property boom to financial market turmoil

79. Since May 2003, the financial industry has been supervised by the Financial Regulator (before April 2006 the Irish Financial Sector Regulatory Authority). It is placed inside the central bank as an autonomous entity, which ensures close co-operation between the two. The main tasks of the Regulator are to provide a sound regulatory environment that facilitates competition, to protect consumers and to foster a stable financial services industry (Financial Regulator, 2006). In addition, it is at the forefront of implementing EU financial market directives. It regulates banks, insurance companies, investment and retail intermediaries, stockbrokers and collective investment schemes, including also those operating in the IFSC.[15] Non-deposit lenders, which issue sub-prime mortgage loans are not regulated.

80. The Regulator had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities (CBFSAI, 2005 and 2006). The private sector debt-to-income ratio had reached 216% of GNI by the end of 2006, up from 100% in the late 1990s. It is among the highest in the European Union. The speed of increase was an additional concern. It noted that, notwithstanding the strength of the banking system, a correction in house and commercial property prices if it were to be combined with a significant increase in arrears, could pose significant difficulties for the health of the banking system. It also highlighted the over-concentration of income and loan books to property-related business,[16] falling net interest margins, a reduction in the forward-looking element in provisioning[17] and a widening funding gap as adding to the vulnerabilities. The funding gap is largely made up by the issuance of securities and borrowing in the interbank market. The widening of the gap is of concern, because wholesale funding is more expensive than retail deposit-funding, thereby reducing profitability, and wholesale funding is generally more sensitive to confidence shocks than deposit-based funding. Liquidity risks are mitigated by the significant medium-term maturity element of many of these liabilities as well as the relatively wide range of funding options available to the domestic banking sector. On the other hand, the Regulator judged that risks arising from the insurance sector were very low.

81. Against the background of the construction boom and the sharp rise in lending, the Regulator took several actions:

- Because of the decline in general provisions and the persistently high growth rate of mortgage lending, it increased the risk weighting on high loan-to-value mortgages for owner-occupiers and for exposures secured by properties that are not occupied by the borrower to increase the capital cushion. It also raised the risk weight applied to speculative commercial real estate lending in Ireland.
- It introduced new liquidity requirements for credit institutions. Rather than focusing on the stock of liquid assets the new regime is based on a forward-looking mismatch approach under which cash flows are assigned to relevant time bands.
- It started implementing a new Consumer Protection Code, which came fully into effect in July 2007. It is legally binding and comprises general principles supplemented by more detailed rules, which regulated financial service providers must obey. It also published Minimum Competency Requirements for persons who provide advice on or sell retail financial products. More recently, legislation was passed that addressed concerns by the Regulator that non-deposit- taking sub-prime market lenders and firms providing home reversion loans or personal loans were not falling under the new Consumer Protection Code and the Minimum Competency Requirements.
- The Central Bank and Regulator initiated stress testing not only for credit,[18] exchange rate, interest rate and equity-related risks, but also for liquidity risks (Kearns, 2006). Concerning the

latter, the Stability Reports now include a test for a decline in deposits and in the value of certain liquid assets. On the other hand, the Reports have underlined the limits of stress testing and that behaviour could change in circumstances where uncertainty increases significantly and rapidly.

82. The significant slowing in house prices and subsequent decline since mid-2007 has eased a key concern as it brings house prices closer to fundamentals, while housing affordability is improving and repayment burdens on new loans are stabilising (CBFSAI, 2007). Moreover the rate of debt accumulation by the household and non-financial corporate sector has eased substantially. On the other hand, housing permits and commencements have plummeted. This is probably reinforced by the buy-to-let market. Since 2004, it has risen very rapidly, with 26% of mortgages outstanding being attributed to investors in June 2007. Investors have relied heavily on capital appreciation for their returns in recent years, while rents have risen little. New investors are facing a shortfall in terms of covering their mortgage obligations with rental income. Those who have invested in mid-2007 face an estimated shortfall of 36%. A faster increase in rents and, for new investors, lower house prices have started to lower this shortfall.

83. The commercial property market has also been booming. As growth in capital values has been very strong until recently, outpacing the increase in rents, yields on commercial property investment have been compressed and are now low in international comparison (Woods, 2007). Capital value growth has eased considerably during 2007, though still rising at a brisk pace in the third quarter of 2007. Investment in the Irish property market is likely to be much weaker in 2008 than in 2007. Irish banks have also provided funding for property investment in the UK property market, which has also weakened considerably. International experience suggests that commercial property busts tend to have greater consequences for the stability of the financial system than a sharp downturn in house prices. Indeed, stress testing involving a severe shock has shown that there is likely to be a larger deterioration in asset quality for commercial property-related lending than for residential mortgages.

84. The high overall share of property-related lending implies a considerable vulnerability to a shock to the sector. Following a shock, banks might find that the performance of the loans is correlated and asset quality could deteriorate in many loans. An additional risk is that price changes in these markets are correlated, which has indeed been the case. Moreover, price cycles have been highly correlated across countries in recent years, so that international diversification could aggravate rather than mitigate risks going forward. While Irish banks earn a significant share of their profits in other countries, the majority of foreign earnings are made in the United Kingdom (Kearns, 2007). On the other hand, the health of the banking sector has remained robust, when measured by a range of indicators and the results of stress-testing exercises.

85. International financial market turmoil has raised funding costs in an environment of already low net interest margins and slower lending growth.[19] Lending standards have tightened considerably and all these factors together could reduce banks' willingness to supply loans. Since August 2007, there has been little effect of higher interbank rates on interest rates for new loans for house purchases as margins are tied to the ECB's main refinancing rate. There has been a slight increase in the average interest rate on existing mortgages (10 basis points) and a further small increase in December. Rates of new business loans have gone up by more (nearly 40 basis points). While difficult to gauge, banks are likely to ask for more documentation and collateral when providing loans.

Policy issues and responses

86. The financial market turmoil has brought a number of policy issues to the forefront (Hurley, 2007 and ECB, 2007). The liquidity freeze is partly blamed on a lack of transparency in banks' exposure to the sub-prime market and credit lines extended to structured investment vehicles, hedge funds and private

equity. A survey undertaken by the Regulator (Doheny, 2007) indicated that exposure to the sub-prime market was low, with the Irish sub-prime market representing only 2.3% of new mortgages issued in 2006. Only one bank had established a special purpose vehicle in order to engage with the sub-prime market, while banks' investment in residential mortgage-backed securities is small. Exposure to hedge funds was also found to be small. Exposure to the private equity sector is more substantial, although it still accounts for a small percentage of total assets. Moreover, the update of Irish banks on their performance to September 2007 did not include any large write-downs. The Regulator's initiative in enhancing transparency is clearly welcome and should be a regular feature. The Regulator also participates in a euro area-wide project that will establish a register of Financial Vehicle Corporations, of which an estimated 600 operate in Ireland, and is monitoring the issuance of Commercial Paper. Unfortunately, to date such initiatives have not reassured markets sufficiently and share prices of financial institutions have not recovered.

87. Given the liquidity problems in the interbank market and despite establishing that liquidity risks are low in the stress-testing exercises, the Regulator has asked banks to draw up weekly liquidity contingency plans that have to be reported to the Regulator to ensure that illiquidity, rather than insolvency does not get a bank into difficulty. The close monitoring of the situation also involves regular information-sharing meetings between the central bank, the Regulator and the CEOs of the main financial institutions.

[redacted]

88. Rating agencies play an important role in risk analysis of complex structured products. However, they face potential conflicts of interest as they are being paid by those whose products are being rated and also provide consulting services on structured products that they are rating. Moreover, a more differentiated scale of ratings may be appropriate. Such issues will be considered in an international context and the Regulator takes part in the deliberations of the relevant EU and other international committees.

89. In the Irish deposit insurance scheme depositors may be compensated 90% of their deposits up to a maximum of € 20 000. This is the minimum required by the EU's Deposit Guarantee Schemes [redacted]. The same amount is guaranteed by many other EU countries, though the guarantee is much higher in the United States where more than $100 000 is covered. The UK authorities have recently announced that the UK guarantee will rise considerably from an already high level, following the bank run on Northern Rock. The Irish scheme is funded *ex ante* by a levy of 0.2% on deposits and currently the fund contains € 400 million. All insurance schemes lead to moral hazard problems so that finding the right amount of deposit insurance is difficult. The optimal coverage is that which will keep depositors whose losses create political sympathy "at home and off the streets" (Kaufman, 2007). More would reduce effective monitoring and disciplining of the banks by depositors competent to do so, though the evidence for the latter actually occurring is thin. More importantly perhaps than the size of the guarantee is that arrangements are in place that give depositors near-immediate access to the par value of their insured deposits, which is the case in the United States, but not in Ireland and most other European countries. In Ireland, the scheme must be in a position to pay within three months of the central bank determining that a credit institution is unable to repay deposits or a court suspending the depositors' ability to make withdrawals. In exceptional circumstances, the scheme may have up to three extensions of three months in line with the European directive. The scheme is obliged to pay out as expeditiously as possible and is not required to wait for three months before payment. Liquidity concerns could still be an important consideration for depositors in withdrawing deposits. Moreover, the fund is small, which could be an additional consideration.[20]

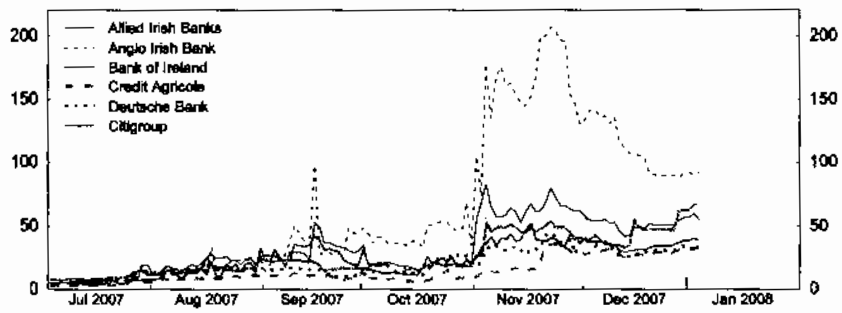
90. Bank insolvencies are rare in Europe, though 1% of all banks in the United States fail per year, which is a considerable number of banks. In Europe, bank failures are covered under general bankruptcy proceedings, which can drag on for some time. In the United States, there is a separate bankruptcy and administrative process for banks and the regulator has legal closure authority (Eisenbeis and Kaufman, 2007). It closes a bank when its equity capital to total balance sheet assets drops below 2%, so that losses

are confined to shareholders. While a failing bank is legally closed, it is kept open physically, either by bringing in another bank quickly or by operating a newly chartered bridge bank. The aim is to have the bank operating again the day after the legal closure. This has helped to avoid bank runs and has minimised the pay-out from the deposit insurance fund. At the same time, moral hazard issues are also limited because banks do fail.

Conclusion

91. The Financial Regulator is a highly respected institution and got high marks in IMF reports on the regulatory system. It has well identified the major financial stability issues and has urged lenders and borrowers to behave in a prudent way. At the same time it has taken regulatory action to reduce risks, has introduced a new Consumer Protection Code, which has helped to avoid predatory lending practices that have occurred elsewhere and has taken measures to enhance the transparency of financial markets. And with fortunate timing, it introduced a forward-looking liquidity regime just before the financial market turmoil struck. In addition, rapid growth has provided extensive earnings opportunities for Irish banks, reducing their incentives to engage to a large extent in more high-risk investment strategies, and they have remained profitable and well-capitalised. But financial market turmoil is not over yet. The share prices of banks have continued to tumble and credit default swap rates are still above those in the early part of 2007 (Figure 3.2).

Figure 3.2. **Credit default swap rates**[1]
One-year senior bonds



1. The reported rate indicates the cost of insuring senior corporate bonds against default. It is measured in basis points. One-hundred basis points implies that it costs € 100 000 to insure debt of € 10 million.

Source: Datastream.

92. Any assessment of the situation can, of course, only be tentative. There is no generally accepted definition of financial stability, or of its converse of financial instability. Regulators can be transparent in the sense of publishing work, assessments and decisions. But financial stability is usually perceived as a negative concept, involving the absence of something unwanted, an extreme event that has not happened yet and the likelihood of which is unknown (Goodhart, 2006). In that sense, those involved in prudential supervision can only keep the shock-absorption capacity of the financial system strong, but also have to be prepared for the worst.

93. The recent financial market turmoil has tempted some to advocate a move into regulatory overdrive. This is not the way to go. The costs and benefits of regulatory steps need to be carefully weighed. Over the past two decades, financial innovation has flourished in an environment of macroeconomic stability; it has reduced liquidity constraints, new credit products suit a wider range of borrowing needs and it has helped the spreading of risks. It is important to secure these benefits, though the recent financial market turmoil has brought some new issues to the forefront. Tackling these, while

remaining vigilant about financial market developments, should keep the Irish financial markets well managed.

Box 3.1. Summary of recommendations on financial stability

- Enhance transparency further by regularly surveying off-balance sheet exposures of banks.
- Improve stress testing further. In this respect, the Central Bank and the Regulator have established a work programme that, *inter alia*, follows up on suggestions by the IMF's FSAP report.
- Rating agencies are likely to improve the services they offer, but there may still be a need for public sector intervention to ensure higher and common standards of assessment and disclosure.
- Consider making pay-outs from the deposit guarantee scheme faster and increase the guarantee [redacted].
- Implement an insolvency procedure specifically adapted to [redacted].

NOTES

15. The total assets of IFSC banks are about as large as those of the domestic banks. But the links between the IFSC institutions and the domestic Irish financial market are limited in terms of providing credit to Irish residents or taking deposits from them. Also interbank borrowing between them is limited. However, IFSC banks could be an important counterpart for domestic banks' credit risk transfer activities, and domestic banks could hold securities issued by IFSC banks (see Box F in Central Bank & Financial Services Authority of Ireland, 2006).

16. In mid-2006, property-related lending was 60% of total lending. In the United Kingdom it was 42%.

17. General provisions are being phased out, because of new International Financial Reporting Standards. These provisions are made against inherent but unidentified losses in the loan book.

18. In October 2007, the Regulator issued revised guidance on stress testing with respect to residential mortgages. Credit institutions should stress test mortgages at 2% above the ECB's minimum bid rate plus a margin of 0.75%; interest only mortgages should be tested on the basis of repayment of interest plus principal; the outcome of the test should inform the decision to grant a loan; and stress testing should be incorporated into the credit institution's credit policy which should be approved by the board. Moreover, the liquidity stress tests have been modified to take into account the new liquidity regime.

19. Financial market turmoil is discussed in a broader context in OECD (2007) and ECB (2007).

20. In the case of a large pay-out, credit institutions can be obliged to make additional lodgements within seven days.

[redacted]

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CHAPTER 4. ADAPTING GOVERNMENT SPENDING TO LOWER REVENUE GROWTH

The softening of economic growth and turnaround in the housing market has marked a turning point for fiscal policy. Strong revenue growth in earlier years financed a massive expansion of government spending and some cuts in tax rates, while still allowing the government to run a substantial fiscal surplus. This left the public finances in a healthy state with net government debt declining to a very low level. But this benign picture is changing as growth slows and tax receipts increase more slowly. Substantially slower growth in expenditure is needed. The challenge is to improve public services further without large increases in resources. In these circumstances, it will be even more important to get better value from public spending and to accelerate public management reforms.

94. Fiscal performance was strong in the years up to 2006 as strong revenue growth outpaced the sharp increase in public spending. Government receipts had risen by close to 50% in real terms in the previous five years, somewhat faster than national income, and this sustained an almost equally large increase in public spending as well as allowing debt to be repaid. But the fiscal balance deteriorated rapidly in 2007 as revenue growth weakened with the general government surplus falling to around 0.5% of GNI, down from 3.4% the previous year. The growth of tax revenues halved, partly due to the weakening of the housing market (Table 4.1).[21] This reflects underlying changes in taxation that play an important role in determining the fiscal outlook and risks. Expenditure growth is set to slow to reflect weaker revenue growth: it is crucial that this is achieved. A small fiscal deficit is likely in the coming years but the underlying fiscal position remains sound, although the budgetary situation is more challenging than in recent years. To meet demand for public services, it will become increasingly important to raise efficiency as the scope to raise spending narrows.

Table 4.1. **General government fiscal position**
Percentage change on previous year

	2001	2002	2003	2004	2005	2006	2007[1]	OECD forecasts 2008	2009
Total receipts	4.4	7.8	10.4	9.6	9.3	13.4	6.1	3.0	5.4
Taxes	2.7	7.2	10.7	10.5	10.2	14.8	5.7	2.6	5.6
Personal	4.3	-4.0	12.7	13.2	9.3	14.9	10.5	5.2	6.1
Business	5.7	15.9	8.0	2.8	3.2	21.5	-15.8	-9.6	3.0
Indirect taxes	0.7	13.2	10.2	11.0	12.7	13.0	8.3	3.4	5.7
Social security contributions	12.2	10.1	9.3	9.6	10.2	10.8	9.1	5.2	5.8
Expenditure	16.7	12.2	7.4	7.1	9.9	8.1	13.7	7.6	5.7
Memorandum items									
General government net lending (% of GNI)	1.2	-0.5	0.6	1.6	1.4	3.4	0.6	-1.2	-1.3
Saving (% of GNI)	5.2	3.3	3.6	4.4	4.2	6.6	4.6	2.7	2.4
Gross debt (%GNI)	44.0	42.3	39.4	38.5	37.8	34.7	34.8	36.6	38.4
Expenditure per person (thousand €, 2007 prices)	11.94	12.58	12.86	13.36	14.00	14.40	15.20	15.78	16.38

1. OECD forecasts based on *Economic Outlook 82*, but updated to include later information on the fiscal position, including the Budget for 2008. The impact of discretionary policy changes on the forecast is small.

Source: OECD (2007), *Economic Outlook 82 database*, Department of Finance, *Budget 2008*, and OECD calculations.

Tax revenues are less robust

95. Revenue growth slowed sharply in 2007 and is expected to be weak in 2008. This slowdown has partly been driven by an unexpectedly sharp fall in stamp duty receipts as housing market activity has dropped. The Budget for 2007 included a number of measures to lower taxes on income by enhancing tax credits, raising standard rate bands and reducing the higher rate of income tax by 1 percentage point to 41%. The Budget for 2008 contained few discretionary measures other than to adjust credits and allowances to keep low earners out of the tax net and average earners below the higher rate of income tax, and a reform to the stamp duty regime for houses. Further ahead, revenue growth will pick up but, as the economy expands more slowly, will remain at around half the rate of recent years.

96. These developments are shaped by a profound shift in the composition of tax revenues. There has been a move away from incomes taxes and social security contributions and towards indirect taxes and taxes on capital (Table 4.2). For example, stamp duty revenues rose from € 0.4 billion in 1995 to € 3.1 billion in 2007 to represent around 5% of total revenues. These growing revenue streams are more volatile than income tax or social security contributions (Figure 4.1). This reflects two factors. Firstly, these tax revenues often respond very strongly to movements in the underlying tax base. For example, firms can offset losses against corporation tax and this can make receipts very sensitive to changes in corporate profitability. Secondly, the underlying tax bases are more volatile than GDP. In the case of stamp duty, this is levied on the value of housing transactions which is very cyclical as the number of houses being sold and house prices tend to move in the same direction. Estimates suggest that a 10% fall in house prices and 20% fall in the volume of transactions might reduce stamp duty revenues by around 0.5% of GNI. In some ways, the growing importance of these taxes weakens the relationship between tax receipts and GNI and diversifies government income, which could make it on average less cyclical. There are also times, however, when these factors can align to create a "perfect storm". In 2006, a strong economy and booming housing market boosted revenues but a weak economy combined with a housing correction could create an opposite large shortfall in revenues. The more volatile nature of receipts needs to be taken into account in making judgments about the appropriate stance of fiscal policy.

85% of tax revenue still comes from the Big 4.

Table 4.2. **The composition of tax revenues has changed**
Share of revenue

		1995		2007	
Income tax and social security		44.3		37.40	
Corporation tax and taxes on capital		9.1		16.41	87.64
Excise duties	88.1	15.4		9.66	
VAT		19.4		24.17	
Stamp duty	11.8	2.1	12.37	5.31	
Other		9.7		7.06	

Raise CT from 10% to 12½%.

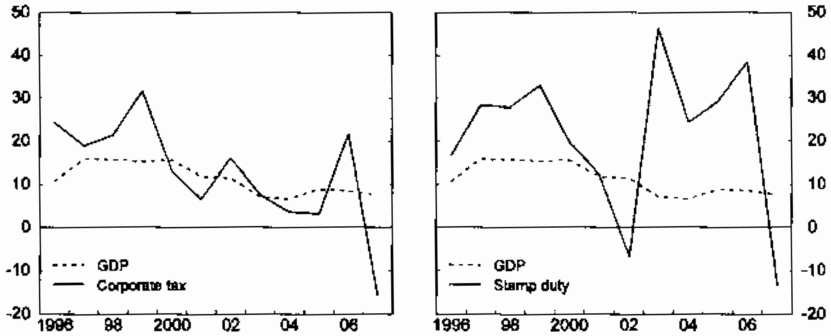
Source: Central Statistics Office, *Annual Income and Expenditure Tables, Department of Finance, Budget 2008, OECD calculations.*

97. Over the longer term, some tax revenue items could undergo a structural decline. In particular, VAT receipts from new houses and stamp duties on housing market transactions will tend to weaken as the housing market completes the "catching up" process of bringing the housing stock up to standard. Furthermore, over half of corporation tax receipts are paid by foreign firms or those active in the IFSC. This is equivalent to 1.5% of GNI. This tax base is highly mobile across borders and it would be relatively easy for these profits to move elsewhere and for tax revenues to decline. Although the authorities remain committed to keeping the tax system attractive for foreign companies, the relative benefits of locating in Ireland depend in part on tax policy in other jurisdictions. The average statutory corporate tax rate has come down considerably in the European Union in recent years and several countries have announced further cuts.

over state tax factor

Supports Argument bottom.

Figure 4.1. **Corporation tax and stamp duty revenues**
Percentage change



Source: Central Statistics Office, *Annual Income and Expenditure Tables;* OECD (2007), *Economic Outlook 82 database* and OECD calculations.

98. The tax system continues to create substantial distortions and a large amount of revenue is foregone due to tax expenditures. For example, a range of tax expenditures remain in place that together have been estimated in the past to be worth around a quarter of current expenditure.[22] Following a review in 2005, several property-related tax reliefs were phased out and a cap placed on the total amount that could be claimed by individual taxpayers. The strong bias towards home ownership and owning property remains and has been modestly reinforced by increasing the ceiling for mortgage interest deductibility, despite the clear advantages of moving towards a more neutral tax system discussed in Chapter 2. The lowering of average stamp duties on residential properties, streamlining of the schedule and exemption of first-time buyers introduced in recent budgets are welcome and should increase mobility as well as giving a boost to housing-market activity, although the tax saving of around € 5 000 on an average property represents less than 2% of its value. Many other tax reliefs remain, despite the phasing out or capping of various measures in 2006. Six more were introduced in the Budget for 2007. As argued in the 2006 *Survey*, these tax expenditures distort economic activity and contribute to lowering the effective tax rate on the highest earners, as these reliefs are typically worth more to them. Data are only currently available for 2003, predating more recent reforms, but these show that one-third of the 400 highest earners had an effective tax rate of less than 25%. A Commission on Taxation is being established with a mandate that includes examining the overall role of different types of tax, the efficacy of tax expenditures, the financing of local government and the introduction of a carbon tax. The Budget for 2008 already contained measures to reduce pollution through the tax system by linking carbon-dioxide emissions to Vehicle Registration Tax and capital allowances and expenses for business cars, in addition to making motor tax rates depend on engine size.

TER is expend only for certain people.

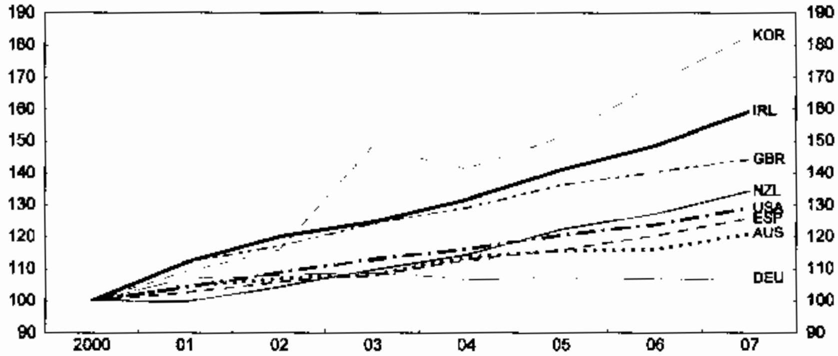
Horizontal Measures cap the Benefit

Government spending is likely to slow

99. Public expenditure increased by around 15% in nominal terms in 2007. Spending growth is expected to moderate in 2008 as a stepping stone to annual growth of around 5-6% in later years. This requires a substantial change of pace after the rapid increases in earlier years: the growth of government expenditure from 2000 to 2006 was second only to Korea in the OECD (Figure 4.2). Such large and sustained increases in public spending have rarely been experienced in developed countries since the

1960s. Although the pace of growth will be very much lower than in recent years, the rate of expansion will still be faster than in most other euro area countries.

Figure 4.2. **Real expenditure has expanded rapidly**
Cumulative growth since 2000



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

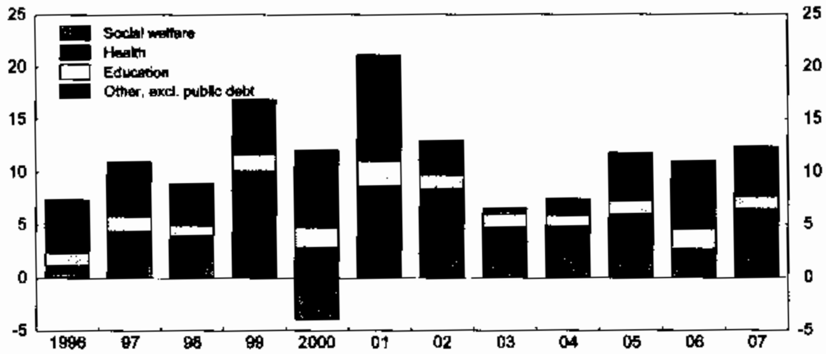
100. Investment has been given priority over current expenditure, particularly through the commitment to implement the programme for € 184 billion of government spending in the NDP 2007-13. The main priorities for NDP spending are improving the economic infrastructure and reducing social exclusion, although substantial funding is also envisaged for enterprise and innovation, increasing human capital, and the social infrastructure. Around € 100 billion of the package relates to infrastructure spending. The 2006 five-year rolling envelope for capital spending, which actually extends to 2013, implied further increases in the share of GNI devoted to public investment. This is already one of the highest rates of public investment in the OECD, on a par with Spain and only below Korea, Mexico and the Czech Republic. The Budget for 2008 brought forward investment relative to earlier plans, particularly for public transport projects and road building. Capital expenditure growth will slow sharply after 2008 but a high level of public investment will be maintained as set out in the NDP. In contrast to previous national development plans, the role of EU funding will be negligible as Ireland is no longer among the European Union's lower income states.

101. Current expenditure growth has also expanded rapidly, albeit at a slower pace than investment since 2006. This is expected to moderate over the coming years. Increases in current government expenditure in the Budgets for 2007 and 2008 were broadly based. The main discretionary changes were to raise the level of the state pension and to provide more generous social benefits in real terms. These have raised the contributing state pension from € 193.30 to € 223.30 per week for a single person, raised child benefit from € 150.00 to € 166.00 and increased the basic rate of benefits for adults under a variety of schemes from € 165.80 to € 197.00.

102. This comes against the background of rising benefit levels and greater funding for healthcare that have been key factors behind the rising share of government expenditure relative to GNI in recent years (Figure 4.3). In real terms, current expenditure on social services such as health and education increased by a quarter between 2004 and 2007.[23] The government increased *basic benefits* (such as the unemployment benefit) by 18% in real terms between 2005 and 2007 and largely achieved its goal of raising the benefit to 30% of the average wage. In the *Social Partnership Agreement* the government commits to maintaining this level over the long term, although it is unclear whether this is in real terms or as a share of the average wage. The sustainability of long-term commitments should be scrutinised in a clearer framework for the

objectives and level of social benefits (Chapter 5). As social welfare payments have become more generous, the design and administration of benefits needs to take more account of the adverse impacts on labour supply. It is striking that one-fifth of the working-age population receives some form of income support, despite the dynamism of the economy, an unemployment rate close to 5%, and a young population.[24] Funding for long-term care has been reformed. From 2008, care recipients will be entitled to the same financial assistance no matter whether they are in a public or private long-stay bed. They will continue to pay fees but will pay no more than 80% of their disposable income up front. If user charges exceed this level, the rest is charged against the value of the person's home and will be paid back when the estate is settled (up to a maximum of 15% of the value of the house).

Figure 4.3. **Main components of higher public spending**
Contributions to annual government spending growth, per cent



Source: Central Statistics Office, *Annual Income and Expenditure Tables*; Department of Finance, *Budget 2008* and OECD calculations.

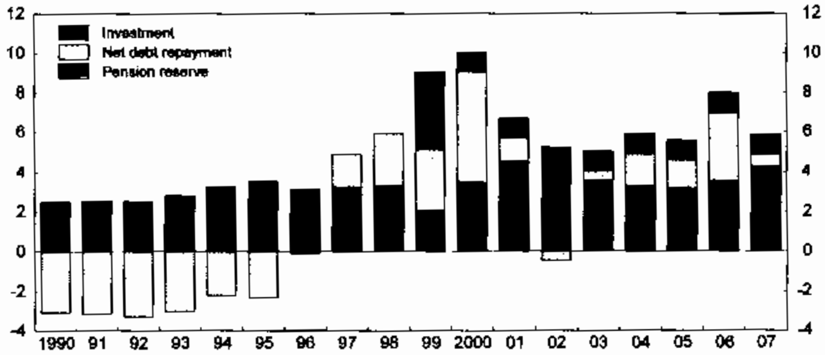
Fiscal performance has remained sound but is weakening

103. In recent years and up to 2006, there was an operating surplus of receipts over current expenditure that has largely been used to improve public infrastructure (Figure 4.4), although some was paid into the National Pension Reserve Fund (NPRF) to cover future pension costs (Chapter 5) and a small part was used to pay down government debt. The fiscal surplus narrowed sharply by around 2 percentage points of GNI in 2007 as revenue growth slowed sharply but expenditure increased at a double-digit rate. Spending growth is anticipated to moderate in 2008 but will remain well above the increase in receipts. The Budget for 2008 anticipates a deficit in coming years of around 1% of GNI. The increase in the deficit is stronger than implied by past relationships which suggest that the primary budget surplus would fall by around 0.4-0.5% of GNI for each 1 percentage point reduction in output relative to potential (Girouard and André, 2005). This shortfall is partly due to an unexpectedly sharp fall in revenues related to property. Although recent Budgets have been prepared on conservative assumptions about economic growth and have included a sizeable General Contingency Provision to deal with an unexpected deterioration in the fiscal balance, the sharp rise in expenditure in 2007 was ill-timed given developments in revenue and the targeted slowdown in expenditure for 2008 only closes part of the gap to the growth rate of receipts. Spending in recent years has tended to overshoot budget targets, increasing by 0.5% of GNI in 2007 more than anticipated. The rapid increase in spending and budget overruns are less serious to the extent that they relate to productive capital investment, which will yield a future social return and where the timing of expenditure on projects can be difficult to predict, but some is due to higher-than-expected current spending. It is important to avoid boom-and-bust cycles in spending. A multi-year framework for current

expenditure should be adopted as in many other countries to avoid sharp changes from year-to-year and excessive spending growth at times of buoyant revenues.

Figure 4.4. **Savings have been invested**

As a percentage of GNI



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

104. The updated *Outlook* projection shows a further weakening in the fiscal balance in 2008 to a deficit of 1.2% of GNI: receipts continue to fall as a share of national income over the forecast horizon but expenditure growth does not fall below income growth until 2009. The scenario of a manageable deterioration of public finances, however, is surrounded by major uncertainties. Tax revenues have become less predictable and more dependent on hard-to-forecast factors such as the housing market and corporate profitability. At the same time, there are major commitments to increase government spending and many years of strong expenditure growth may be hard to reverse. This creates a large risk to the soundness of government finances if revenue falls below expectations and expenditure does not adjust (Box 4.1).

Box 4.1. **Uncertainty around the fiscal balance as the economy slows**

The budget balance is inherently hard to predict. During a slowdown, the lull in economic activity leads to a slowdown in tax revenues but spending tends to rise as more people claim social benefits and as discretionary fiscal policy is used to stimulate demand. Forecasts often miss the scale of such effects. This can lead to a large and unexpected deterioration in the budget balance.

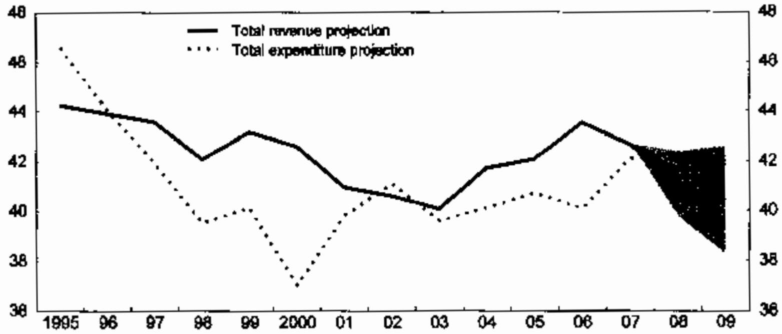
There are a number of standard approaches to assessing the outlook for government finances. It is common to try to identify "structural" and "cyclical" components of the fiscal balance, either based on a "bottom-up" evaluation of how different tax revenues vary with the cycle given how the tax system is constructed (Girourard and André, 2006) or using "top down" econometric analysis of how tax receipts have varied with GDP or the relevant tax base (Morris and Schuknecht, 2007).

Projections show that tax revenues are likely to decline as a share of national income (Figure 4.5), leading to a fiscal deficit as the share of expenditure does not contract. This slowdown in revenue is broadly in line with Girourard and André (2006), although the exact timing is influenced by the particular characteristics of this economic slowdown. The uncertainty around all these forecasts is large. Figure 4.5 gives an indication of revenue uncertainty based on a simple econometric model that allows for the difficulty of forecasting several different taxes and their respective tax bases. For example, a forecast of housing transactions is used to predict stamp duties but there are unknowns in predicting both the tax base and the resulting revenue. This basic approach suggests that there is a substantial risk that revenues will fall more sharply than anticipated and that there will be a larger-than-forecast deficit if expenditure does not adjust.

Box 4.1. **Uncertainty around the fiscal balance as the economy slows** *(cont.)*

Figure 4.5. **A larger fiscal deficit is a risk**

As a percentage of GNI



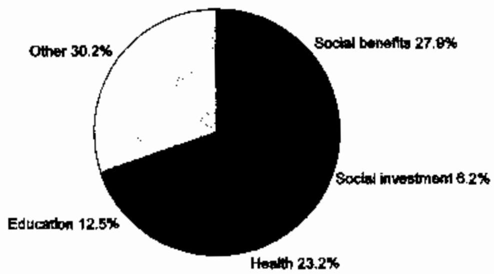
Note: The shaded area shows indicative one standard error bands around the revenue projection.

Source: Department of Finance, Budget 2008; OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Such a shortfall in receipts would weaken the fiscal balance. The overall impact would depend on how government expenditure is managed. The government is committed to capital spending as part of the five-year envelopes and has said that the NDP will have priority in terms of government spending in coming years. Public expectations for better healthcare and education are running high. Figure 4.6 suggests that there is little room for manoeuvre on the spending side because the share of spending that is not related to major government priorities or commitments is small. A relatively large change in other elements of government spending would be needed to offset the growth in these priority areas. Furthermore, the wage bill is around two-thirds of current spending which highlights the importance of controlling public sector wages. Given the vulnerability of government revenues and the size of commitments on public expenditure, great vigilance is required in setting fiscal policy.

Figure 4.6. **Spending is heavily committed to priorities**[1]

Per cent of total spending, 2005



1. Social benefits include social security and welfare payments and housing (excluding investment). Social investment includes capital formation for transport, health, education and housing. Health and education refer to current spending. Shares of government spending exclude interest payments.

Source: Central Statistics Office, *National Income and Expenditure Tables.*

105. Ireland is committed to the EU Stability and Growth Pact as the medium-term fiscal framework to ensure sustainability. The anticipated fiscal deficit in the coming years would not compromise Ireland's commitments under the Pact, either in terms of the 3% of GDP limit for the actual deficit or the 1% cyclically-adjusted deficit that is allowed because of strong government investment. The Budget for 2008 anticipates a cyclically-adjusted deficit of 0.6% of GDP in 2010, giving some limited room for manoeuvre under the Pact. It is particularly important for Ireland, as a small member of a much larger monetary union, to maintain a sound medium-term fiscal position to allow the automatic stabilisers to operate freely as its particular circumstances will have little impact on how monetary policy is set. The cyclically-adjusted fiscal position has been relatively volatile compared with other OECD countries, which suggests the discretionary use of fiscal policy.[25] The Budget for 2008 usefully contributed to mitigating the impact of the slowdown in housing construction by reducing stamp duty, bringing forward infrastructure investment and raising social benefits. By contrast, the Budget for 2007 was overly expansionary and put additional pressure on the supply capacity of the economy over the past year when aggregate demand was already strong and which may eventually limit the room for manoeuvre in future years. Given that Ireland has a very open economy and a relatively low share of government activity in national income, which requires larger proportional changes in revenue and expenditure to achieve a given change in the government deficit as a share of GDP, the scope of discretionary fiscal policy to be effective is relatively narrow. As discussed in Chapter 2, a well-designed property tax could help to dampen the economic impact of housing cycles.

106. The medium-term position can be assessed with the cyclically-adjusted fiscal stance, which takes into account the estimated gap between actual output and the economy's long-run supply potential. Nevertheless, the rapid pace of economic growth in past years and the unexpectedly large inflow of migrants make the structural supply capacity of the economy hard to assess. Labour productivity growth of around 3% per year over the past five years offers a very different outlook for sustainable public spending growth than the average of over 5½ per cent annual growth in the late 1990s. Expansionary fiscal policy should not be used to stimulate demand if supply has in fact slowed. The 2007 Agreed Programme for Government, although giving priority to keeping low income earners out of the income taxation and average earners out of the higher band aims, also commits to abolishing the cap on Pay Related Social Insurance (PRSI) contributions and lowering the rate of employee contributions from 4% to 2%.[26] This would lead to a more rational and fair system, although such a low rate raises questions about the purpose of having such a tax at all and whether it is cost effective to administer. Once these commitments are met, the government aims to lower the standard rate and higher rates of income tax to 18% and 40% respectively by the end of the parliament if conditions allow. These tax cuts were not made in the Budget for 2008 and should only be considered if medium-term economic circumstances allow.

107. The long-term outlook for the public finances is relatively strong as Ireland has a very low level of public debt compared with most other OECD countries. The current fiscal settings would, however, eventually become unsustainable due to the pressures from ageing as shown in the 2007 Actuarial Review of the Social Insurance Fund. As discussed in Chapter 5, there are a number of options for dealing with the rising budgetary cost of pensions. These include greater pre-funding, increases in taxes and cutting back on other forms of spending, but changes to the pension system itself and encouraging adequate private pension saving must play a major role.

Additional resources should be used effectively

108. Despite the anticipated slowdown in government spending, the rate of public investment will remain high and the increases in government expenditure will be substantial compared with most other OECD countries. This makes it particularly important that additional resources are well used. The scale of additional government spending in past and future years puts pressure on the public sector's ability to manage the resources effectively and the economy's ability to deliver the additional services.

109. It is clear that Ireland has a need to improve its public service and infrastructure but it is important that the overall level of spending and the projects are a good use of limited resources. It is of concern that the NDP sets overall spending at a higher level than recommended by the Economic and Social Research Institute's (ESRI) *Ex ante Evaluation of the Investment Priorities for the National Development Plan (2007-2013)* on the basis of its assessment of how much additional investment the economy is able to deliver. The subsequent downturn in house-building may have eased this constraint but the Budget for 2008 also showed in any case a willingness to set investment levels in response to the economic conditions. Although the pressures from housing on the construction sector are weakening, it should not be taken for granted that this removes all supply-side limits to improved infrastructure as the two activities do not require exactly the same skills. At the same time, non-residential construction has remained firm and Ireland faces competition for construction capacity from the boom in the North and major projects elsewhere such as the London Olympics.

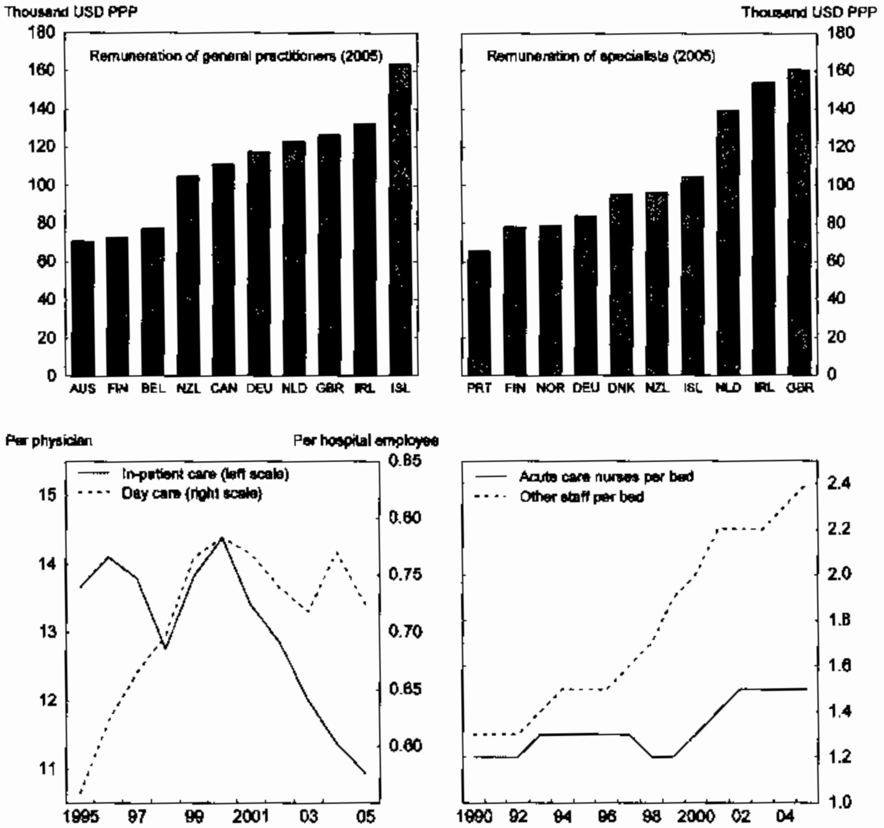
110. Higher wages have absorbed much of the increased funding in the past. In particular, the first Public Service Benchmarking Body (PSBB) report in 2002 recommended an overall increase in public service pay costs of 8.9% (PSBB, 2002), leading to a sharp relative increase in public sector wages. These pay increases were tied to the elimination of many inefficient working practices, such as the system of linking pay in different parts of the public sector, and a greater volume of output. In practice, progress is hard to evaluate: although reports were published that show compliance with the agreed changes in working practices, no evidence was made available to demonstrate that better outcomes had been achieved and changes in working practices were found to be acceptable in almost every case. Furthermore, doubts were raised even at the time about whether public sector wages were actually out of line with the private sector (O'Leary, 2002), The first benchmarking report did not produce clear evidence to justify its conclusions and the generosity of public sector pensions was not taken into consideration (Chapter 5).

111. By contrast, the second PSBB found that "in general public service salaries compare well with the private sector" and recommends a limited number of specific pay increases representing just 0.3% of overall pay costs. This is based on a wide-ranging and transparent analysis of how public sector wages compare with the private sector. It confirms other recent evidence, such as an estimated 7% public sector wage premium for recent graduates, even after allowing for underlying differences in the two sectors and more extensive use of bonuses in the private sector but without taking into account pensions or job security (O'Connell and Russell, 2006). Public sector pensions are estimated by the PSBB to be worth 12% of salary more than the private sector equivalent. The challenge now is to ensure that this is reflected in the next pay deal under the *Towards 2016* Social Partnership agreement. Locking-in high pay commitments would be risky given uncertainty about future revenues and the need to improve competitiveness.

112. Public spending on *healthcare* rose by 64% in real *per capita* terms between 1999 and 2005.[27] Staff numbers have increased by around a third, with salary levels and capital investment accounting for the remainder.[28] The health system has treated more people, with a 50% increase in the number of hospital day cases and a small increase in the number of bed days. There have been significant improvements in life expectancy at birth and mortality. But there is a large gap between the additional expenditure and the growth of outputs. This could be explained by some combination of a change in the composition of treatment towards more expensive activities and a rise in the cost of performing the same activities. The high cost of some new drugs, for example, could explain a shift towards more costly activities, although technological advances that require less time in hospital act in the opposite direction to reduce costs. But some crude measures of productivity such as the number of procedures per physician or the number of staff per bed have worsened in recent years (Figure 4.7). The proportion of procedures carried out as day cases is below the OECD average, and this too can be a sign of inefficiency. Clearly, these indicators are simplistic and it would be unwise to draw any strong conclusions from them alone. They do, however, point to a need to analyse in greater depth whether the additional spending on healthcare has delivered all that it could have done in terms of the amount and quality of healthcare provided to patients. Investment is needed to produce statistical information to track changes in costs and the volume of health services more

closely. One notable result of the increase in health spending is that Irish healthcare professionals are among most highly paid in the OECD. Of course, Ireland competes for medical staff with the United Kingdom and any inefficiency there will drive up costs in Ireland (OECD, 2004), but there are also risks to health sector pay from inefficiency and large increases in spending within the Irish system.

Figure 4.7. **Indicators of healthcare efficiency**



Source: OECD, Health Data 2007.

113. The additional resources for healthcare have been provided at a time when the organisation of the health service is in a state of transition. A major reform of the structure of Ireland's health system was undertaken in 2004. This replaced the previous system of regional Health Boards with a single national organisation, the Health Service Executive (HSE). The HSE operates some hospitals directly, while most are owned by trusts/foundations. Pouring extra money into the system at such a time, before the new organisation has been shown to work, is a risky strategy. The HSE overspent its budget for 2007 by €216 million, which has led to a cost-containment plan and temporary recruitment freeze. Financial incentives and control in the health system should be improved to avoid such short-term emergency measures. The newly established Health Forum provides a mechanism whereby the social partners can engage with each other to improve the operation of the health system.

Deleted: The additional resources for healthcare have been provided at a time when the organisation of the health service appears to be struggling.

Deleted: A major reform of the structure of Ireland's health system was undertaken in 2004. This replaced the previous system of local Health Boards with a centralised Health Service Executive (HSE) based around 8 regional health boards. The HSE operates some hospitals directly, while most are owned by

money into the system at such a time, before the new organisation has been shown to work, is a risky strategy. The HSE overspent its budget for 2007 by € 255 million, which has led to a cost-containment plan and temporary recruitment freeze

Improving public sector management

114. Stronger public sector management is crucial to delivering a better public service from existing and additional resources. Previous *Surveys* in 2003 and 2006 included extensive discussions of the steps Ireland had taken and could take to get better value for money from public expenditure in line with the Strategic Management Initiative launched in 1994 and the subsequent Developing Better Government programme. Public sector management and procedures have again been strengthened since the previous *Survey*, but the needs of Irish society have also evolved and reform has often been piecemeal. Further reforms are necessary to improve how policies are implemented, to raise the agility of the public service, and to make reforms to the public sector more coherent. This section draws heavily on the recommendations of the OECD *Review of the Irish Public Service* (OECD, 2008).

115. The overall management of public expenditure has been improved. The new unified budget brings together spending and revenue decisions. The Pre-Budget Outlook, published around two months beforehand, provides an update of the economic context and the fiscal position to provide a basis for discussions during the budget round. Expenditure projections are based on the cost of maintaining the existing level of service (ELS), which tends to increase in real terms as population growth and other factors increase the demand for public services. By taking current practice as the reference point, the ELS approach does not achieve tight budget constraints that would encourage departments each year to seek efficiency gains or prioritise more effectively between different activities. In addition, the Pre-Budget Outlook includes an Indicative Allocated Provision which amounted to 0.75% of GNI for 2008. This makes the overall fiscal projections more realistic but risks creating the perception of scope for additional expenditure or tax measures, particularly as there is no indexation of tax brackets or social welfare payments. A more effective starting point for negotiations with departments would be a top-down publicly-stated, rather than internal, target for actual overall spending increases without reference to the ELS. This would be a tighter constraint on departments and encourage greater efficiency. Similar measures have been found to be helpful in countries such as Australia and Sweden. A transparent multi-annual budgeting framework should be considered to provide a clearer sense of direction for spending in the medium term.

116. The Efficiency Review requires each department to submit specific proposals to maximise administrative savings by March 2008, which may help to counterbalance the ELS approach of the budgeting process. Departments that do not engage sufficiently with this process face a lower settlement in the 2009 spending round. This type of incentive could be extended to public spending more generally. It could be made more effective if there were more explicit targets for savings and a clearer benchmark against which outcomes in the 2009 round could be assessed. The absence of targets has the benefit of providing flexibility and avoiding that departments simply try to satisfy the stated objective rather than engaging in a deeper process to raise efficiency, but there is a risk it will not provide sufficient encouragement to use resources better. Such explicit goals have been used in the past, such as in Administrative Budget Agreements that included an "efficiency dividend" of a 2% real term reduction in administrative costs.

117. Management of public spending should focus on outputs and outcomes, rather than on spending and inputs. Resources should be aligned with the NDP and other major government commitments. The introduction of Annual Output Statements, a list of outputs and objectives submitted to parliament by each department, is an important step towards best practice in this area. These provide clear information about what services government plans to deliver and the cost of delivering each element, in addition to raising accountability and parliamentary oversight. But there is no requirement to link output statements to departmental statements of strategy so there can be too much emphasis on what will be done rather than how overall objectives can be achieved. Early indications suggest that some departments have made this link but this should be required of all departments. Output statements should also serve as a reference for the Performance Verification Process in the determination of public sector wages together with links to

other processes such as the cascading of performance objectives and employee evaluation. The 2008 statements will be crucial as these provide the first evaluation of actual performance against the stated objectives. There is scope to improve output statements to make them clearer and more quantifiable. This framework should be extended to cover government agencies. The output statements and evaluation should have a real impact on where spending is directed in future years, including re-directing funds where necessary.

118. The focus on outputs to raise performance could also be raised by changes to the relationship between departments and agencies. The current system uses strong input controls but there is little emphasis on the level of performance delegated bodies achieve. OECD experience shows that the benefit of agencies lies mostly in their ability to focus on delivering specific results. Efficiency could be increased if agencies had greater managerial autonomy and if departments developed a greater capacity to provide effective oversight of the outcome. A clear rationale needs to be established for the creation, role and accountability of the plethora of different agencies.

119. Further progress should be made to tie analysis into the decision-making process and use it more actively to decide the effective allocation of resources. The Management Information Framework (MIF) is intended to address this in part. The system has been rolled out across government but further action is needed to exploit its full potential. Staff should be better trained in the use of the system and departments need to take ownership of its use. Furthermore, the MIF should be better integrated with other performance initiatives so that the operational data produced meets the needs of the output statements and strategic plans. This would both make it easier to integrate this information into decision-making and reduce the administrative burden on departments. Given the difficulties experienced with rolling out this programme, pilot studies could be used to develop the approach to be taken.

120. The expenditure review process should be further strengthened. The Value for Money (VFM) circular letter of 25 January 2006 strengthened the existing guidelines for appraisal of capital projects, requiring full cost benefit analysis for all projects worth more than € 30 million. The VFM Reviews, introduced in 2006 cover a minimum 10-15% of each department's budget. Ninety reviews have been approved for the period 2006 to 2008. The effectiveness of this approach may be weakened by the fact that departments themselves are mostly responsible for choosing which areas of expenditure to review and evaluating their own performance. Although the reports are subject to parliamentary scrutiny and generally published, there may be an incentive to focus on areas where departments are doing well and to avoid self-criticism. A best practice guidance manual has now been published to help departments (Department of Finance, 2007). As recommended in earlier *Surveys*, a centralised Efficiency Unit has been established in the Ministry of Finance and this should help to strengthen the evaluation process for VFM Reviews, as well as capital projects, by building up centralised expertise. This role should be strengthened. It is important that evaluations produced under this initiative actually have a substantial impact on budgeting decisions: VFM Reviews should systematically be taken into account in budget preparation. The role of the Comptroller and Auditor General should be enhanced to include *ex ante* evaluation of large-scale proposals, rather than being limited to commenting after the project has been implemented.

121. The accounting framework for public expenditure should be improved. The Exchequer accounts are calculated on a cash rather than accruals basis so there is no clear picture of the underlying evolution of government liabilities, unlike in countries such as Australia and the United Kingdom. Departments are not charged for the cost of capital, making it difficult to allocate capital efficiently and creating few incentives to minimise on capital such as office space. Although consistent with Eurostat national accounts guidelines,[29] there is no clear statement of future government liabilities accumulated under Public-Private Partnerships (PPP). This would be useful for understanding the fiscal position, even if there are many other implicit government liabilities that are also excluded from the accounts, because one potential risk with

[redacted]

PPP funding is that the legal contract to purchase services from the provider may be less flexible than other forms of funding if needs change or spending needs to be cut.

122. The capacity of the public service to provide services effectively depends on a well-motivated and well-equipped workforce. The share of the workforce employed in the general government and state-funded sectors is not high among OECD countries, despite recent increases, and a lack of capacity has sometimes been apparent.[30] Strategic workforce planning should be improved, both to help individuals plan their careers and cope with future ageing issues. Ireland's exceptional level of *ex ante* controls on personnel numbers and costs hinders flexibility to hire appropriately. These should be replaced by stronger requirements on departments to report on their output performance. There is also a lack of mobility across departments, and between the Civil Service and the wider public service including local government and agencies. A unified labour market would help to create more opportunities for individuals to develop within the relatively small public sector labour market, as well as allowing skills and experience to be allocated more widely. In terms of attracting talent from outside the public service, open recruitment procedures have been extended and now include middle and senior management positions. This, however, has resulted in very few external hires. A strategic decision now needs to be made about the role of this greater openness to outsiders and how far the current career-based system should move towards a position-based model. Pay is determined according to centrally-determined pay scales. These should be replaced with pay bands that would allow individual departments to set salaries as a function of their needs, in particular for staff with specialist skills such as IT, finance and project management. This could be a first step towards a system of performance-related pay. There has already been substantial progress in this direction through the now well-developed Performance Management and Development System, although this should be better integrated with decision-making about human resources policies. There is a need to professionalise human resource functions, making more use of specialists rather than relying on generalists to carry out these activities.

123. The decentralisation programme aims to move half of government departments (some 10 000 staff) out of Dublin into the regions. Although the original deadline of 2007 was shown to be unrealistic, projections for progress towards the new goal of 2009 have consistently been revised down. The number of staff transferred was expected to be just over 2 000 by the end of 2007. Progress so far appears to have been evaluated in terms of the process of decentralising - acquiring property, construction and persuading staff to move. The programme should also be evaluated in terms of the overall economic costs and benefits. Now that substantial numbers of staff are moving, there is a new challenge in terms of making the new locations work and avoiding any fragmentation in government operations.

124. The search for value for money needs to go wider than central government. Inefficiencies at the local government level are also a concern, especially when rising costs are passed on to the business sector. Local government monopolies could become more efficient by contracting out service delivery and by making more use of full-cost user charges while ensuring they are levied fairly on the households and businesses that actually use the services. Incentives could also be improved by using *ex ante* estimation of standard costs, increasing co-financing of earmarked grants by local authorities and moving towards block grants for projects without spillover effects. Local government finances will be reviewed by the Commission on Taxation.

125. The use of outsourcing is relatively limited, partly because the lack of information makes it hard for the public service to evaluate the cost of providing services itself. A central unit should be established to share good practice and provide technical assistance to departments in contracting out services that would benefit from this type of procurement.

126. E-government can contribute to making the public service more efficient, as well as making it easier for society to interact with government. Reducing the administrative burden on firms in this way can

raise competitiveness and help to attract foreign investment. Despite some significant success such as the Revenue Online Service for taxation, implementation of e-government lags behind in many areas. This has reflected a lack of technical capacity and strategic focus, as well as overly ambitious initial plans. A more incremental, bottom-up and user-centred approach is required. There should be a clear link between e-government plans and other strategic objectives.

Public-Private Partnerships

127. Public-Private Partnerships involve the private sector in the provision of public services through a number of different mechanisms. Ireland is making extensive use of these arrangements to deliver improved public services and infrastructure. The importance of this mechanism should not be overstated as it still represents only a small part of spending on infrastructure under the NDP (Table 4.3), where it is mostly concentrated in road building. PPPs have also been used for projects such as new schools and prisons. The recent experience of PPPs for road construction, where many projects have been delivered on budget and ahead of schedule, indicates the benefits of this method of procurement.

Table 4.3. **Spending on economic infrastructure under the National Development Plan**

Total spending from 2007-13 as a percentage of GNI

	Exchequer	PPPs	Local authorities and other state bodies	Total
Transport	1.4	0.5	0.4	2.4
Roads				*1.3*
Public transport				*0.9*
Air transport and ports				*0.2*
Energy	0.0	0.0	0.6	0.6
Environmental services	0.3	0.0	0.1	0.4
Communications and broadband	0.0	0.0	0.0	0.0
Government. infrastructure	0.1	0.0	0.0	0.1
Local authority development	0.0	0.0	0.2	0.2
Unallocated capital reserve	0.1	0.1	0.0	0.3
Economic infrastructure, total	2.0	0.7	1.3	4.0

Source: National Development Plan 2007-2003 (2007), OECD (2007), *Economic Outlook 82* database and OECD calculations.

128. Ireland has moved towards best practice with respect to PPPs (Box 4.2), having made similar mistakes to other countries such as Australia and the United Kingdom when this type of procurement was initially used. A Central PPP Policy Unit has been established at the Ministry of Finance. Its key function is to develop the legislative framework, technical and policy guidance to support the PPP process and to disseminate best practice in PPPs. It is not directly involved in projects which are a matter for the procuring agencies.

Deleted: A Central PPP Policy Unit has been established at the Ministry of Finance to co-ordinate projects and act as a centre of expertise.

In addition, a centre of expertise to advise some ministries on their projects, essentially in areas outside transport, has been established within the National Development Finance Agency.

Box 4.2. **OECD principles for private sector participation in infrastructure**

First, the decision to involve the private sector has to be guided by an assessment of the relative long-term costs and benefits and availability of finance, taking into account the pricing of risks transferred to the private operators and prudent fiscal treatment of risks remaining in the public domain.

Second, authorities need to ensure an enabling policy framework for investment.

Third, the success of private involvement in infrastructure depends on public acceptance and on the capacities at all levels of government to implement agreed projects.

Fourth, the public authorities and the private sector need to establish a working relationship toward the joint fulfilment of the infrastructure needs.

Fifth, insofar as they are not rooted in formal legal requirements, governments' expectations regarding responsible business conduct need to be clearly communicated by governments to their private partners.

Conclusion: fiscal policy must adapt to a more challenging environment

129. Strong revenue growth in the years leading up to 2006 allowed Ireland to maintain a sound fiscal position and repay debt while substantially increasing public investment, social spending and welfare benefits. The rapid turnaround in revenue growth in 2007 has led to a deterioration in the public finances and expenditure growth will need to slow as the Budget projects. There are substantial risks around future tax revenue, both in the short and longer term. The slowdown in revenue growth implies that the need to improve public services and infrastructure will have to be met by raising the performance of the public service. A wide range of measures has already been taken to improve the management of public resources and value for money but much remains to be done, particularly with regards to improving performance, raising capacity and mechanisms to increase the focus on the outputs of the public service rather than inputs. Some parts of the PPP programme, for example, are now working well. However, many of these reforms have been slow and remain incomplete. The challenge is now to push these processes further.

Box 4.3. **Summary of recommendations on fiscal policy**

Public spending growth should slow to reflect lower revenue growth. Upgrading infrastructure should be given priority over current expenditure.

Further steps should be taken to reconsider the large number of tax expenditures and those that are shown to be inefficient by cost-benefit analysis should be eliminated. This includes phasing out tax distortions that favour housing (Chapter 2).

Expensive commitments on public sector pay should be avoided. The conclusions of the second public sector pay benchmarking exercise should be implemented in the next pay deal under the Towards 2016 Social Partnership agreement. The link between higher pay and improved performance in the public service should be more explicit and transparent.

A transparent, top-down budgeting process should be adopted to strengthen the emphasis on value for money. Multi-annual budgeting should be considered in line with the existing approach to capital expenditure. Budgeting should not be solely on a cash basis. A balance sheet for the government should be produced.

The recommendations of the OECD *Review of the Irish Public Service* should be implemented:

- Improve flexibility of human resource management, reducing direct centralised controls on employment and pay, enhancing mobility within the public service, improving planning and making human resources management more professional.

- Move further from input control to output management. The Annual Output Statements of each department should be tied to the Statements of Strategy and used as a reference for Performance Verification Groups and in other processes. The output statement framework should be improved and extended to cover agencies. The Management Information Framework (MIF) should be developed further and the information it produces integrated with other initiatives.

Use analysis more systematically for decision-making. The Value for Money initiative should be strengthened and the outcome of the process should be systematically applied in setting budgets and lessons learned applied to future decisions.

-

- Clarify the governanco framework to improve the accountability of agencies, reducing the role of input controls and increasing the focus on performance.

Deleted: made more independent. The outcome of this process should be systematically applied in setting budgets and lessons learned applied to future decisions.

NOTES

21. The main figures produced by the Department of Finance for the budget and other documents are presented on an Exchequer basis. This differs from the national accounts basis used in the *Economic Outlook* and there are differences in the headline numbers from the two sources, including the fiscal balance.

22. The latest figures on the total estimated cost of tax expenditures are € 11.6 billion for 2003. Since then, some schemes have been closed but the cost of others may have increased. If the basic personal tax credits are excluded, the total cost was € 6.6 billion or 16% of current expenditure in 2003.

23. Based on budget estimates.

24. In December 2006, 604 830 working-age people were receiving a weekly social welfare payment.

25. However, this could also reflect the relatively volatile nature of government revenues that is not accounted for in standard methods of cyclical adjustment.

26. The rate of PRSI contributions paid by the self-employed would fall from 3% to 2%.

27. See *OECD Health Data 2007*.

28. Employment in hospitals increased by 35% over this period. The remuneration of general practitioners increased by 64% in real terms (compared with a 12% real increase in the manufacturing sector and financial sectors). Salary figures for specialists and nurses in 1999 are not available. Increased investment spending accounts for 5.3% of the total increase in public expenditure on healthcare over that period.

29. If risk is transferred to the private sector, the guidelines do not require the government's liabilities under the contract to appear on the government's balance sheet.

30. The state-funded sector here includes voluntary schools, hospitals and universities that are mainly financed by public funding.

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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Ireland were reviewed by the Committee on 20 February 2008. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 5 March 2008.

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes and David Rae under the supervision of Peter Hoeller. Research assistance was provided by Isabelle Duong.

The previous Survey of Ireland was issued in March 2006.

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BASIC STATISTICS OF IRELAND (2006)

THE LAND

Area (1 000 km^2)		Major cities (thousand inhabitants)	
Total	70	Dublin (borough)	1 187
Agricultural	43	Cork	119
		Galway	72

THE PEOPLE

In thousands		Total labour force (thousands)	2 132
Population	4 240	Civilian employment (% of total)	
Natural increase (2005)	34	Agriculture, forestry and fishing	5.8
Net migration	70	Industry and construction	27.7
Number of inhabitants per km^2	61	Services	67.5

PRODUCTION

Gross national income (GNI)		Gross fixed capital investment	
In billion €	149	In % of GNI	30.9
Per head (€)	35 174	Per head (€)	10 881

THE GOVERNMENT

Public consumption (% of GNI)	18.8	Composition of Parliament (seats)	
General government (% of GNI)		Fianna Fail	78
Current and capital expenditure	38.7	Fine Gael	51
Current revenue	42.2	Labour	20
Net debt	2.0	Other	17
Last general elections: May 2007		Total	166

FOREIGN TRADE

Exports of goods and services (% of GNI)	93.8	Imports of goods and services (% of GNI)	81.2
Main merchandise exports (% of total)		Main commodity imports (% of total)	
Office and electrical machinery	22.4	Manufactured goods and articles	27.4
Organic chemicals	19.8	Office and electrical machinery	24.5
Manufactured goods and articles	17.8	Other machinery and transport equipment	19.3
Medical and pharmaceutical products	16.6	Chemicals and related products	13.7

THE CURRENCY

Monetary unit: Euro		Currency unit per $, average of daily figures	
		Year 2007	0.730
		February 2008	0.679

Executive 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.*

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 world-wide 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.*

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Assessment and recommendations

Growth has slowed, testing the resilience of the economy

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.

Raising productivity growth is the key long-term challenge

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.

Greater female participation would boost labour supply

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.

The housing market cycle has turned

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. 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.

Financial system risks have been contained

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.

Public expenditure growth needs to slow and efficiency must be increased

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 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.

The pension system should be put on the right track

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. 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.

Migration has helped the economy grow rapidly but more should be done to integrate migrants

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.

The infrastructure programme needs to cope with large uncertainties about future migration flows

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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Chapter 1

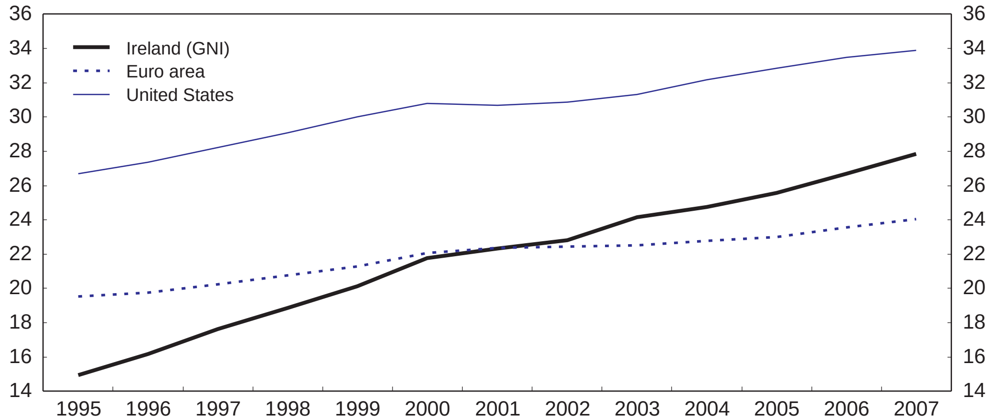
Key challenges

Strong economic activity has been maintained and economic fundamentals remain sound. The end of the long housing expansion will, however, slow growth and presents more difficult challenges than in recent years. In the short run, the economy must adjust to lower housing activity and the risks the slowdown creates. In the long term, maintaining high rates of productivity growth is the key challenge. It is important that Ireland remains internationally competitive. Policy can support productivity growth through achieving stronger competition, improved infrastructure, more innovation, increased human capital and higher labour market participation. Ireland should ensure the stability and sustainability of its economic and social gains. A more efficient housing market would contribute to greater stability and recent international financial market turmoil highlights the need to continue to prepare for financial shocks. Maintaining a prudent fiscal policy as revenue growth slows will help to promote stability, although this will require more efforts to improve efficiency if services are to be improved. Ageing will eventually pose significant challenges that can be reduced if action is taken now to prepare the pensions system. Successful long-term integration will help to ensure that immigration is a success.

Ireland has maintained a very strong economic performance in recent years (Figure 1.1). Growth in income per capita has been among the highest in the OECD, unemployment is low and the country remains an attractive place to do business. It is receiving more than its fair share of foreign investment in high value added sectors and, by opening its borders and having a flexible labour market, it has been a magnet for an astonishingly large number of migrants from Eastern Europe.

Figure 1.1. **Real GDP per capita**

Thousand euros, at 2000 purchasing power parities



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Source: OECD (2007), *Economic Outlook 82 database*; IMF(2007), *World Economic Outlook*, October.

The economy is beginning to adjust to the end of the long housing expansion that saw construction and house prices appear to overshoot their long-run sustainable levels. Residential investment has declined and a substantial number of construction workers needs to find jobs elsewhere. Dealing with the short-term adjustment will require labour market flexibility, wage restraint and a prudent fiscal policy.

Over the longer term, the government has ambitious objectives for economic growth and social progress over the next five years, as set out in the 2007 Agreed Programme for Government, and beyond. Sustaining economic growth requires efforts to boost productivity and labour market participation. Further action is needed to remove bottlenecks of physical and human capital as well as to strengthen competition to ensure that Ireland does not price itself out of the global market. In a number of areas, there is the opportunity to set policies on the right path to limit instability and ensure long-term sustainability. This includes housing policy, financial stability issues, fiscal policy, pension reform and the integration of immigrants. This chapter provides an overview of these challenges.

Short-term economic adjustment

The economy is slowing sharply as house-building falls

Growth picked up and the economy grew strongly in the most recent years (Figure 1.2). Activity was largely driven by domestic demand rather than by exports as in the Celtic Tiger era of the late 1990s. Demand was supported by strong consumption, large increases in government spending and a buoyant housing market.

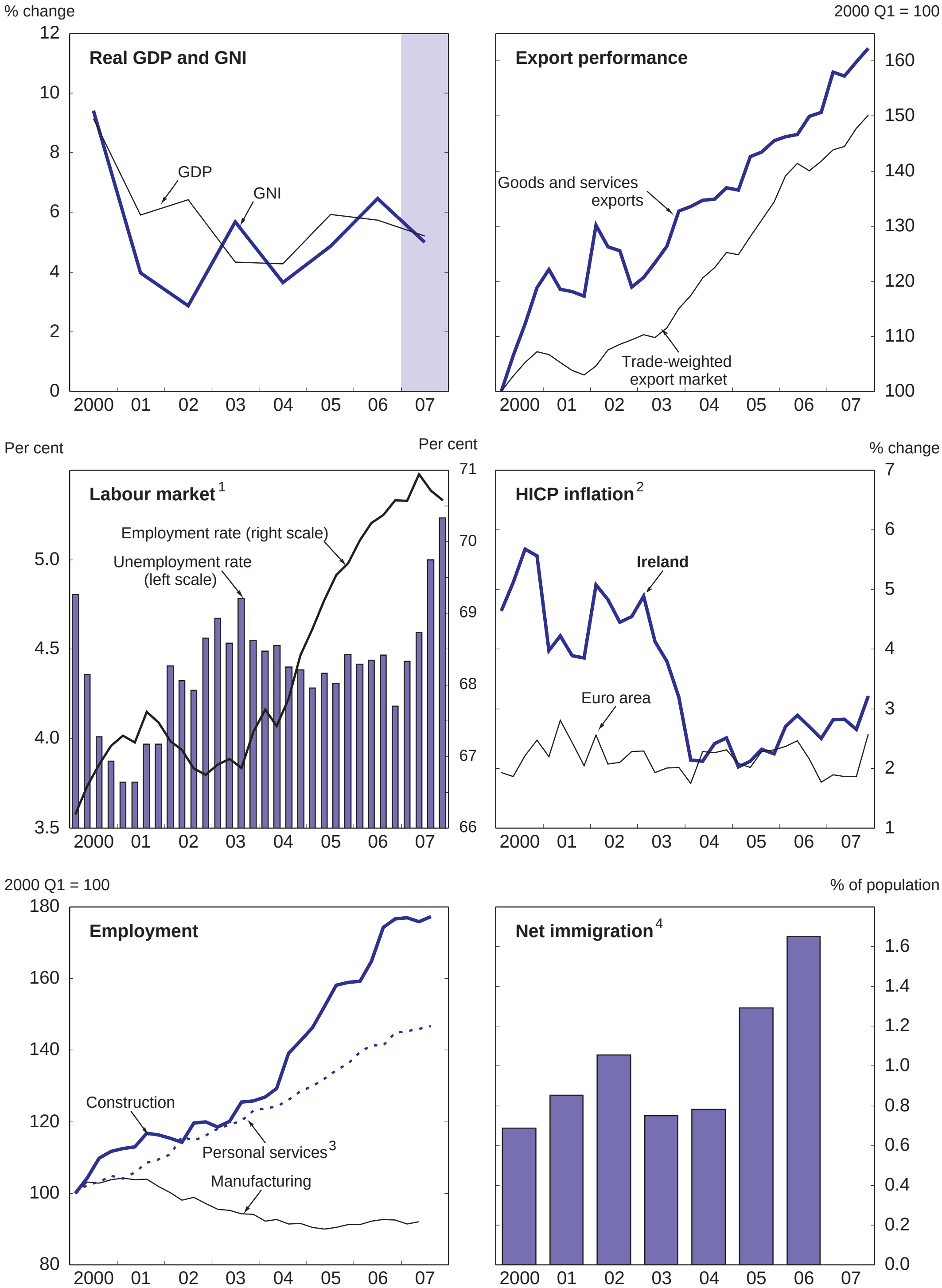
The rapid increase in output during recent years was facilitated by rising employment due to higher rates of labour force participation and strong inward migration, particularly from the new member states of the European Union. Despite these favourable improvements in supply capacity, the buoyant housing market and strong domestic demand led to annual HICP inflation that was above the euro area as a whole throughout 2006 and 2007: the annual rate of inflation on the harmonised measure, which excludes mortgage interest payments, was almost a percentage point higher in 2007 and the national consumer price index (CPI) measure of inflation peaked at above 5% as rising interest payments added to domestic cost pressures. Despite this, the impact on relative unit labour costs of manufactured goods and Ireland's share of world trade has been relatively modest so far.

The strong activity in the housing market that sustained strong economic growth is over (Chapter 2). House prices are falling (Figure 1.3), housing market activity has dropped and loan approvals are down by one fifth on a year ago. In the short run, higher interest rates did much to cool demand but this slowdown was needed to bring down house price inflation and housing activity to more affordable and sustainable levels. It remains likely that the housing market as a whole will not make a hard landing but there is a risk of a larger and more sustained correction.

The pace of economic growth slowed in the second half of 2007 and is likely to remain well below potential in 2008 (Table 1.1). Residential investment, which accounted for more than a sixth of gross national income (GNI) in 2006, is falling very sharply. This will continue to have a substantial impact on the growth of output and employment in 2008. Unemployment is forecast to reach around 5½ per cent. Although growth will be low by Irish standards, it will still be stronger than in many other OECD countries. With the decline in housing projected to bottom out during 2008, growth could strengthen again in 2009.

There is a risk that the fall in housing construction will be greater or more sustained than anticipated. Larger falls in house prices or tighter credit conditions could also slow growth. There is a further downside risk to activity from economic weakness in the United States and the United Kingdom, and the strength of the euro against the dollar and the pound. Ireland is particularly sensitive to these factors due to the direction of its trade flows and the very important role played by foreign investment by US firms.

Figure 1.2. **The 2000s so far**



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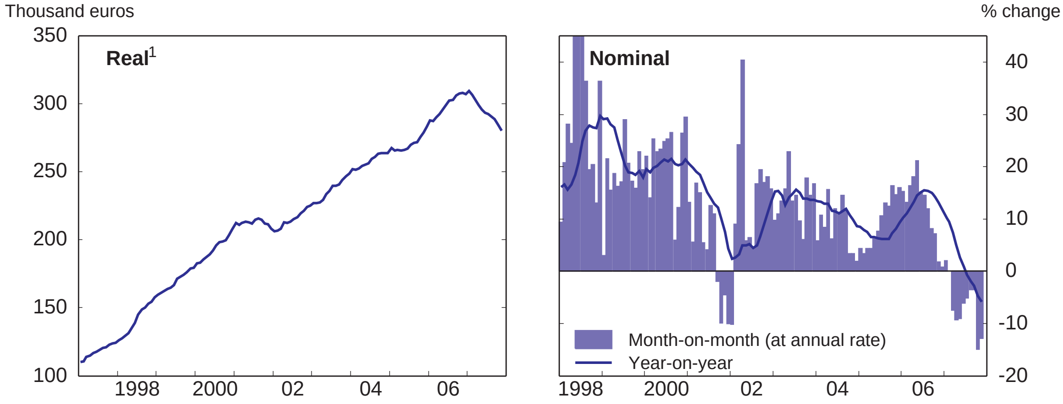
1. Unemployment in per cent of labour force, employment in per cent of working-age population.
2. Harmonised Index of Consumer Prices, per cent growth over the same quarter of previous year.
3. Public administration and defence, education, health and other services.
4. Estimates from the Central Statistics Office.

Source: OECD (2007), *Economic Outlook 82 database* and Central Statistics Office.

Figure 1.3. **House prices have begun to fall**

permanent tsb/ESRI house price index



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1. In 2006 prices, deflated using the harmonised consumer price index.

Source: Permanent tsb, *www.permanenttsb.ie/house-price-index/*.

Table 1.1. **Short-term outlook**[1]

Percentage change

	Outcomes				Projections	
	2004	2005	2006	2007[2]	2008	2009
Real gross domestic product (GDP)	**4.3**	**5.9**	**5.7**	**5.2**	**2.9**	**4.2**
Private consumption	4.0	7.4	5.3	6.4	4.7	3.8
Government consumption	2.3	4.1	6.4	6.3	5.2	4.5
Gross fixed investment	6.9	12.0	3.0	3.5	–1.8	4.2
Total domestic demand	3.8	7.9	5.7	3.4	2.7	4.1
Net exports[3]	0.4	–0.9	0.6	2.2	0.8	0.6
Real gross national income (GNI)	**3.7**	**4.9**	**6.4**	**5.0**	**3.0**	**4.6**
Memorandum items						
Inflation: Harmonised CPI	2.3	2.2	2.7	2.8	2.5	2.0
Inflation: Harmonised underlying[4]	2.1	1.8	2.5	2.3	2.1	2.0
Employment	3.0	4.7	4.4	3.3	1.5	2.3
Unemployment rate (% of labour force)	4.4	4.4	4.4	4.8	5.6	5.4
Current account balance (% of GNI)	–0.7	–4.2	–5.0	–5.0	–3.8	–3.6
Government net lending (% of GNI)	1.6	1.4	3.4	0.6	–1.2	–1.3

1. Projections are those published in *Economic Outlook* No. 82. Government net lending projections were updated to include later information on the fiscal position.
2. Estimate.
3. Contribution to GDP growth.
4. Excluding energy, food, alcohol and tobacco.

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

Sustaining robust long-term growth

Long-term growth potential remains high relative to the OECD average. Although gross domestic product (GDP) growth is well below the rates of the Celtic Tiger era of the second half of the 1990s, it has nevertheless averaged over 5% per year since 2001 (Table 1.2). In recent years, activity was fuelled by a substantial rise in the working-age population, reflecting both domestic demographic factors and inward migration, while labour productivity growth has slowed.

It is, however, difficult to disentangle the underlying productivity trend from special factors such as the contribution from the "modern" sector and structural shifts in activity.

Table 1.2. **Decomposition of GDP growth**

Average annual growth rates, per cent

	1989-95	1995-2001	2001-07
GDP	5.3	9.1	5.3
Total hours worked	1.3	3.6	2.4
Of which:			
Working-age population	1.3	1.9	2.4
Employment rate	1.1	3.3	0.8
Average hours	–1.1	–1.5	–0.7
Labour productivity	3.9	5.3	2.9
Of which:			
Capital intensity[1]	0.0	1.5	0.9
Multi-factor productivity	3.9	3.8	2.0

1. Capital intensity defined residually as labour productivity less multi-factor productivity growth.

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

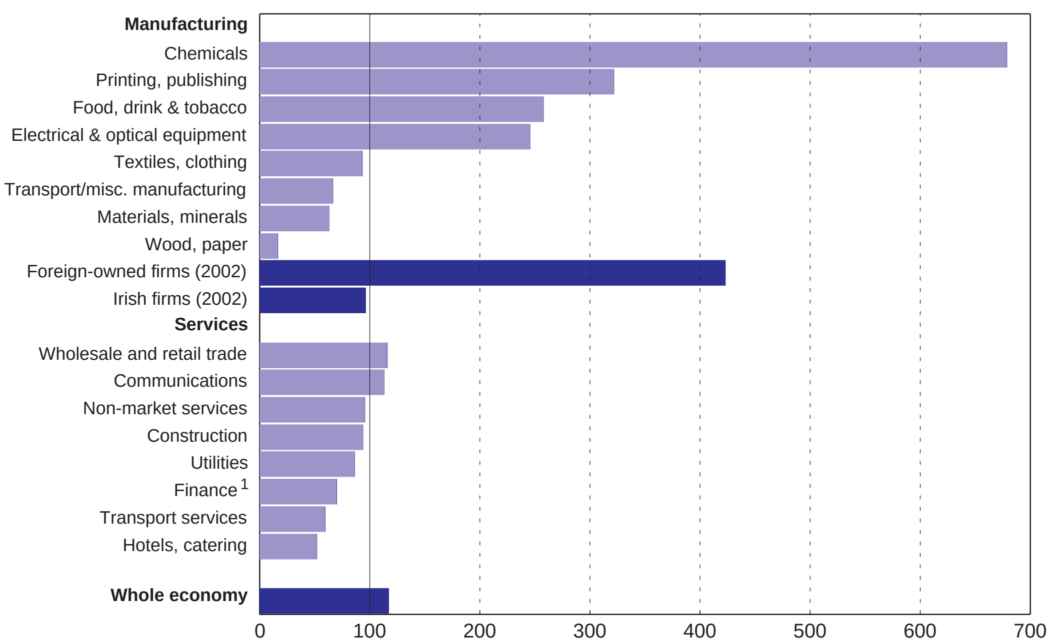
For instance, between 2000 and 2006, the shift in employment away from high-tech manufacturing and towards the relatively low-productivity construction and non-market service sectors has reduced measured productivity growth by nearly 1 percentage point per annum. Some of this will unwind as employment in the building industry falls.

Maintaining productivity growth is the key longer-term challenge

Labour productivity levels in manufacturing are high by international standards. Output per worker is close to or above the EU15 average in most manufacturing industries (Figure 1.4). Foreign multinationals have much higher (measured) productivity than local

Figure 1.4. **Productivity levels relative to EU15**

Gross value added per hour in 2003, EU15 = 100



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1. Finance sector covers financial intermediation, insurance and pension funding (except compulsory social security), and related auxiliary activities. These correspond to ISIC Revision 3 industries 65, 66 and 67.

Source: Cassidy, M. and D. O'Brien (2007), "Ireland's Competitiveness Performance", *Quarterly Bulletin*, No. 2, Central Bank and Financial Services Authority of Ireland, Dublin (based on *Groningen 60-industry database*).

firms and have generated the lion's share of growth over the past decade, but it would be misleading to regard the Irish success story as exclusively driven by the multinational sector as labour productivity in Irish-owned manufacturing firms is respectable in its own right: in level terms, it is close to the European average and has grown relatively quickly over the past decade (OECD, 2006).

In contrast, productivity in several service sectors appears to be less impressive (bearing in mind the difficulties in measuring and comparing service sector productivity across countries). Productivity is below the EU15 average in most service sectors, the exceptions being communications and distributive trades.

Ireland remains highly dependent on foreign trade and investment

As a financial and production intermediary, Ireland has one of the OECD's most open economies. While this has contributed to its impressive economic performance, it has also left it exposed to shocks originating abroad not just because of the scale of its financial and trade linkages but also because these links are concentrated on a small number of partner countries. Total foreign assets and liabilities amount to more than 1 300% of GNI each (Table 1.3). Much of this is portfolio investment through the International Financial Services Centre (IFSC), but even non-IFSC assets and liabilities are large relative to GNI. Approximately half of all liabilities are owed to the United States.[1] On the trade side, exports amounted to around 93% of GNI in 2007 while imports were 80%. Two industries – chemicals, and information and communication technology (ICT) – account for three-quarters of goods exports. These industries are almost entirely US-owned and they sell mainly to Europe.

Table 1.3. **Ireland's international investment position**

Per cent of GNI

	In 2002			In 2006		
	Total	IFSC[1]	Non-[2]IFSC	Total	IFSC[1]	Non-IFSC
Assets						
Direct investment abroad	53	13	39	63	15	48
Portfolio investment	514	438	76	812	693	111
Total[2]	871	680	191	1 345	1 089	256
Liabilities						
Direct investment in Ireland	164	71	92	80	37	43
Portfolio investment	420	351	69	822	698	123
Total[2]	893	635	257	1 352	1 049	303
Net position						
Direct investment	–111	–58	–53	–17	–22	5
Portfolio investment	94	87	7	–9	–6	–4
Total[2]	–22	44	–66	–7	40	–47

1. International Financial Services Centre.
2. Total does not equal the sum of the preceding rows because it includes other investments not shown in the table.
Source: Central Statistics Office.

While swings in foreign direct investment (FDI) have been large, this mainly represents financial transactions rather than tangible projects (Table 1.4).[2] A better gauge of Ireland's attractiveness to foreign investors undertaking physical investment is the number of people employed by overseas firms supported by the Industrial Development Agency and other development agencies. While there have been some high-profile closures of plants by

Table 1.4. **Foreign direct investment**

Per cent of GNI

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Investment in Ireland	11.6	22.4	31.4	11.0	29.4	17.2	–6.9	–18.8	–0.5
Investment abroad	5.1	7.5	5.6	4.6	11.0	4.2	11.7	8.5	7.8
Net investment	6.5	14.9	25.8	6.4	18.3	13.0	–18.6	–27.2	–8.3

Source: Central Statistics Office.

foreign multinationals, the rate of job losses has declined since 2002 and the entry of new firms means that net job creation returned to positive territory in 2005-06 (Figure 1.5). The type of FDI projects that Ireland attracts continues to change with a larger share of financial services and ICT activity. FDI in the life sciences, including pharmaceuticals, healthcare and biotechnology, has been strong: Ireland received a quarter of all the FDI into Europe in the life sciences area in the year to June 2007.

Figure 1.5. **Employment in development agency assisted companies**

Full-time employment in manufacturing and internationally traded financial services

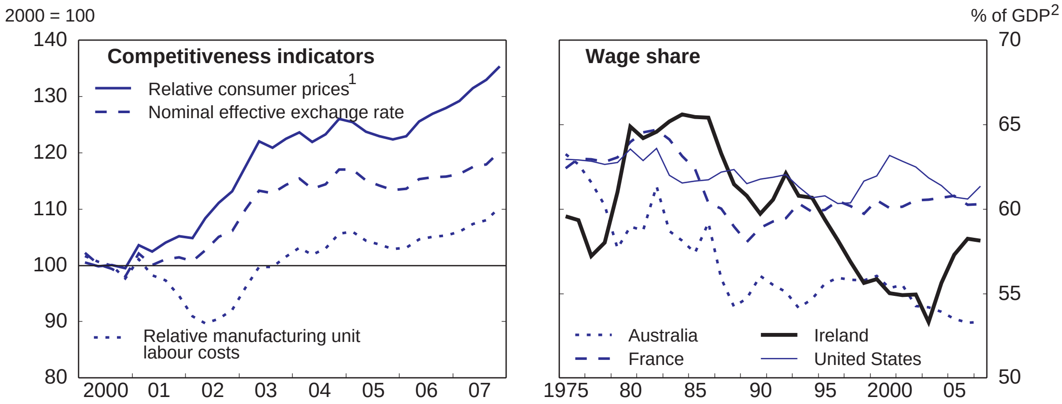
StatLink http://dx.doi.org/10.1787/285015351472

Source: Forfás, *Annual Employment Survey*.

Competitiveness needs to improve to boost exports

Long-run growth prospects depend heavily on export performance as the Irish economy is particularly open. More immediately, higher net exports would boost demand and ease the adjustment process following the downturn in housing construction. Ireland has been losing competitiveness since the year 2000 as measured by relative consumer prices (Figure 1.6). The nominal exchange rate has appreciated, and wages and consumer prices have been growing faster than in its trading partners. But unit labour costs in the more export-orientated manufacturing sector have risen less sharply since 2000, initially falling, as wages in that sector have kept more in line with productivity growth. As a result of the developments in competitiveness, the improvement in Ireland's share of world exports has stalled and even fallen back modestly since 2002. The contribution of net exports to growth has been small or negative in recent years (Figure 1.7). But even more or less maintaining market share is a reasonable performance given the growing weight of emerging economies in world trade. Since the late 1990s, Ireland has gained market share

Figure 1.6. **Indicators of competitiveness**



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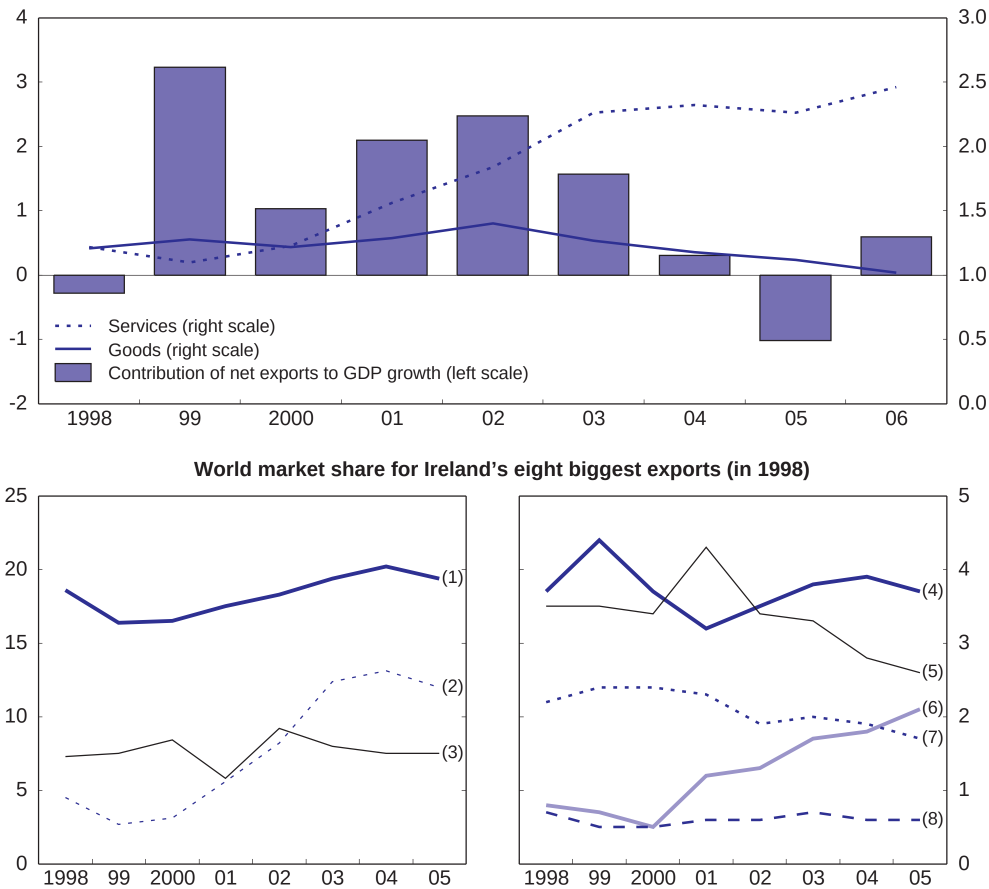
1. Relative consumer prices in terms of consumer price indices.
2. GDP at factor cost. GNI for Ireland. Wage share excludes self-employment income.

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

Figure 1.7. **Ireland's share of world export markets**

Per cent



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(1) Computer services; (2) Financial services (including insurance); (3) Chemicals and pharmaceuticals; (4) Meat products; (5) ICT manufactures; (6) Business services (other); (7) Recorded media; (8) Transport and travel services.

Source: UN, *Comtrade database* and OECD calculations.

in financial and business services and has more or less maintained the share in most other categories except ICT manufactures and recorded media.

The dilemma now facing Ireland is that improved competitiveness would help macroeconomic adjustment in the short run, but there are signs that exports are becoming *less* competitive: relative manufacturing unit labour costs have risen by 7% over the past two years and the share of national income going to wages has been rising sharply since 2003 (Figure 1.6, right-hand panel). The rise in the wage share is even more striking considering that it goes against the international trend. These indicators suggest that the loss of competitiveness may be starting to become a serious problem. Although it is natural that wages in Ireland should rise in line with productivity growth, these natural or equilibrium forces may have been overtaken by disequilibrium effects. Wage growth does not appear to have responded quickly enough to the slowdown in productivity growth; strong construction activity has put additional pressures on demand; and there are concerns about whether the increase in public expenditure and wages has been fully justified in terms of efficiency (Chapter 2). Unless wage and price inflation are reined in, the export sector will not be able to contribute either to short-term adjustment or the long-run improvement in living standards. Real wage growth needs to be limited to increase in line with productivity or by even less in the short term. Competitiveness problems are exacerbated by rapid increases in non-wage costs as diverse as electricity prices, insurance premiums, office rents and local authority charges.

Policies to underpin growth

Ireland faces policy challenges to maintain strong growth. These include boosting competition, upgrading infrastructure, generating more innovation, raising human capital and increasing labour market participation. These issues were covered extensively in the previous *Survey* and are the policy priorities identified in the OECD's *Going for Growth* study (OECD, 2007). There remains scope for progress in these areas. This section provides an update on policy actions and highlights outstanding weaknesses that need to be addressed.

Stronger competition would boost productivity and reduce costs

Ireland compares well with other OECD countries when it comes to the regulatory environment. Overall regulation of the business sector is relatively light-handed and competition-friendly. Nonetheless, there are still too many sheltered sectors where competition is restricted and where the interests of producers and suppliers are favoured over the interests of consumers (Table 1.5). Boosting competition in these sectors would help to reduce prices, make Irish firms more competitive and raise productivity.

The need to increase competitive pressures remains in some of the network industries:

- In the *electricity sector*, the main problem continues to be the market power of the state-owned Electricity Supply Board (ESB). It currently owns the transmission network and has a large share of the generation capacity. Its dominance contributes to higher prices: one study estimates that 30% of the gap in electricity prices between Ireland and the average EU country can be explained by inefficiencies in the Irish market.[3] The previous *Survey* and the *Review of Energy Policy* conducted by the International Energy Agency (IEA, 2007) recommended a range of measures to reduce ESB's dominance.

Table 1.5. **Progress in structural reform: Competition policy**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Consider giving the Competition Authority power to impose sanctions. Review the Authority's staffing. Reduce the costs and delays of court proceedings.	No progress, but the Competition Act 2002 is under review.
Abolish the Groceries Order. Revise the retail planning guide to allow bigger stores.	The Groceries Order was abolished in 2006 leading to a noticeable drop in (relative) prices.
For pharmacies, replace the 50% retail mark-up with a flat dispensing fee, auction the right to run a pharmacy and abolish the "three year" rule for pharmacists who were not trained in Ireland.	The pharmacies sector was reformed in 2007. The government intends to abolish the three-year rule at an unspecified future date once other regulatory reforms are bedded in.
Remove the ceiling on the number of pub licenses.	No progress but the alcohol legislation is up for review in 2008.
Remove unnecessary restrictions in the legal profession including abolishing the bar council's monopoly on legal training. Speed up the registration process for foreign professionals.	There have been some minor reforms regarding barristers but other competition restrictions remain in place. The government has not responded to the Competition Authority's recommendation for an independent regulator.
Integrate the electricity market with Northern Ireland and the rest of the United Kingdom. Split up ESB by separating the transmission grid from the generation capacity. Consider splitting generation into competing firms.	An all-island wholesale electricity and gas market took effect in November 2007. By the end of 2008, ownership of the transmission network will be transferred from ESB to EirGrid. The regulator has ordered ESB to sell some generation plants to reduce its market share to 40% by 2010.
Liberalise the bus market. Appoint an independent regulator and remove restrictions on the number of bus routes that can be operated by private firms.	In the Programme for Government, the government has committed to improving bus services by reforming the bus licensing legislation. The European Commission is investigating whether state aid to bus companies is legal.
Reduce state ownership.	No progress.

- In the *telecoms sector*, the main issue is the slow rollout of broadband. Eircom, the telephone incumbent, dominates the market and the regulator (ComReg) has persistently criticised Eircom for dragging its feet over local loop unbundling.[4]
- The *bus market* is also relatively sheltered as private companies are restricted from competing with the state-owned bus firm on certain routes, and the regulator is not independent.

Unnecessary restrictions crop up in other sectors including the *licensed trades* such as the legal, medical, dental and veterinary professions. These rules are sometimes put in place to protect the public but they can be out of all proportion to their objectives. All EU countries are currently doing a stock-take of restrictions in the service sector as part of implementing the services directive. This provides a good opportunity for Ireland to clear away these barriers to competition and trade.

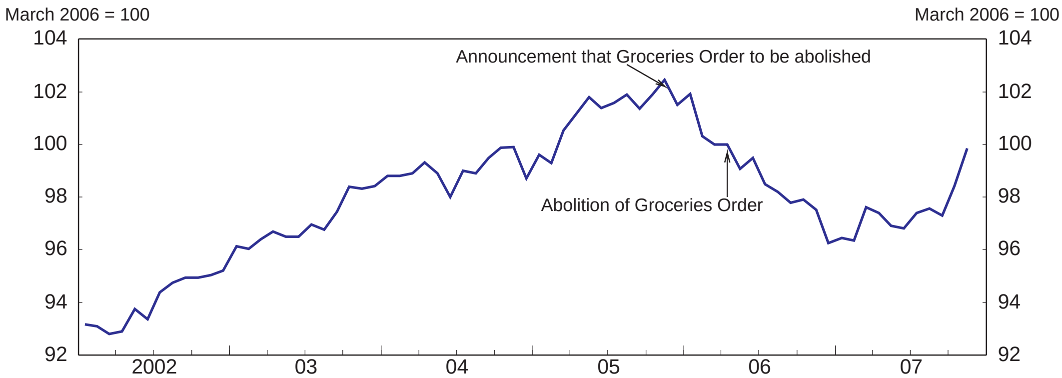
A reduction in *state ownership* could also improve economic efficiency. Today, government-owned firms have a monopoly or dominant position in the postal, energy, transport, health insurance, television and forestry industries. The government also has a minority shareholding in the national flag-carrier airline. Even if there are no explicit rules that favour them, state-owned enterprises can enjoy a competitive advantage through more gentle regulatory oversight, a lower cost of capital due to implicit guarantees, implicit subsidies or cross-subsidies and the dominant position they may have inherited from their days as protected monopolies.

A general problem with the *competition framework* is that enforcement can be difficult because it has to use criminal law processes and meet criminal law standards of proof. However, progress has been made recently with the Irish Competition Agency securing 18 criminal convictions in a cartel case and this is encouraging for the strategy of using the criminal law: the Irish competition authorities are the first in Europe to get a custodial sentence for a breach of competition law. The Competition Act is under review. It may be useful to include clearer guidance regarding fines since the penalties handed down so far have typically been light.

Despite these weaknesses, there has been solid progress in several areas since the previous *Survey*. First, the Groceries Order, which prevented price competition for basic foodstuffs, was abolished. This has been a notable success for competition policy: since the Order was abolished, the relative price of those items has fallen sharply (Figure 1.8). Second, restrictions on foreign-trained pharmacists, which were a major barrier to competition in the sector, will shortly be removed. Third, the powers of the telecoms regulator were greatly strengthened in April 2007. Just one month later, it reached agreement with Eircom to resolve all substantial matters holding back the local loop unbundling process. Fourth, the electricity regulator ordered ESB to sell some of its generation plants to reduce its market share. In addition, an all-island wholesale electricity and gas market was implemented in November 2007. It will have an independent market operator and ESB will no longer own the grid.

Figure 1.8. **Relative price of items covered by Groceries Order**

Relative to similar items not covered by the Order[1]



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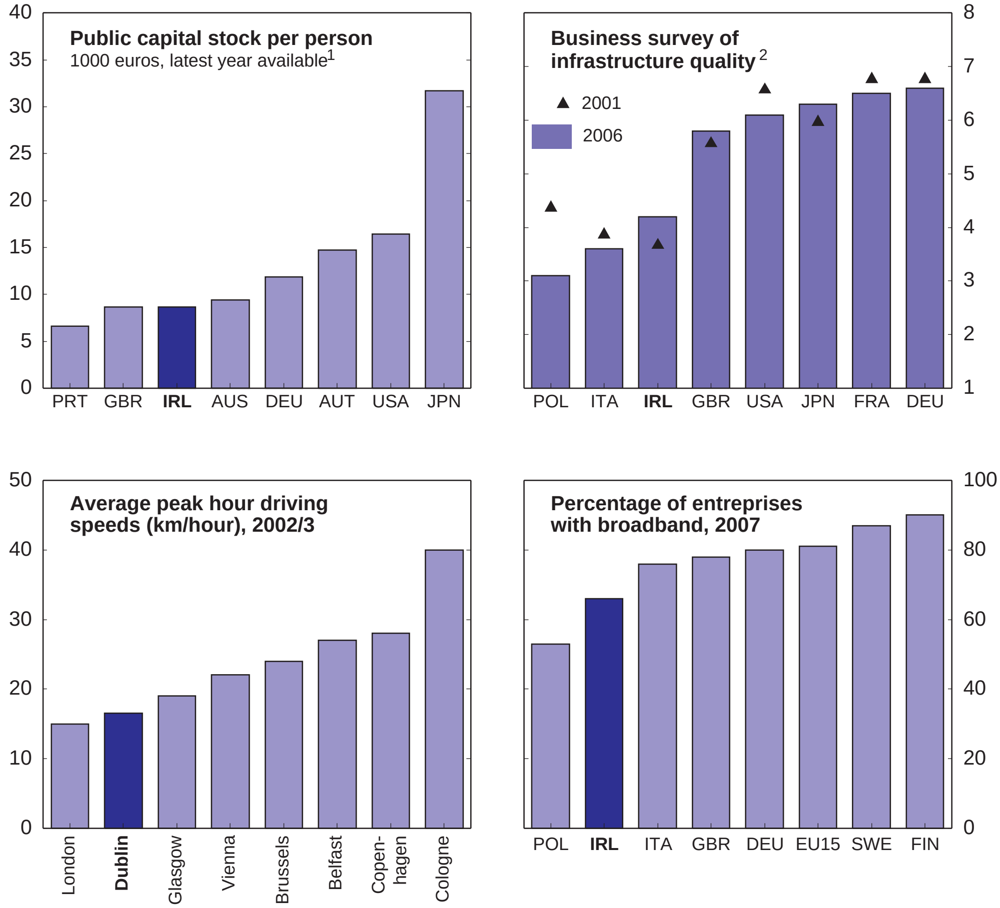
1. Groceries Order items included elements of food and non-alcoholic beverages, off-licence alcohol and household non-durable goods. Non-Groceries Order items included elements of foods and non-alcoholic beverages and household non-durable goods.

Source: Central Statistics Office, *CPI release*, *www.cso.ie/releasespublications/documents/prices/current/pic.pdf*.

Infrastructure bottlenecks may be holding back growth

Soaring activity and rapid population growth have created a number of infrastructure bottlenecks. Major pressures are evident in roads, airports, electricity transmission, landfill, waste water treatment and broadband internet (Figure 1.9). In 2007 a global business survey ranked Ireland 25th in the OECD for the quality of its infrastructure, one place better than its 2002 ranking. These bottlenecks can have direct economic consequences, especially since foreign investors put a high weight on the quality of infrastructure when deciding where to locate. They can also have environmental and social consequences, such as pollution and long commuting times. While Ireland has one of the lowest levels of public capital in the OECD, it has one of the highest rates of public investment – higher even than some transition economies such as Hungary and Poland. So far this decade, public investment has averaged around 4½ per cent of GNI.[5] The latest National Development Plan (NDP) envisages average investments (including PPPs) of about 6% of GNP over the lifetime of the plan running

Figure 1.9. **Indicators of infrastructure**



StatLink http://dx.doi.org/10.1787/285085883828

1. At 1995 prices, using 2000 purchasing power parities. Data cover 2004 for Ireland, 2000 for other countries.
2. A high score indicates a high quality of infrastructure.

Source: OECD (2006), *OECD Economic Surveys: Ireland*; World Economic Forum (2002, 2007), *The Global Competitiveness Report* 2001-2002 (resp. 2006-2007); National Competitiveness Council (2007), *Annual Competitiveness Report* 2006, Vol. 1; Eurostat (2008), *Information Society Statistics*, online database (January).

to 2013.[6] This includes the ten-year *Transport 21* plan that covers some large-scale public transport and road projects. But even with this amount of spending, it will take until 2020 before the level of public capital per person reaches the OECD average and policy action is needed to speed up infrastructure projects, improve infrastructure planning and to allow for a better use of infrastructure services (Table 1.6).[7]

The innovation system should be enhanced

Maintaining strong rates of productivity growth will require a greater focus on research and innovation. A key challenge is to increase innovation capacity in Irish-owned firms. Having a stronger domestic research base would make it easier to deliver home-grown innovation and to capitalise on advances made abroad. While business expenditure on research and development (R&D) has increased in recent years, it remains low by OECD standards. Most of the research in the private sector is undertaken by foreign multinationals, but even then they do most of their research at home. Ireland needs to improve its

Table 1.6. **Progress in structural reform: Upgrading infrastructure**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Reduce the length and uncertainty of challenges during the planning process. To guarantee a balance between giving due regard to the concerns of people affected by projects and the need to ensure that public goods be delivered timely and efficiently:	53 major infrastructural projects have been submitted directly to the Planning Board for fast-track planning permission.
• Restrict the possibility of challenging planning decisions to persons whose financial interests would be affected by the project.	No change.
• Introduce a "silence is consent" rule to give the planning board greater incentive to comply with its statutory deadlines.	No change.
Ensure that projects deliver benefits greater than costs. To this end:	
• Suppress the possibility of avoiding a cost-benefit analysis.	Full cost-benefit analysis is now required for all projects worth more than € 30 million and measures have been taken to ensure compliance.
• Create an independent central unit responsible for the oversight and quality control of cost-benefit analyses.	A unit has been set up in the Department of Finance to promote best practice.
Avoid over-investment in infrastructure and ensure its efficient use by generalising user charges. For example:	
• Charge the full cost of providing drinking water and collecting and treating sewage.	Meters for most non-domestic users are in place by end 2007. Households continue to receive free water.
• Introduce a congestion charge in central Dublin when public transport alternatives improve.	Action will not be required until more of the Transport 21 plan has been completed.

framework conditions and ensure a ready supply of skilled researchers in order to capture a greater share of this research. At the government level, Ireland has been a late starter in investing in research. Funding for R&D has more than doubled since the late 1990s, but when measured as a share of GNI it remains on the low side compared with other countries. Staffing bottlenecks are among the factors that have limited the growth of R&D expenditure until now. The number of people graduating with a PhD each year is below the OECD average, however the Strategy for Science Technology and Innovation (SSTI) launched in June 2006 aims for a doubling in the number of PhD graduates. The implementation of the Strategy forms a central plank of the NDP and will involve expenditure of € 8.2 billion over the period of the Plan, € 3.2 billion of which will be accounted for by the higher education sector. There has been an increase in the number of high-level science researchers in Ireland as a result of additional funding through Science Foundation Ireland (SFI).

The previous *Survey* put forward some suggestions for refining the science framework in order to get the most out of the relatively limited innovation budget (Table 1.7). For

Table 1.7. **Progress in structural reform: Research and innovation**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Improve economy-wide framework conditions as they are the most important determinant of R&D.	Ongoing.
Consider rebalancing the science budget by making more use of market-led measures and scaling back direct grants. Evaluate the new tax incentive, and if successful channel more funding through it.	A new Science, Technology and Innovation (STI) strategy puts more emphasis on industry led initiatives. The tax credit was made more generous in both 2006 and 2007.
Consider whether public funding is being spread too thinly and whether Ireland would be better off concentrating its resources in a small number of world-class centres of excellence.	The Strategic Research Clusters (SRCs) programme aims to bring together internationally-competitive researchers from academia and industry in key areas such as biotechnology.
Improve co-ordination among the different players. In particular, infrastructure spending needs to be better aligned with programme funding and with the investment being made in human capital. Review the structure of the innovation system to see whether combining some of the agencies would be the best way to improve coherence. There may be a need for fewer but more specialised business incubators.	Ongoing through various bodies and committees.

example, there are many funding streams that overlap to some extent, and a tidy-up may be helpful. As in many countries, universities could make greater efforts to commercialise their research and build links with industry. Finally, funding may be spread too thinly. It might be better to focus on a small number of centres of excellence rather than promoting research centres in regions that may not be able to attain critical mass. Greater amalgamation and specialisation among institutions may therefore be useful.

Education policy should aim to match the best countries

The sharp increase in educational attainment of the adult population has been an important factor behind Ireland's success. Even so, Ireland is well below the OECD's best performers in terms of the quantity and quality of education. Its economic structure and its ambitious target for R&D both require a more skilled workforce than the average country.[8] There is room for improvement at all levels of the education system (Table 1.8). For example:

- Pre-school attendance remains low while classes are large and of short duration. Other areas of the education system have been given greater priority. The recent expansion of childcare places, however, gives a good opportunity to move towards an integrated childcare system that combines pre-primary education with crèche-based day-care at the same location. International experience has shown that this is best for children and provides greater parental satisfaction.
- In secondary schools, the OECD's PISA study shows that Irish 15-year olds do well at reading while their performance in mathematics and science is average. One issue is insufficient help for pupils who are struggling. Targeting special assistance programmes on children who have learning difficulties is more efficient than focussing help on children who come from disadvantaged backgrounds. As a result of the "mainstreaming approach", there are few remedial or catch-up programmes for children who fall behind while a number of special programmes are targeted at those from difficult backgrounds. Spending on special education has doubled since 2004, which has in part allowed more teachers and Special Needs Assistants to work solely with children in need of additional help. More intensive and better targeted catch-up programmes will become increasingly important as the children of migrants, many of whom do not speak English at home, start to enter the school system.

Table 1.8. **Progress in structural reform: Education**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Invest more in pre-primary schooling by:	
• Generalising pre-primary education from the age of three.	No progress.
• Avoiding infant classes of more than 30 children.	Average class sizes at *primary* level have fallen and the staffing schedule currently provides for an average 27 children per class, but class sizes remain determined locally.
• Expanding the duration of daily classes.	No progress.
Improve outcomes in primary and secondary education by targeting efforts on children with learning difficulties rather than on those from disadvantaged backgrounds.	Funding and resources for special needs education are substantially higher.
Give universities the means to increase their resources and the incentive to be more responsive to students' needs by levying fees that students (including part-time students) repay from their subsequent earnings. Public funding should not be cut back as fees increase.	No progress.

- Funding per student in tertiary education is around the OECD average, following recent increases in funding, but substantially below the best performers. Higher education institutions are constrained in their ability to expand and attract high quality staff from abroad. The funding situation is partly because undergraduate tuition fees were abolished in 1995.[9] This was done to improve equality of access but while significant improvements have been made in this regard, the goal has not been achieved. The economic and equity arguments for students paying a greater share towards the cost of their tertiary education are strong. Ireland should consider the system in Australia, New Zealand and the United Kingdom with upfront tuition fees that can be covered by a loan, repaid later when the individual begins to earn above a certain threshold. Aside from bringing more funding into the system, this type of scheme can make education institutions more innovative and more geared to the needs of students. It can also raise efficiency by encouraging students to choose more useful courses and not waste time in their studies. Some structural re-organisation may also help to obtain better quality and value for money at the tertiary level. The OECD's *Review of Higher Education in Ireland* in 2005 made several suggestions, such as greater management autonomy and more specialisation and amalgamation among the smaller institutions in order to reach critical mass. Greater flexibility, such as evening and weekend courses, will become more important to help working adults up-skill without dropping out of the workforce.

Participation can be raised further

While immigration has been a main source of labour supply growth in recent years, there are areas where indigenous labour supply can be raised substantially such as the participation of women. To some extent this will happen naturally as cohort effects and changing cultural attitudes work their way through, but the increase could be stronger with some help from policy reforms (Table 1.9).

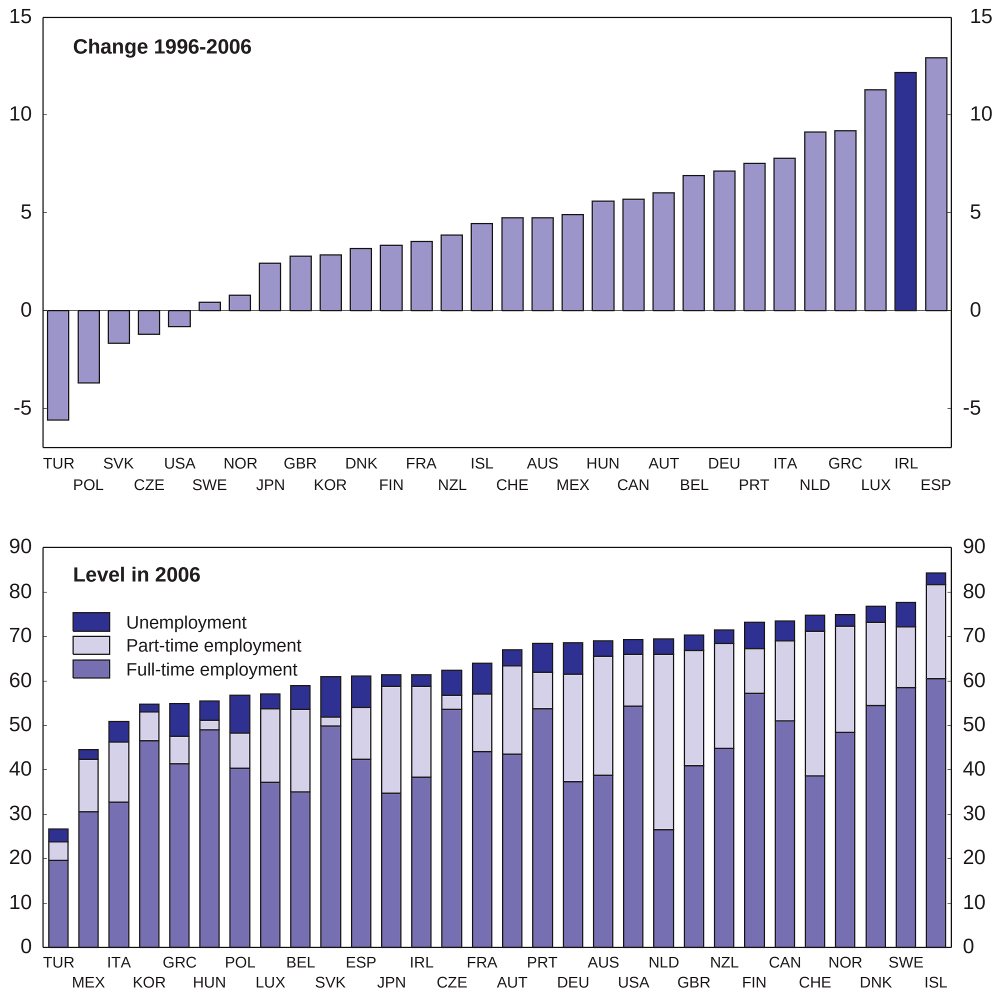
Table 1.9. **Progress in structural reform: Female participation**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Encourage more out-of-school-hours care where school facilities are suitable.	Recent budgets have allocated funding in this area, and school boards are becoming more willing to offer their facilities.
Implement plans to increase the supply of training places for childminders.	No progress yet, but there is a target of 17 000 new training places by 2010.
Over time, link childcare support such as the Early Childcare Supplement to employment status or to the use of formal childcare.	The government moved in the opposite direction by raising the universal Child Benefit by up to 7% in the budget for 2007 without making it more targeted. It also changed the subsidy system for childcare support so that recipients of social welfare get substantially more than working parents.
Phase out the Home Carer's Tax Credit.	No progress.
Give priority access to community childcare to working parents, especially lone parents.	Priority is given to disadvantaged parents, especially those on welfare.
In order to reduce child poverty, provide job-search assistance and childcare support to lone parents. In return, boost job search requirements for lone parents on income support whose children are of school age. Consider allowing lone parents to keep some of their benefit for a limited time after going back to work. Raise the threshold from which the One Parent Family Payment starts being withdrawn and reduce its phase-out rate.	A substantial reform of lone parent support is under consideration. It proposes a mutual obligations approach, including some job search requirements. The upper income threshold for entitlement to the one parent benefit was raised in the budget for 2007.
Continue reducing average and marginal effective tax rates on second earners. Consider moving to individual taxation.	The top rate of income tax has been reduced to 41% and average rates reduced through higher thresholds and allowances.
Introduce fines for employers found in breach of Equal Pay legislation.	No progress.

While the female participation rate has increased enormously over the past decade, it started from such a low base that it is still below the OECD average (Figure 1.10). Part-time employment is more common in Ireland than elsewhere, so the effective female labour supply is well below average. Women with children have a very low participation rate by OECD standards. As argued in *Going for Growth* (OECD, 2007), raising pre-school attendance by children is also important for developing Ireland's human capital.

Figure 1.10. **Female participation has risen a lot but is still low**

Percentage of women aged 15-64 in the labour force



StatLink http://dx.doi.org/10.1787/285107263173

Source: OECD (2007), *Labour Force Statistics – online database*, September.

Part of the problem is that there are not currently enough childcare places, though the National Childcare Strategy is helping to fix that. It includes the construction of childcare facilities and aims for 50 000 extra places by 2010. When fully up and running, it will bring the coverage rate of formal childcare close to the current OECD average. Rather than concentrating on expanding supply, a more balanced policy would put greater focus on the demand side by providing income support to make childcare more affordable. There are limits to how quickly this could be done because if demand grows more quickly than supply, it is likely to simply raise costs in the sector. The government already spends a considerable amount on child benefits and child benefits have been raised by 85% since 2004.[10] But this expenditure is poorly targeted as the Child Benefit and the Early Childcare Supplement are cash transfers that are paid whether parents are working or not and regardless of whether they are actually using childcare services. Ireland could get significantly greater value for money if support was linked to employment, job search or the use of formal childcare services (OECD, 2003). It has chosen not to go down this route because of a perception that it would discriminate against mothers at home. However, it is important to convince the public that the tax-benefit system is already biased against mothers at work, so a more targeted approach would not only deliver better value for money but would make the system fairer as well.

There is also a scarcity of out-of-school-hours care. In the past, school boards have been reluctant to open up their facilities for after-school programmes, but a few trail-blazers have succeeded in changing the attitude of some of the more hesitant boards. There is a target of 5 000 new out-of-school-hours places by 2010 and, while this seems achievable, it would cover less than 1½ per cent of the population aged 6-12. The government should ensure that public investment in school buildings also benefits communities after school hours, which would help to raise after-school provision of childcare, improve value for money and avoid the need to ferry children from one location to another.

The country also suffers from having a large number of single parents whose employment rate is low by OECD standards. This has clear economic costs, but the social costs associated with child poverty are far more important. The best way to reduce child poverty is to help parents return to work. The problem in the past has been a hands-off welfare system that does not encourage lone parents to work even part-time combined with a high effective marginal tax rate if they shift from a part-time to a full-time job. This is changing for the better. The Community Childcare Subvention Scheme (CCSS) helps provide childcare to disadvantaged families through grants to community providers enabling them to charge reduced fees to parents based on their ability to pay. The government also plans to move towards a mutual obligations approach for single parents. The details have not yet been worked out, but the proposal is to provide greater support for training, job search and childcare combined with a work requirement after the youngest child reaches a certain age. It is essential for these activation initiatives to be successful that the public employment service (FÁS) has sufficient resources to activate people effectively and meet additional demands as more people are covered.[11]

The income tax system also contributes to reducing the incentives for second-earners to work full time, though the problem is less severe in Ireland than in some other European countries. Ireland has a hybrid income tax system that is somewhere between individual and joint taxation of household members, with the consequence that second earners can pay the highest marginal tax rate (48%, including social contributions) at a relatively low income level.[12]

Setting policies to underpin stability and sustainability

In the short run, the major challenge is to keep the economy on a stable path; in the long run, the sustainability of economic and social progress needs to be ensured. This *Survey* discusses these issues in depth. The functioning of the housing market should be improved and gradual change needs to start soon, before the next upturn begins. The downturn in the housing market and international financial market turmoil has highlighted the need to be prepared for shocks to the financial system. Slower revenue growth will put a premium on maintaining fiscal prudence and progressing in the on-going efforts to improve value for money from government spending. Ageing will pose fiscal challenges in the long term. The special chapter focuses on how to ensure that the recent boom in migration results in the successful longer-term integration of migrants.

Support for housing should be more efficient and promote stability

Over the past decade, Ireland has enjoyed the largest increase in house prices in the OECD, though prices started at a low level. The increase was propelled by the large rise in disposable income and low real interest rates. Demographic changes also spurred the market, with strong growth of the population at the age where people tend to buy a house, while the average number of people per dwelling has fallen. And there has been significant immigration. However, house prices have overshot and are now declining. The most likely scenario is a rapid adjustment in house-building to a more sustainable level and some further decline in house prices. To help avoid volatility in the housing market, which is difficult to cope with in a monetary union, the newly-created Commission on Taxation should review the taxation of housing (Chapter 2).

Ireland has a high rate of owner occupation of housing partly reflecting Ireland's social and cultural preferences. Although this may have some benefits, it is partly the result of costly and inefficient policies that distort the housing market and increase the role of housing in the economy as a whole. The tax treatment of housing is very favourable and the ceiling on mortgage interest tax relief for first-time buyers has been increased. Support should be reduced and better targeted. This would lead to a better use of resources and could help to dampen future housing cycles. Phasing out mortgage interest relief, or introducing a well-designed property or capital gains tax would be desirable. The abolition of stamp duty on housing transactions for first-time buyers and rationalisation of the regime for others, leading to lower payments for most buyers, will help to make the housing market more efficient and flexible. Housing support for those with low incomes is focussed on building new houses. This approach is costly and only provides immediate help to a small number of people. It would be more effective to provide means-tested housing benefits or vouchers that could be used to pay either a mortgage or rent.

Lending growth and international financial market turmoil have raised issues for the financial system

As well as the buoyant housing market, the commercial property market and the construction industry have also expanded very rapidly. Bank lending rose substantially in the context of very low real interest rates and more relaxed lending conditions. The private sector debt-to-income ratio now exceeds 200%, up from 100% in the late 1990s, and is high by international comparison, with a heavy concentration of lending in the property and construction sector. The Central Bank and Financial Services Authority of Ireland (CBFSAI) clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities. In addition, Irish banks are funded to a considerable extent by issuing securities and borrowing in the interbank market, which has also raised concerns.

The CBFSAI has taken action to reduce risks, including higher risk weightings on some assets, an improved regime to monitor liquidity and the implementation of a new

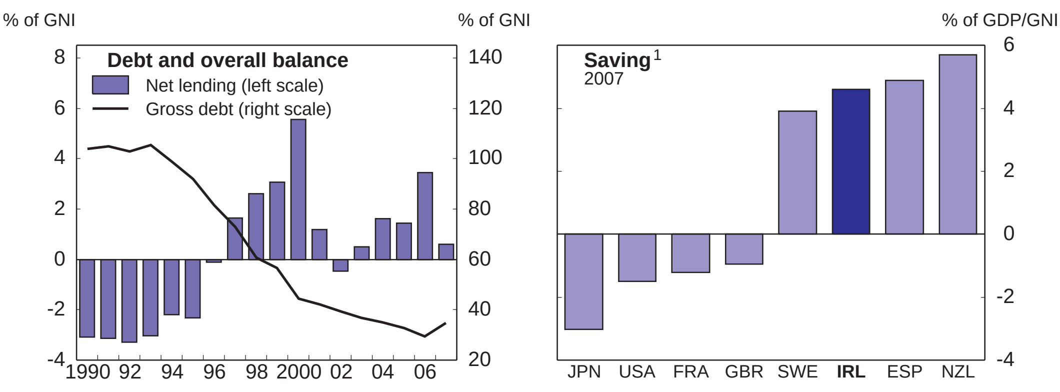
Consumer Protection Code to avoid predatory lending practices. The slowing in house prices and subsequent decline since mid-2007 has eased a key concern, as it brings house prices closer to fundamentals, improves housing affordability and helps to stabilise repayment burdens for new borrowers. Internationally, the ongoing financial market turmoil has led to a liquidity squeeze, higher funding costs for banks and a tightening in lending standards. It has also raised transparency issues about banks' exposures and credit lines to structured investment vehicles, hedge funds and private equity. A survey undertaken by the CBFSAI indicated that exposure of mainstream Irish banks to the sub-prime market was low, with Irish credit institutions reporting very limited exposures to the US sub-prime market, while banks' investment in residential mortgage-backed securities is small. Irish banks are profitable and well-capitalised, so that they should have considerable shock-absorption capacity. But the financial system should also be prepared to deal with downside risks. The EU Deposit Guarantee Schemes Directive is under review and Ireland should consider the design of its own scheme when the European framework is settled (Chapter 3).

Fiscal policy should adapt to lower revenue growth

The fiscal position was strong in the years up to 2006, despite one of the largest increases in public spending in the OECD, owing to the rapid expansion in revenues (Chapter 4). The general government account has been close to balance or in surplus since 1995 and public debt has become very small (Figure 1.11). The level of public savings (current revenue minus current expenditure) was one of the highest in the OECD and this has left ample room to fund longer-term capital investment. Around 4½ per cent of GNI has been spent on public investment so far this decade.[13] By law, 1% of Irish GNP is put into a pension reserve fund in order partly to pre-fund future pension liabilities.

Figure 1.11. **Fiscal performance has weakened**

General government sector



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1. OECD estimates; current revenue less current expenditure. Ireland in per cent of GNI. *Outlook* projections for Ireland updated to include later information on the fiscal position.

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

Revenue growth, however, slowed sharply in 2007 and the fiscal balance fell to around 0.6% of GNI from 3.4% the previous year. Stamp duty and corporation tax receipts were lower in 2007 than the previous year, although the latter was partly anticipated due to negative cash flow effects from bringing forward the payment date for preliminary corporation tax. Stamp duty receipts are expected to decelerate further in 2008. This weakness in revenues, alongside the planned slowdown in expenditure growth, is anticipated to lead to a deficit of around 1¼ per cent of GNI for 2008 and 2009. Recent developments highlight some fragility in elements of tax revenue (Chapter 4). In the longer term, distortionary and costly tax expenditure should be eliminated where these cannot be shown to be effective. A Commission on Taxation has been established to consider these issues, as well as others such as the financing of local government and a carbon tax.

Spending growth is planned to slow in the coming years but will continue to be fairly rapid in 2008. Implementation of the NDP and infrastructure investment has been given priority and fiscal plans remain prudent overall. However, it is important to avoid locking in generous long-term social expenditure and public sector wage commitments at this point of the revenue cycle.

With revenue growth likely to be constrained over the next few years, the public sector will need to give more emphasis to boosting efficiency and effectiveness. Steps have already been taken in this direction but more needs to be done. A review of the Irish Public Service by the OECD, which has been commissioned by the Irish government, is currently underway.

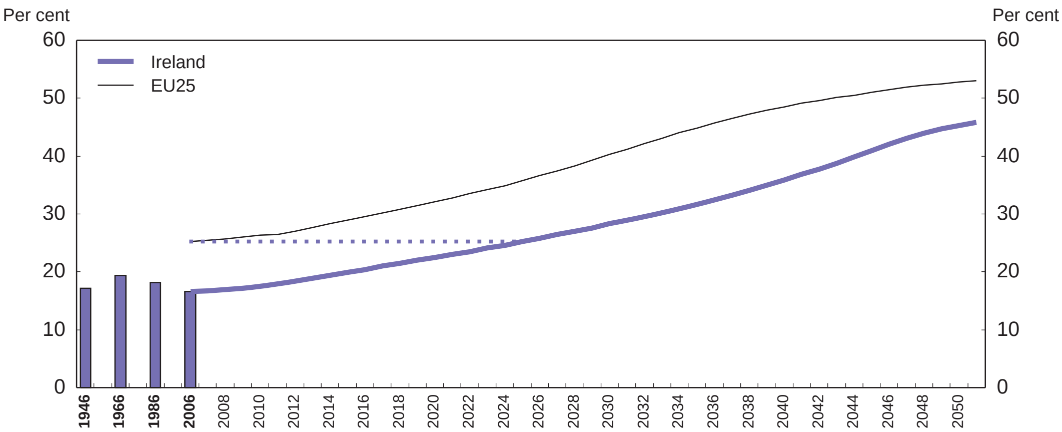
In the future, it is important that additional expenditure leads to an increased volume and quality of public services rather than being absorbed in wages and prices. The second Public Sector Benchmarking Body report has shown that wages in the public sector compare well with those in private firms, in part due to more generous pension entitlements, and that no substantial increase in public sector wages is necessary.

Population ageing will put substantial pressure on public finances in the long term

Looking to the longer term, Ireland faces one of the sharpest increases in age-related public spending in Europe, largely because its young population means that it is starting from a low base. Currently it has one of the youngest populations in Europe. It has some time on its hands: it will not be before 2025 that the old-age dependency ratio rises to the level that the EU25 faces today (Figure 1.12). But this should not be seen as an excuse to put

Figure 1.12. **Old-age dependency ratio**

Population aged over 65 relative to working-age population



StatLink http://dx.doi.org/10.1787/285131038583

Source: Eurostat and Central Statistics Office.

off some needed expenditure reforms such as a redesign of the pension system (Chapter 5). Many other European countries have left it too late, while Ireland has the luxury of being able to start early and therefore spread the adjustment over a longer time period. As the population ages, it will become increasingly difficult to provide an adequate retirement income for older people and maintain a fiscally sustainable pension system. Increases in benefits have reduced old-age poverty but there is a gap for most households between the state pension and a reasonable replacement income in old age. Ireland relies heavily on private savings to close this gap but many people are not saving enough. The challenge is to provide a long-term framework that achieves an adequate level of private saving.

The effective retirement age is now 65 and it is not uncommon to work beyond this age, but there remain obstacles to the participation of older workers. The phasing out of the Pre-Retirement Allowance (PRETA) and extension of the preventive process of unemployment assistance have removed incentives for those aged above 55 to leave the workforce. It is, however, important to ensure that other effective early retirement pathways do not open up through disability benefits.

Better integration is needed to get the most out of immigrants

The surge in immigration over the past decade, and especially since the European Union was enlarged in 2004, means that around 15% of the workforce was born in another country. Immigrants who arrived in the 1990s were predominantly British, American or had Irish nationality through their parents. This cohort has integrated easily into society and the job market. Since 2004, the inflow has been dominated by Eastern European migrants, mainly from Poland and Lithuania. They are well educated on average and have a very high employment rate, but they tend to work in jobs well below their skill level. In this sense, they are not fully integrated into the workforce and their talents are not being put to their best use. There is a third group of immigrants, from outside Europe. This covers a diverse range of people, some of whom face significant integration problems. Apart from the economic and labour market issues, the public sector will face new challenges over the next few years as more migrants settle permanently and bring over their spouses and children. Integration policy is only just getting off the ground. Policies for better integrating migrants are discussed in depth in Chapter 6 as well as the challenges that uncertainty about future migration flows poses for infrastructure planning.

Notes

1. This figure applies to 2001-03 and is based on ultimate beneficial ownership (if a US company channels funds through another jurisdiction, the statistics look through this and attribute it to the US rather than the intermediary). The estimates are based on CSO statistics reported in Lane and Ruane (2006).
2. For example, the cumulative net FDI outflow of 35% of GNI in 2005 and 2006 was mainly due to loans from IFSC companies to their affiliates abroad.
3. The rest is due to a different fuel mix. See Deloitte and Touche (2005).
4. See the regular *Status Reports on Local Loop Unbundling*, published by ComReg.
5. The definition of public investment in the OECD National Accounts differs from that used in Ireland, which show that public investment has been around 6% of GNI over the same period.
6. . This figure excludes public non-exchequer capital investment, such as in the electricity and gas sectors, of about € 18 billion over the same period.
7. See Chapter 5 of OECD (2006).

8. For a discussion of future skills needs, see Expert Group on Future Skills Needs (2007).
9. The Exchequer has in effect been paying fees on behalf of the students since their abolition.
10. This figure is for the child benefit payment rate in respect of the first and second child and includes the Early Childcare Supplement that was introduced in the budget for 2006.
11. € 50 million has been allocated under the National Development Plan (NDP) for the Department of Social and Family Affairs to provide an activation programme that engages with all social welfare recipients, but this covers a wide range of people including lone parents, people with a disability and the unemployed.
12. Using a model based on micro-economic data for Ireland, Callan *et al.* (2007) show that changing the tax treatment of couples would have a substantially greater impact on participation by married women than would a general tax cut that costs the Exchequer the same amount.
13. The definition of public investment in the OECD National Accounts differs from that used in Ireland, which show that public investment has been around 6% of GNI over the same period.

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Chapter 2

The housing market cycle has turned

After many years of sustained growth, the housing market has slowed: house prices are falling and there has been a sharp reduction in the number of new homes being built. The exceptional rise in property values in recent years was largely driven by higher income and demographics, but did appear to overshoot the sustainable level. House prices may ease further and could even fall below their long-run value. Residential investment is experiencing a sharp slowdown. This will have some effect on wider economic activity. If a more severe slowdown occurs, the housing market could pose risks for economic growth and the financial system. Phasing out policies that distort the housing market could help to dampen future housing cycles and maintain the competitiveness of the economy.

Although housing markets boomed in most OECD countries over the past decade, the increase in real house prices in Ireland has been exceptional: house prices are more than 2.5 times higher in real terms than 10 years ago. This partly reflects the same factors that have driven housing markets elsewhere, such as a period of relatively low nominal interest rates, but also the "catch-up" in Ireland following the Celtic Tiger years, strong inward migration and the starting position of relatively cheap housing. The housing market has now turned. Indeed, house prices have begun to fall while they are still rising in many other countries, even if at a slowing rate. The main consequence for wider economic activity so far has come from the sharp slowdown in housing construction, although there are risks of a stronger impact and effects on the financial system (Chapter 3). This housing cycle, the first since Ireland joined Economic and Monetary Union (EMU), raises a number of structural policy issues that should be addressed before the next cycle begins.

The housing market slowdown

House prices are falling as measured by the mix-adjusted permanent tsb/ESRI House Price Index and the price for second-hand houses recorded by the Department of the Environment (Table 2.1). This follows a sustained deceleration in prices since the second half of 2006. Some further easing of house prices is possible. The weakness in house prices has been matched by a sharp fall in the number of transactions. As demand slows and prices fall, owner-occupiers are less likely to trade-up or down and fewer new households try to get onto the housing ladder. Although houses are becoming more affordable, potential buyers are likely to be cautious until prices appear to have stabilised.

Table 2.1. **Housing market indicators show a slowdown**

Year-on-year growth rate

	2006				2007		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
House prices							
Permanent tsb/ESRI series	11.1	14.3	15.3	13.0	9.2	2.9	–1.8
New houses	11.4	11.9	12.1	9.0	9.0	7.7	3.2
Second-hand houses	14.4	14.1	18.9	6.8	9.0	2.1	–4.0
Loan approvals (number, all agencies)	28.6	7.8	–23.3	–24.5	–21.9	–28.4	–18.3
Planning permissions	–4.5	–16.8	–6.9	–11.8	–3.1	0.7	–2.6
Construction volume	16.8	–2.6	–12.3	5.5	–19.8	–6.2	
Quarterly house completions	24.3[1]	n.a.	18.3	1.5	–8.6	–13.8	–22.8
New house registrations	15.0	12.5	13.6	–14.0	–28.0	–40.7	–52.2

1. Data for 2006 Q1 and Q2 were not published separately.
Source: Central Statistics Office; Department of the Environment, Heritage and Local Government; permanent tsb.

A housing market slowdown had been widely anticipated, although the timing was difficult to predict, and activity in the early part of 2007 was depressed in the short term by expectations in the run up to the general election that changes to stamp duty would occur.

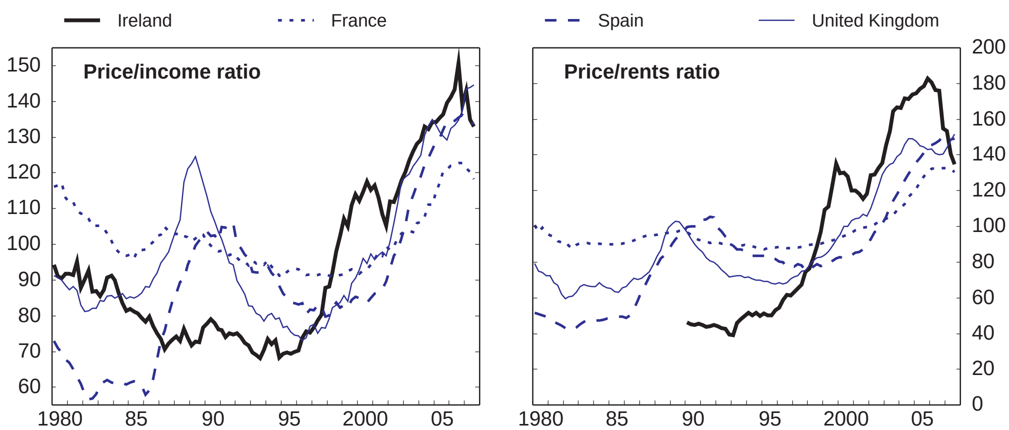
In 2005, probit analysis by the OECD suggested that the likelihood of being at a peak in real house prices in Ireland was then around the mid-point of the countries considered (van den Noord, 2006). The subsequent increase in the real value of houses, however, made it more likely that the market would soon reach a peak given past experience of how housing cycles evolve. The doubling of ECB's policy rate from 2% to 4% since December 2005 had a strong cooling effect on the housing market, even if the rate rises did not bite immediately. Econometric analysis suggests that house prices in Ireland are more sensitive to short-term interest rates than in many other countries, consistent with the popularity of variable-rate mortgages (Rae and van den Noord, 2006).

The outlook for house prices is highly uncertain but the falls to date have been relatively small compared with the massive rise over recent years. The dynamics of house prices are hard to predict. Housing cycle corrections often occur through small falls in prices followed by long periods of flat prices as homeowners are reluctant to sell at a nominal loss, waiting until the equilibrium level of prices catches up to actual prices. However, past experience cannot rule out that prices fall more sharply and overshoot the sustainable level on the downside. The long-run sustainable level of house prices, however, is likely to be much higher than in the past and prices may not be far from their fundamental level; the exceptional increase in house prices in Ireland relative to other OECD countries partly reflects the very strong economic performance of Ireland, rapid inward migration and its unusual demographic position. The sharp rise in employment and incomes, together with a rising population and a high rate of formation of new households, is likely to have increased the sustainable level of house prices considerably. The number of housing units relative to the population has caught up from a low level by European standards to 417 per thousand inhabitants, close to the EU average but still below the stock in France and Germany.

There are a number of ways of assessing the balance between demand and supply in the housing market and hence the sustainable level of house prices. The ratio of house prices to incomes has fallen sharply, as nominal house price inflation has eased and incomes have continued to increase rapidly (Figure 2.1). The ratio of house prices to rents

Figure 2.1. **House prices in relation to income and rents**

Average 1990 Q1-2007 Q2 = 100



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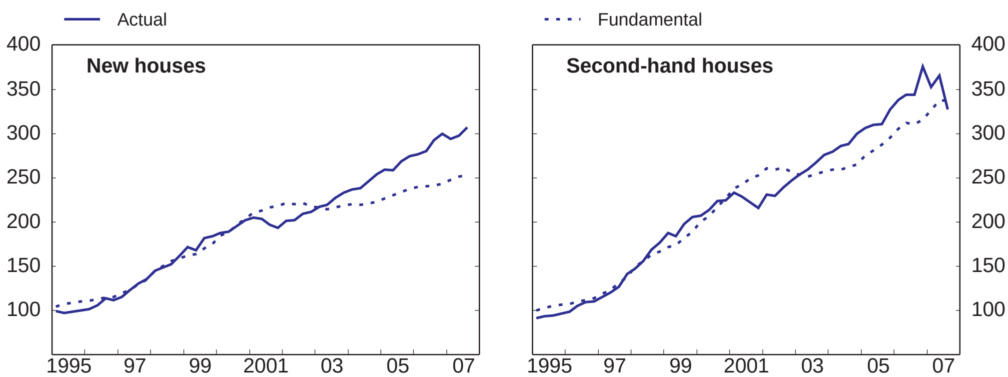
Source: OECD (2005), *OECD Economic Outlook*, No. 78, updated data.

has also fallen. By bringing the cost of buying and renting more into line, this is likely to stimulate demand for owner-occupation. Furthermore, rents have accelerated and rose by 12% over the past year. The strong current demand for rental accommodation partly reflects first-time buyers being unable to afford to buy a house and thus renting for longer. Migration is likely to have increased demand for rental property too. As rents rise and house prices fall, some first-time buyer households will return to purchase housing although the impact is likely to be initially concentrated on the lower end of the housing market. Despite the rebalancing of the housing market, the value of houses in Ireland remains high compared with historical experience on these measures.

Evidence from an economic model suggests that house prices were below their long-run sustainable level in the early part of the decade but then overshot (Figure 2.2). The sustainable level of both new and second-hand house prices has continued to rise at a relatively fast rate of 5-10% annually, which would be high in international comparison but is well below the rate of increase in the late 1990s. This continued rise has been driven in large part by higher incomes and demographic factors. The model may overstate the effect on prices of demographic effects given that the large number of migrants who arrived in the past two years are more likely to have modest housing demands initially. For second-hand houses, the fall in house prices appears to have eliminated the gap with the fundamental level, although such estimates are highly uncertain. For prices of new houses, a large gap has opened up with the long-run level of house prices and there has been little adjustment to date.

Figure 2.2. **Actual and fundamental house prices**

In thousand euros, real prices[1]



StatLink http://dx.doi.org/10.1787/285203131543

1. Nominal prices deflated using the harmonised consumer price index.

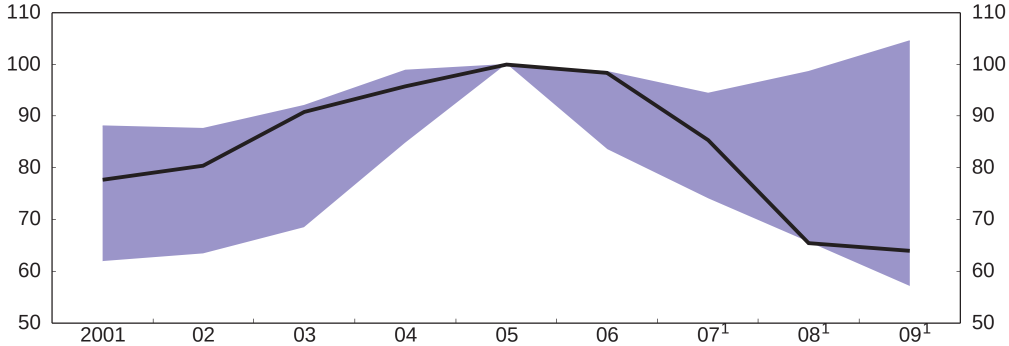
Source: Rae, D. and P. van den Noord (2006), "Ireland's Housing Boom: What Has Driven It and Have Prices Overshot?", *OECD Economics Department Working Papers*, No. 492, June, updated data.

The sharp fall in residential construction

Housing investment was 12% lower in the first half of 2007 than a year earlier. This ends the expansion in house-building that began in 1993. Over this period, housing investment more than doubled as a share of GNI to reach a peak of 16%, the highest share in the OECD. Residential investment is characterised by pronounced boom-bust cycles. Compared with the experience of 46 house-building booms in 23 countries between 1960 and 2004, the recent expansion in Ireland was big and the current slowdown is consequently likely to be relatively severe (Figure 2.3). The OECD projects a fall in

Figure 2.3. **Residential investment per capita**

Index, peak = 100



StatLink http://dx.doi.org/10.1787/285206310120

Note: The shaded area indicates the 10th to 90th percentiles of the distribution of residential investment per capita in 46 booms in 23 countries between 1960 and 2004, where the peak is normalised at 100 and set at 2005.

1. OECD forecasts.

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

completions from around 90 000 in 2006 to 50 000-60 000 in 2008, which is close to the level regarded as sustainable given rising incomes and demographic effects. But the cutback in investment could be even sharper. International experience suggests that the correction in house-building is usually relatively short-lived with sharp falls in the first two years, followed by a couple of years of stagnation. Some slumps, however, last longer and this remains a risk, especially if immigration were to recede.

Given the large share of economic activity, the fall in housing construction will have a substantial impact on overall economic activity. Construction, including commercial and civil engineering, accounts for 12% of employment but the housing component is relatively labour intensive. Furthermore, construction accounted for one quarter of the increase in employment over the past five years. Some of this increased supply of labour has been provided by migrants (Chapter 6).

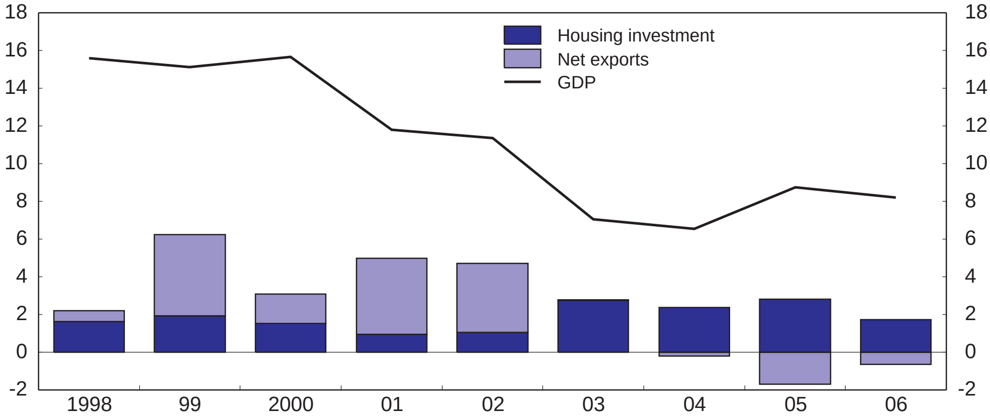
The macroeconomic impact of the housing market cycle

Housing demand has had a major impact on the economy in recent years. Residential investment has constituted around a sixth of GNI. Moreover, as the strong contribution of net exports to the growth of demand in the late 1990s receded, house-building made a major contribution to nominal growth (Figure 2.4). The strength of consumption growth is also likely to have been supported by rising house prices. People tend to purchase big-ticket durable goods when they move. There may also be more general wealth and confidence effects. These could fade as house prices fall. Many studies have failed to find a strong effect of housing wealth on consumption in Ireland: the strong growth of consumption in recent years could be explained by rising incomes and employment rather than housing. Evidence from a cross-country study, however, suggests that consumption in Ireland is relatively sensitive to the housing market as there is a high rate of home ownership, loan-to-value ratios on new mortgages are high and short-term interest rate loans are popular (Catte *et al.*, 2004). Consumer confidence has already fallen to its lowest level since 2003.

The slowdown will have a wide range of effects including putting pressure on the financial system (Chapter 3) and lowering tax revenues (Chapter 4). Simulations of the OECD's macroeconomic model for the previous *Survey* suggested that a one-third decline in

Figure 2.4. **Housing investment and net exports**

Contribution to nominal GDP growth, per cent



StatLink http://dx.doi.org/10.1787/285233667611

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

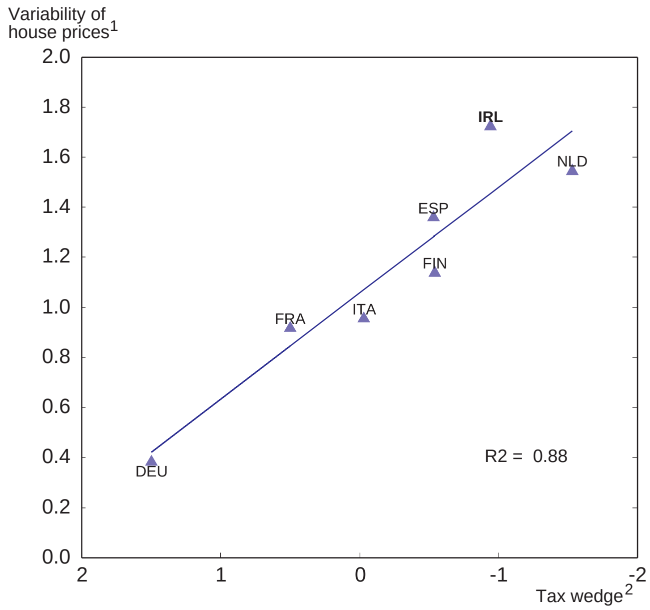
housing investment from the level at that time would reduce GNI by 2% and raise unemployment by as much as 2 percentage points. Although the current *Economic Outlook* projections paint a less severe picture, the housing market nevertheless weighs heavily on growth in 2008. The effect on overall construction activity of lower house-building is partly offset by government infrastructure construction and more spending on home improvements facilitated by the greater availability of builders. There will also be effects on the supply capacity of the economy. The reduced demand for workers in the construction industry is likely to reduce the number of migrant workers, but average productivity will increase as resources are redirected towards more productive sectors of the economy.

This is the first housing cycle in Ireland since EMU. In the past, many of the effects of the housing market slowdown on aggregate demand could have been offset in the short run by an accommodative monetary policy. This mechanism is unlikely to come into play this time, particularly because Ireland appears to be leading other economies in this episode. It has been fortunate for Ireland that the European Central Bank did not raise short-term interest rates in the autumn of 2007 as expected prior to the global financial market turmoil. The size and structure of the housing market makes Ireland particularly sensitive to changes in interest rates. Furthermore, the initial rise in house prices was related to low real interest rates in Ireland, brought about by low nominal interest rates reflecting sluggish euro area growth, while Irish inflation was relatively high. House price growth has been more rapid on average in those euro area countries with low real interest rates. This emphasises the role of other policies and the importance of Ireland maintaining external competiveness so that net exports can contribute to rebalancing the economy (Hoeller and Rae, 2007).

Housing market policies should not contribute to housing market instability, particularly as the monetary policy instrument is not available. The variability of real house prices tends to be higher where the tax wedge between after- and pre-tax real interest rates on mortgages loans is most negative (van den Noord, 2004, Figure 2.5). This is because the impact of rising house prices on the cost of purchasing a house are partly offset by the tax break so there are weaker forces in the system to slow down rising house prices. Higher house prices tend to increase the value of loans that people take out but this

Figure 2.5. **House price volatility and the tax treatment of housing**

Per cent



StatLink http://dx.doi.org/10.1787/285240733821

1. Root mean square deviation of real house price from trend, 1970-2006.
2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

Source: van den Noord, P. (2004), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale* and OECD calculations.

is partly countered by the government through the higher value of tax relief on mortgage interest payment. In addition, there is no property or capital gains tax that might curb housing demand as prices increase, although relatively high stamp duty payments have some slowing effect on housing market turnover.

More efficient policies towards housing

There would be long-run gains from more efficient policies towards housing, in addition to mitigating the cyclical volatility of the housing market. Table 2.2 summarises the recommendations of the previous *Survey* and subsequent policy action. Ireland remains the only country in the OECD that allows households some tax deduction for mortgage interest payments at the same time as not taxing property values, capital gains or imputed rent. Income invested in owner-occupied housing may therefore effectively never be fully taxed during a person's lifetime.

Other countries that previously had similar arrangements have moved towards a more efficient framework for taxing housing (Box 2.1). By contrast, the Budget for 2008 moved modestly in the other direction by raising the ceilings for mortgage-interest tax relief for first-time buyers.* Recent measures to exempt first-time buyers from stamp duty, reduce it for most others and introduce a more incremental schedule, however, will contribute

* The ceiling for rent relief was also raised to € 2 000 for a single person and € 4 000 for a couple aged under 55, which is one-fifth of the ceiling on mortgage interest tax relief. This illustrates how both housing in general and owner-occupation in particular are favoured by the tax system.

Table 2.2. **Progress in structural reform: Housing**

Recommendations from previous *Surveys*	Action taken since the March 2006 *Survey*
Phase out the bias towards housing that is embedded in the tax system. Reduce the tax incentive for speculative investment on properties.	The government moved in the opposite direction by doubling the ceiling on mortgage tax relief for first-time buyers. Reforms to the stamp duty regime will reduce the transactions costs for most buyers of residential property.
Introduce a property tax in order to fund local infrastructure and services and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.	No change.
Social housing policy should become more tenure-neutral by scaling back house-building and providing more by way of income support and/or housing vouchers.	The Rental Accommodation Scheme (RAS) pays private landlords for long-term accommodation for those who have been receiving rent supplement for more than 18 months. The latest NDP envisages large-scale investment in public housing.
Promote the supply of under-developed land.	No progress.

Box 2.1. **Reforming taxation of housing**

Many countries find it difficult to reform the taxation of housing but no other OECD country has kept such a range of favourable tax treatments of housing as Ireland. It is a complicated and sensitive policy issue in all countries, although Ireland's high rate of home ownership tends to increase such constraints. There is an understandable reluctance by policymakers to change housing taxation at a time when the market is relatively weak. However, it would be beneficial for the long run to make tax policies towards housing more efficient both to reduce the likelihood of boom-bust cycles and to make the economy more competitive. Given the current position of the housing cycle and possible impacts on prices, it would be desirable to act only gradually but to begin soon.

The least distortionary system for taxing housing, the most consistent with the way other assets are taxed, would be to tax the imputed rents on housing and treat capital gains on owner-occupied housing in the same way as for other assets,[1] preferably using a scheme that avoids the risk of accumulating a large liability to capital gains tax when the property is sold. Under such a system, mortgage and other costs relating to a house would be tax deductible. No OECD country applies this set of policies exactly, but Ireland is alone in allowing deductibility, not taxing capital gains and having no property tax.

Other countries that once had such a wide range of tax-favoured treatments of housing as Ireland have made reforms that make their tax systems less distortionary. Some countries reformed taxation of housing by removing the tax deductibility of mortgage interest: Germany (1987), France (1997/1998),[2] and the United Kingdom (2000). UK Mortgage Interest Tax Relief (MIRAS) was scrapped in a number of separate changes over a long period of time. Such a gradual approach would limit the disruptive impact on the housing market.

Ireland has also made some moves towards a more efficient system. Mortgage interest deductibility was first capped in 1974, although limits were raised in 1993 and 2003 and in 2007 for first-time buyers, and it was limited to the standard rather than the marginal rate in 1994. Further incremental steps to reform the taxation of housing could:

- Limit deductibility to first-time buyers in line with the stated objective of helping young people and families to buy their first home. The upper limit on relief to people who have owned a house for more than seven years is € 6 000 for a couple and € 3 000 for a single person. € 255 million was spent in 2007 on this relief to homeowners who had not purchased their house in the previous seven years.

Box 2.1. **Reforming taxation of housing** *(cont.)*

- Reduce the number of years over which first-time buyers can claim relief from the first seven.
- Lower the annual ceiling on the generous relief for first-time buyers.

A useful strategy is to remove the tax deduction at a time when mortgage interest payments are set to fall, for example due to cuts in interest rates, to cushion the impact on the disposable incomes of families with mortgages. The reduction of interest deductibility could be made fiscally neutral by offsetting reductions in other taxes. For example, this could finance further reductions in stamp duty, following from those made in the Budget for 2008, that would improve the functioning of the housing market. At a minimum, a long-term commitment to freezing the ceiling for relief in nominal terms, as has been done in Spain, would slowly reduce the distortionary impact of the tax break.

An alternative approach is to maintain interest deductibility but introduce a property or capital gains tax on owner-occupied housing. Denmark, Finland and Sweden raised or introduced property taxes on homeowners, although in some cases these taxes are rather low. This attempts to approximate a tax on imputed rents. This might also be desirable in Ireland for other reasons, such as recovering some of the gains to private property owners from the benefits of public expenditure on infrastructure that raises local property values.[3]

1. Residential investment property (buy-to-let) in Ireland is essentially taxed in this way with expenses being tax deductible but rental income subject to taxation and capital gains tax applied.
2. It was re-introduced in a limited way in 2007.
3. Development contributions are currently used in Ireland by local authorities to help to pay for public infrastructure servicing new developments, such as roads and sewerage.

somewhat to making the housing market more flexible and efficient; the impact of these measures is relatively small for the average house and totally exempting first-time buyers is most valuable to the few buyers able to purchase the most expensive properties (those worth in excess of € 635 000).

Ireland has achieved very high levels of ownership relative to most other OECD countries. However, this is partly due to the tax system, which generates strong incentives towards home ownership at the expense of renting and spending money on other things. The case for a more neutral tax system was discussed in the 2006 *Survey*. The high share of the average household budget spent on housing relative to other countries is indicative of the way the current system encourages people to spend more money on it. Given that the supply of housing in desirable locations is limited, much of the extra demand pressure leads to people paying more to live in the same houses. These incentives may encourage households to invest too much of their wealth in housing and not enough in other assets such as equities or a pension. Households would face less risk if they spread their wealth more evenly across different assets. The high level of house prices could also discourage migrants, particularly where there is competition for skilled workers who can easily choose to settle in another country where housing is more affordable. High levels of stamp duty and unrecoverable costs associated with moving house may reduce the mobility of workers between different parts of the country. A deeper rental market could also ease cyclical pressures in the housing market by making it easier for households to switch at the margin between the two types of accommodation.

Spending on housing support for people with low incomes is largely directed towards capital expenditure and building new social housing. Under the National Development

Plan (NDP), € 18 billion is provided for social and affordable housing programmes and only € 3 billion for rent allowance schemes. The Affordable Housing scheme involves building homes for those with low incomes to buy at prices significantly below the actual market value. Combined with the generosity of the tenant purchase scheme for existing social housing tenants, this set of policies strongly favours home ownership. Although there may be reasons for looking favourably on owner-occupation, Ireland already has one of the highest rates of home ownership in Europe and households should be free to choose the most appropriate form of housing tenure for their circumstances, rather than facing a skewed choice. Furthermore, the current system provides support to a relatively small number of people at a very high cost as it is very expensive to build houses to sell at a discount. It can also be difficult to allocate scarce new public housing to the people who need it most. Increasing the emphasis on means-tested housing benefits or vouchers that households can use either to pay a mortgage or rent, along the lines of the Rental Accommodation Scheme (RAS), could be desirable. The low marginal tax rates facing low income households increase the scope to introduce such an element of means testing while maintaining good incentives to work.

Box 2.2. **Summary of recommendations on the housing market**

- Begin gradually to reduce the bias towards home ownership in the tax system following the possible approaches identified in Box 2.1, either by starting to phase out mortgage-interest tax relief or by introducing a property or capital gains tax on owner-occupied housing.
- Introduce a property tax to fund local infrastructure and services. This would broaden the tax base and redistribute some of the windfall gains from those who benefit from living close to public infrastructure projects.
- Social housing policy should become less reliant on direct provision of publicly-owned housing and provide assistance more through alternative methods such as the Rental Accommodation Scheme (RAS) which makes use of good standard private rental housing to meet long-term housing assistance needs.

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Chapter 3

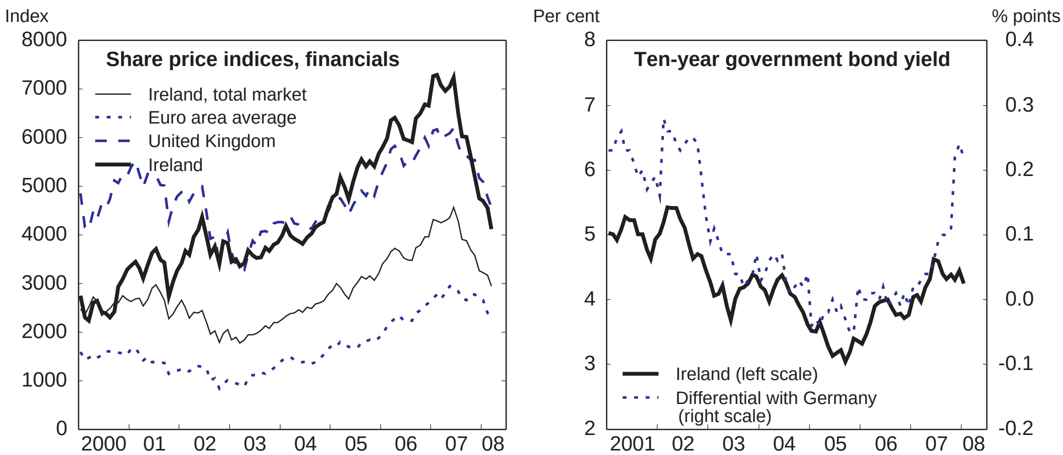
Financial stability: Banking on prudence

Lending has been strong, with debt ratios reaching very high levels. The Central Bank and Financial Services Authority of Ireland (CBFSAI) had clearly identified the major vulnerabilities and taken action to mitigate them. The Irish banks are well-capitalised and profitable, which provides a cushion to weather the more difficult times ahead. This chapter reviews financial market developments, the actions by the CBFSAI and the new policy issues that have come to the fore with the financial market turmoil.

The Irish financial markets have grown very fast since the turn of the century. Domestic bank lending has risen by about 25% annually, double the rate in the euro area as a whole. Stronger competition has reduced interest margins, to which banks reacted by cost cutting, while lending was spurred by the strong property market. Property-related lending (residential mortgages, commercial property and lending to construction companies) now accounts for more than half of the stock of bank lending. Deposit growth has not kept up with lending growth. An increasing share of lending was funded mainly by the issuance of securities as well as by borrowing from other financial institutions, with nearly half coming from UK banks. At 60% in mid-2007, Ireland is the country with the lowest deposit-to-credit ratio in the European Union.

Prior to the weakening in the Irish housing market and the recent international financial market turmoil, the Irish banks were in great financial shape: they had the highest rate of return on assets in the euro area, while non-performing loans to total loans had fallen to 0.7% in 2006 from 1% in 2000. Moreover, the agency ratings of Irish banks are among the highest in the euro area. The financial share price index on the Irish Stock Exchange more than tripled between 2000 and 2006. It then fell sharply and the decline was much larger than in the euro area on average (Figure 3.1). Even though Ireland's government net debt position is much better than that of Germany, the government bond yield differential with Germany re-emerged in late 2007. This is a reflection of the international financial turmoil.

Figure 3.1. **Banking sector share prices and government bond yield**



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Source: Datastream and European Central Bank.

Containing risks to the financial system

Since May 2003, the financial industry has been supervised by the Financial Regulator (before April 2006 the Irish Financial Sector Regulatory Authority). It is placed inside the central bank as an autonomous entity, which ensures close co-operation between the two. The main tasks of the Regulator are to provide a sound regulatory environment that facilitates competition, to protect consumers and to foster a stable financial services industry (Financial Regulator, 2006). In addition, it is at the forefront of implementing EU financial market directives. It regulates banks, insurance companies, investment and retail intermediaries, stockbrokers and collective investment schemes, including those operating in the IFSC.[1] Non-deposit lenders, which have been involved in the development of Ireland's still limited market for sub-prime mortgage loans, were not regulated until recently. Sub-prime mortgages are estimated to account for about 2% of mortgage lending in Ireland, providing a new mortgage mechanism for some customers who might previously have experienced difficulty obtaining a loan because, for example, of the nature of their employment, or being new to Ireland. The CBFSAI in its *Financial Stability Report 2007* found that the mainstream Irish banking sector has a minimal level of involvement in this market and that average loan-to-value ratios were generally modest.

The CBFSAI had clearly identified strong credit growth and rising indebtedness as major systemic vulnerabilities (CBFSAI, 2005 and 2006). The private sector debt-to-income ratio had reached 216% of GNI by the end of 2006, up from 100% in the late 1990s. It is among the highest in the European Union. The speed of increase was an additional concern. It noted that, notwithstanding the strength of the banking system, a correction in house and commercial property prices if it were to be combined with a significant increase in arrears, could pose significant difficulties for the health of the banking system. The CBFSAI also highlighted the over-concentration of income and loan books to property-related business,[2] falling net interest margins, a reduction in the forward-looking element in provisioning[3] and a widening funding gap as adding to the vulnerabilities. The funding gap is largely made up by the issuance of securities and borrowing in the interbank market. The widening of the gap is of concern, because wholesale funding is more expensive than retail deposit-funding, thereby reducing profitability, and it is generally more sensitive to confidence shocks than deposit-based funding. Liquidity risks are mitigated by the significant medium-term maturity element of many of these liabilities as well as the relatively wide range of funding options available to the domestic banking sector. The CBFSAI judged that risks arising from the insurance sector were very low.

Against the background of the sharp rise in lending, the CBFSAI took several actions:

- Because of the decline in general provisions and the persistently high growth rate of mortgage lending, the CBFSAI increased the risk weighting on high loan-to-value mortgages for owner-occupiers and for exposures secured by properties that are not occupied by the borrower to increase the capital cushion. It also raised the risk weight applied to speculative commercial real estate lending in Ireland.
- It introduced new liquidity requirements for credit institutions. Rather than focusing on the stock of liquid assets, the new regime is based on a forward-looking mismatch approach under which cash flows are assigned to relevant time bands.
- It implemented a new Consumer Protection Code, which came fully into effect in July 2007. It is legally binding and comprises general principles supplemented by more detailed rules, which regulated financial service providers must obey. It also published

Minimum Competency Requirements for persons who provide advice on or sell retail financial products. More recently, legislation was passed that addressed CBFSAI concerns that non-deposit-taking sub-prime market lenders and firms providing home reversion loans or personal loans were not covered by the new Consumer Protection Code and the Minimum Competency Requirements.

- The CBFSAI initiated stress testing not only for credit,[4] exchange rate, interest rate and equity-related risks, but also for liquidity risks (Kearns, 2006). Concerning the latter, the Stability Reports now include a test for a decline in deposits and in the value of certain liquid assets. On the other hand, the Reports have underlined the limits of stress testing and that behaviour could change in circumstances where uncertainty increases significantly and rapidly.

The significant slowing in house prices and subsequent decline since mid-2007 has eased a key concern as it brings house prices closer to fundamentals, while housing affordability is improving and repayment burdens on new loans are stabilising (CBFSAI, 2007). Moreover the rate of debt accumulation by the household and non-financial corporate sector has eased substantially. On the other hand, housing permits and commencements have plummeted. This is probably reinforced by the buy-to-let market. Since 2004, it has risen very rapidly, with 26% of mortgages outstanding being attributed to investors in June 2007. Investors have relied heavily on capital appreciation for their returns in past years as rents were fairly stable. New investors are facing a shortfall in terms of covering their mortgage obligations with rental income. Those who have invested in mid-2007 face an estimated shortfall of 36%. A faster increase in rents and, for new investors, lower house prices have started to lower this shortfall.

The commercial property market has also been strong. As growth in capital values has been buoyant until recently, outpacing the increase in rents, yields on commercial property investment have been compressed and are now low in international comparison (Woods, 2007). Capital value growth has eased considerably during 2007, though still rising at a brisk pace in the third quarter of 2007. Investment in the Irish property market is likely to be much weaker in 2008 than in 2007. Irish banks have also provided funding for property investment in the UK property market, which has also weakened considerably. International experience suggests that commercial property busts tend to have greater consequences for the stability of the financial system than a sharp downturn in house prices. Indeed, stress testing involving a severe shock has shown that there is likely to be a larger deterioration in asset quality for commercial property-related lending than for residential mortgages.

The high overall share of property-related lending implies a considerable vulnerability to a shock to the sector. Following a shock, banks might find that the performance of the loans is correlated and asset quality could deteriorate in many loans. An additional risk is that price changes in these markets are correlated, which has indeed been the case. Moreover, price cycles have been highly correlated across countries in recent years, so that international diversification could aggravate rather than mitigate risks going forward. While Irish banks earn a significant share of their profits in other countries, the majority of foreign earnings are made in the United Kingdom (Kearns, 2007). On the other hand, the health of the banking sector has remained robust, when measured by a range of indicators and the results of stress-testing exercises.

International financial market turmoil has raised funding costs in an environment of already low net interest margins and slower lending growth.[5] Lending standards have tightened considerably and all these factors together could reduce banks' willingness to supply loans. Since August 2007, there has been little effect of higher interbank rates on interest rates for new loans for house purchases as margins are tied to the ECB's main refinancing rate. There has been a slight increase in the average interest rate on existing mortgages (10 basis points) and a further small increase in December. Rates of new business loans have gone up by more (nearly 40 basis points). While difficult to gauge, banks are likely to ask for more documentation and collateral when providing loans.

Policy issues and responses

The international financial market turmoil has brought a number of policy issues to the forefront (Hurley, 2007 and ECB, 2007). The global liquidity squeeze is partly blamed on a lack of transparency in banks' exposure to the sub-prime market and credit lines extended to structured investment vehicles, hedge funds and private equity. A survey undertaken by the CBSFAI (CBSFAI, 2007) indicated that exposure of mainstream Irish banks to the sub-prime market was low, with the Irish sub-prime market representing only 2.3% of new mortgages issued in 2006. Irish credit institutions report very limited exposures to the US sub-prime market, while banks' investment in residential mortgage-backed securities is small. Exposure to hedge funds was also found to be small. Exposure to the private equity sector is more substantial, although it still accounts for a small percentage of total assets. The CBFSAI's initiative in enhancing transparency is clearly welcome and should be a regular feature. Updates of Irish banks on their performance did not include any large write-downs. The CBFSAI is also participating in a euro area initiative to collect information on Financial Vehicle Corporations. Unfortunately, to date such initiatives have not reassured markets sufficiently and share prices of financial institutions have not recovered.

Given the liquidity problems in the interbank market and despite establishing that liquidity risks are low in the stress-testing exercises, the CBFSAI has asked banks to report weekly on their liquidity situation and receives regular updates on liquidity contingency plans. The close monitoring of the situation also involves regular information-sharing meetings between the central bank, the Regulator and the CEOs of the main financial institutions.

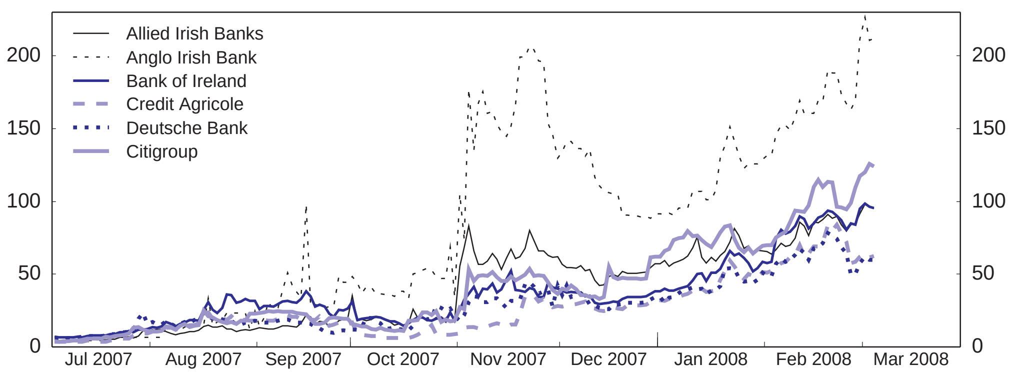
In the Irish deposit insurance scheme, depositors may be compensated 90% of their deposits up to a maximum of € 20 000. This is the minimum required by the EU's Deposit Guarantee Schemes Directive, but it is in mainstream of European law and practice and should be sufficient to provide protection to the vast majority of depositors. While the same amount is guaranteed by many other EU countries, the guarantee is much higher in the United States where more than $100 000 is covered. The UK authorities have recently announced that the UK guarantee will rise considerably from an already higher level, following the bank run on Northern Rock. The Irish scheme is funded *ex ante* by a levy of 0.2% on deposits and the fund contained € 460 million at end June 2007. All insurance schemes lead to moral hazard problems so that finding the right amount of deposit insurance is difficult. The optimal coverage is that which will keep depositors whose losses create political sympathy "at home and off the streets" (Kaufman, 2007). More would reduce effective monitoring and disciplining of the banks by depositors competent to do so, though the evidence for the latter actually occurring is thin. More importantly perhaps than the size of the guarantee is that arrangements are in place that give depositors near-immediate access to the par value of their insured deposits, which is the case in the United States, but not in Ireland and most other European countries. In Ireland, the scheme must be in a position to pay within three months of the central bank determining that a credit institution is unable to repay deposits or a court suspending the depositors' ability to make withdrawals. In exceptional circumstances, the scheme may have up to three extensions of three months in line with the European directive. The scheme is obliged to pay out as expeditiously as possible and is not required to wait for three months before payment. Liquidity concerns could still be an important consideration for depositors in withdrawing deposits. Moreover, the fund is small, which could be an additional consideration.[6] A review of the EU Deposit Guarantee Schemes directive is currently being undertaken in the context of the EU roadmap in response to international financial market turmoil.

Conclusion

The CBFSAI is a highly respected institution and the Irish regulatory framework got high marks in IMF reports (IMF, 2006). It has well identified the major financial stability issues and has urged lenders and borrowers to behave in a prudent way. At the same time, it has taken regulatory action to reduce risks, has introduced a new Consumer Protection Code, which has helped to avoid predatory lending practices that have occurred elsewhere, and has taken some measures to enhance the transparency of financial markets. And with fortunate timing, it introduced a forward-looking liquidity regime just before the financial market turmoil struck. In addition, rapid growth has provided extensive earnings opportunities for Irish banks, reducing their incentives to engage to a large extent in more high-risk investment strategies, and they have remained profitable and well-capitalised. But international financial market turmoil is not over yet. Credit default swap rates are still above those in the early part of 2007 (Figure 3.2).

Figure 3.2. **Credit default swap rates**[1]

One-year senior bonds



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1. The reported rate indicates the cost of insuring senior corporate bonds against default. It is measured in basis points. One-hundred basis points implies that it costs € 100 000 to insure debt of € 10 million.

Source: Datastream.

Any assessment of the situation can, of course, only be tentative. There is no generally accepted definition of financial stability, or of its converse of financial instability.

Regulators can be transparent in the sense of publishing work, assessments and decisions. But financial stability is usually perceived as a negative concept, involving the absence of something unwanted, an extreme event that has not happened yet and the likelihood of which is unknown (Goodhart, 2006). In that sense, those involved in prudential supervision can only keep the shock-absorption capacity of the financial system strong, and also be prepared to deal with specific downside risks.

The recent international financial market turmoil has tempted some to advocate a move into regulatory overdrive. This is not the way to go. The costs and benefits of regulatory steps need to be carefully weighed. Over the past two decades, financial innovation has flourished in an environment of macroeconomic stability; it has reduced liquidity constraints, new credit products suit a wider range of borrowing needs and it has helped the spreading of risks. It is important to secure these benefits, though the recent financial market turmoil has brought some new issues to the forefront. Tackling these, while remaining vigilant about financial market developments, should keep the Irish financial markets well managed.

Box 3.1. **Summary of recommendations on financial stability**

- Enhance transparency further by regularly surveying off-balance sheet exposures of banks.
- Improve stress testing further. In this respect, the CBFSAI has established a work programme that, *inter alia*, follows up on suggestions by the IMF's FSAP report.
- The EU Deposit Guarantee Schemes Directive is being reviewed. Ireland should consider the efficacy of its own arrangements following the review.

Notes

1. The total assets of IFSC banks are about as large as those of the domestic banks. But the links between the IFSC institutions and the domestic Irish financial market are limited in terms of providing credit to Irish residents or taking deposits from them. Also interbank borrowing between them is limited. However, IFSC banks could be an important counterpart for domestic banks' credit risk transfer activities, and domestic banks could hold securities issued by IFSC banks (see Box F in Central Bank & Financial Services Authority of Ireland, 2006).
2. In mid-2006, property-related lending was 60% of total lending. In the United Kingdom it was 42%.
3. General provisions are being phased out, because of new International Financial Reporting Standards. These provisions are made against inherent but unidentified losses in the loan book.
4. In October 2007, the Regulator issued revised guidance on stress testing with respect to residential mortgages. Credit institutions should stress test mortgages at 2% above the ECB's minimum bid rate plus a margin of 0.75%; interest only mortgages should be tested on the basis of repayment of interest plus principal; the outcome of the test should inform the decision to grant a loan; and stress testing should be incorporated into the credit institution's credit policy which should be approved by the board. Moreover, the liquidity stress tests have been modified to take into account the new liquidity regime.
5. Financial market turmoil is discussed in a broader context in OECD (2007) and ECB (2007).
6. In the case of a large pay-out, credit institutions can be obliged to make additional lodgements within seven days.

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Chapter 4

Adapting government spending to lower revenue growth

Softening economic growth and the slowdown in the housing market mark a turning point for fiscal policy. Strong revenue growth in earlier years financed a sustained expansion of government spending and some cuts in tax rates, while still allowing the government to run a substantial fiscal surplus. This left the public finances in a healthy state with net government debt declining to a very low level. But this benign picture is changing as growth slows and tax receipts increase more slowly. Public spending growth needs to slow. The challenge is to improve public services further without large increases in resources. In these circumstances, it will be even more important to get better value from public spending and to accelerate public management reforms.

Fiscal performance was strong in the years up to 2006 as strong revenue growth outpaced the sharp increase in public spending. Government receipts had risen by close to 50% in real terms in the previous five years, somewhat faster than national income, and this sustained an almost equally large increase in public spending as well as allowing debt to be repaid. But the fiscal balance deteriorated rapidly in 2007 as revenue growth weakened with the general government surplus falling to around 0.6% of GNI, down from 3.4% the previous year. After several years of unexpectedly buoyant receipts, the growth of tax revenues more than halved, mainly due to the weakening of the housing market (Table 4.1).[1] This reflects underlying changes in taxation that play an important role in determining the fiscal outlook and risks. Expenditure growth is set to slow to reflect weaker revenue growth: it is crucial that this is achieved. A small fiscal deficit is likely in the coming years but the underlying fiscal position remains sound, although the budgetary situation is more challenging than in the recent past. To meet demand for better public services, it will become increasingly important to raise efficiency as the scope to raise spending narrows.

Table 4.1. **General government fiscal position**

Percentage change on previous year

	2001	2002	2003	2004	2005	2006	2007[1]	OECD forecasts	
								2008	2009
Total receipts	4.4	7.8	10.4	9.6	9.3	13.4	6.1	3.0	5.4
Taxes	2.7	7.2	10.7	10.5	10.2	14.8	5.7	2.6	5.6
Personal	4.3	–4.0	12.7	13.2	9.3	14.9	10.5	5.2	6.1
Business	5.7	15.9	8.0	2.8	3.2	21.5	–15.8	–9.6	3.0
Indirect taxes	0.7	13.2	10.2	11.0	12.7	13.0	8.3	3.4	5.7
Social security contributions	12.2	10.1	9.3	9.6	10.2	10.8	9.1	5.2	5.8
Expenditure	16.7	12.2	7.4	7.1	9.9	8.1	13.7	7.6	5.7
Memorandum items									
General government net lending (% of GNI)	1.2	–0.5	0.6	1.6	1.4	3.4	0.6	–1.2	–1.3
Saving (% of GNI)	5.2	3.3	3.6	4.4	4.2	6.6	4.6	2.7	2.4
Gross debt (% of GNI)	44.0	42.3	39.4	38.5	37.8	34.7	34.8	36.6	38.4
Expenditure per person (thousand €, 2007 prices)	11.94	12.58	12.86	13.36	14.00	14.40	15.20	15.78	16.38

1. OECD forecasts based on *Economic Outlook 82*, but updated to include later information on the fiscal position, including the Budget for 2008. The impact of discretionary policy changes on the forecast is small.

Source: OECD (2007), *Economic Outlook 82 database*, Department of Finance, *Budget 2008*, and OECD calculations.

Tax revenues are less robust

Revenue growth slowed sharply in 2007 and is expected to be weak in 2008. This slowdown has partly been driven by a sharper than expected fall in stamp duty receipts as housing market activity has dropped. The Budget for 2007 included a number of measures to lower taxes on income by enhancing tax credits, raising standard rate bands and reducing the higher rate of income tax by 1 percentage point to 41%. The Budget for 2008 contained few discretionary measures other than to adjust credits and allowances to keep low earners out of the tax net and average earners below the higher rate of income tax, and a reform to the stamp duty regime for houses. Further ahead, revenue growth will pick up but, as the economy expands more slowly, will remain at around half the rate of recent years.

These developments are shaped by a profound shift in the composition of tax revenues, although income, corporation and consumption taxes continue to make up the vast bulk of receipts. There has been some move away from income taxes and social security contributions and towards indirect taxes and taxes on capital (Table 4.2). For example, stamp duty revenues rose from € 0.4 billion in 1995 to € 3.2 billion in 2007 to represent around 5% of total revenues. As is evidenced by recent developments, these growing revenue streams are relatively volatile (Figure 4.1). This reflects two factors. Firstly, these tax revenues often respond very strongly to movements in the underlying tax base. For example, as in other countries, firms can offset losses against corporation tax and this can make receipts very sensitive to changes in corporate profitability. Secondly, the underlying tax bases are more volatile than GDP. In the case of stamp duty, this is levied on the value of housing transactions which is very cyclical as the number of houses being sold and house prices tend to move in the same direction. Estimates suggest that a 10% fall in house prices and 20% fall in the volume of transactions might reduce stamp duty revenues by around 0.5 percentage points of GNI. In some ways, the growing importance of these taxes weakens the relationship between tax receipts and GNI and diversifies government income, which could make it on average less cyclical. There are also times, however, when these factors can align to create a "perfect storm". In 2006, a strong economy and housing market boosted revenues but a weak economy combined with a housing correction could create an opposite large shortfall in revenues. The more volatile nature of receipts needs to be taken into account, as has been the case in recent budgets, in making judgments about the appropriate stance of fiscal policy.

Table 4.2. **The composition of tax revenues has changed**

Share of revenue

	1995	2007
Income tax and social security	44.3	37.4
Corporation tax and taxes on capital	9.1	16.4
Excise duties	15.4	9.7
VAT	19.4	24.2
Stamp duty	2.1	5.3
Other	9.7	7.1

Source: Central Statistics Office, *Annual Income and Expenditure Tables;* Department of Finance, *Budget* 2008 and OECD calculations.

Over the longer term, some tax revenue items could undergo a structural decline. In particular, VAT receipts from new houses and stamp duties on housing market transactions will tend to weaken as the housing market completes the "catch-up" process of bringing the housing stock up to standard. Furthermore, around half of corporation tax receipts in 2006 were paid by firms supported by the Industrial Development Agency (IDA, 2007). This is close to 1.5% of GNI. Corporate tax bases are highly mobile across borders and

Figure 4.1. **Corporation tax and stamp duty revenues**

Percentage change

StatLink http://dx.doi.org/10.1787/285241183630

Source: Central Statistics Office, *Annual Income and Expenditure Tables;* OECD (2007), *Economic Outlook 82 database* and OECD calculations.

it would be relatively easy for these profits to move elsewhere and for tax revenues to decline. Although the authorities remain committed to keeping the current corporate tax rate, the relative benefits of locating in Ireland depend on many factors including the tax rate in other jurisdictions. The average statutory corporate tax rate has come down considerably in the European Union in recent years and several countries have announced further cuts.

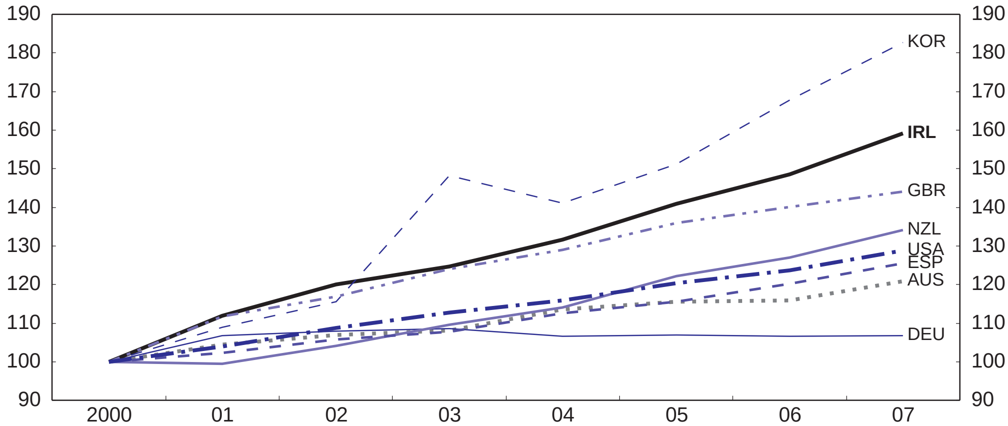
The tax system continues to create substantial distortions and a large amount of revenue is foregone due to tax expenditures. Over half of the cost of credits is due to basic personal tax credits and pensions. There are also substantial tax expenditures related to housing (Chapter 2). In 2003, tax expenditures (excluding basic personal tax credits) were estimated to be worth around a sixth of current expenditure. Following a review in 2005, several property-related tax reliefs were phased out and a cap was placed on the total amount that could be claimed by individual taxpayers, but the cost of some of the remaining credits may have increased. Many tax reliefs remain. A small number of new reliefs was introduced in the Budget for 2007 and some others were expanded or renewed. As argued in the 2006 *Survey* (OECD, 2006), these tax expenditures distort economic activity and contribute to lowering the effective tax rate on the highest earners, as these reliefs are typically worth more to them. Data for 2003 showed that one-third of the 400 highest earners had an effective tax rate of less than 25%. The cap introduced in 2006 to ensure that at least 50% of a person's gross income will be subject to tax has helped to address this issue and is estimated to have brought in an additional € 70 million in revenue. The top 1½ per cent of income earners contributed over a quarter of total income tax revenues in 2007. The lowering of average stamp duties on residential properties, streamlining of the schedule and exemption of first-time buyers introduced in recent budgets are welcome and should increase mobility as well as giving a boost to housing-market activity, although the tax saving of around € 5 000 on an average property represents less than 2% of its value. A Commission on Taxation has been established with a mandate that includes examining the overall role of different types of tax, the efficacy of tax expenditures, the financing of local government and the introduction of a carbon tax. The Budget for 2008 already contained measures to reduce pollution through the tax system by linking carbon-dioxide emissions to Vehicle Registration Tax and capital allowances and expenses for business cars. The Budget also makes motor tax rates depend on engine size.

Government spending is likely to slow

Public expenditure increased by around 15% in nominal terms in 2007. Spending growth is expected to moderate in 2008 as a stepping stone to annual growth of around 5-6% in later years. This requires a substantial change of pace after the rapid catch-up growth in earlier years: the increase of government expenditure from 2000 to 2006 was second only to Korea in the OECD (Figure 4.2). Such large and sustained increases in public spending have rarely been experienced in developed countries since the 1960s, even if the share of government spending in national income remains low by OECD standards. Although the pace of growth will be very much lower than in recent years, the rate of expansion will still be faster than in most other euro area countries.

Figure 4.2. **Real expenditure has expanded rapidly**

Cumulative growth since 2000



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

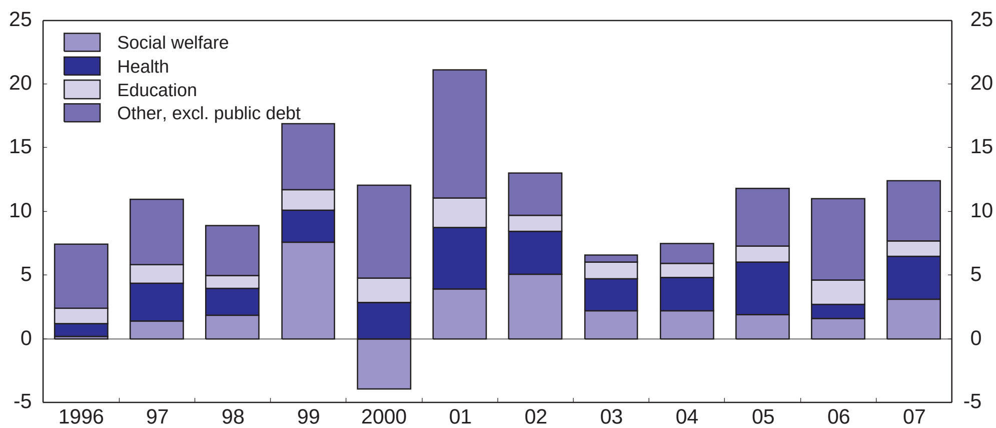
Investment has been given priority over current expenditure, particularly through the commitment to implement the programme for € 184 billion of government spending in the NDP 2007-13. € 56.6 billion has been allocated to capital investment in the 2008-12 Multi Annual Capital Envelope. The main priorities for spending are improving the economic infrastructure and reducing social exclusion, although substantial funding is also envisaged for enterprise and innovation, increasing human capital, and the social infrastructure. Ireland already has one of the highest rates of public investment in the OECD, on a par with Spain and only below Korea, Mexico and the Czech Republic. The Budget for 2008 brought forward investment relative to earlier plans, particularly for public transport projects and road building. Capital expenditure growth will slow sharply after 2008 but a high level of public investment will be maintained as set out in the NDP. In contrast to previous national development plans, the role of EU funding will be negligible as Ireland is no longer among the European Union's lower income states.

Current expenditure growth has also expanded rapidly, albeit at a slower pace than investment since 2006. This is expected to moderate over the coming years. Increases in current government expenditure in the Budgets for 2007 and 2008 were broadly based. The main discretionary changes were to raise the level of the state pension and to provide more generous social benefits in real terms. These have raised the contributory state pension from € 193.30 to € 223.30 per week for a single person, raised child benefit from € 150.00 to € 166.00 and increased the basic rate of benefits for adults under a variety of schemes from € 165.80 to € 197.00.

This comes against the background of rising benefit levels and greater funding for healthcare that have been key factors behind the rising share of government expenditure relative to GNI in recent years (Figure 4.3). In real terms, current expenditure on social services such as health and education increased by a quarter between 2004 and 2007.[2] The government increased basic benefits (such as the unemployment benefit) by 18% in real terms between 2005 and 2007 and largely achieved its goal of raising the benefit to 30% of the average wage. In the *Social Partnership Agreement* the government commits to maintaining this level over the long term, although it is unclear whether this is in real terms or as a share of the average wage. The sustainability of long-term commitments should be scrutinised in a clearer framework for the objectives and level of social benefits (Chapter 5). As social welfare payments have become more generous, the design and administration of benefits needs to take more account of the adverse impacts on labour supply. It is striking that one-fifth of the working-age population receives some form of income support, despite the dynamism of the economy, an unemployment rate close to 5%, and a young population.[3] Funding for long-term care has been reformed. From 2008, care recipients will be entitled to the same financial assistance no matter whether they are in a public or private long-stay bed. They will continue to pay fees but will pay no more than 80% of their disposable income up front. If user charges exceed this level, the rest is charged against the value of the person's home and will be paid back when the estate is settled (up to a maximum of 15% of the value of the house).

Figure 4.3. **Main components of higher public spending**

Contributions to annual government spending growth, per cent



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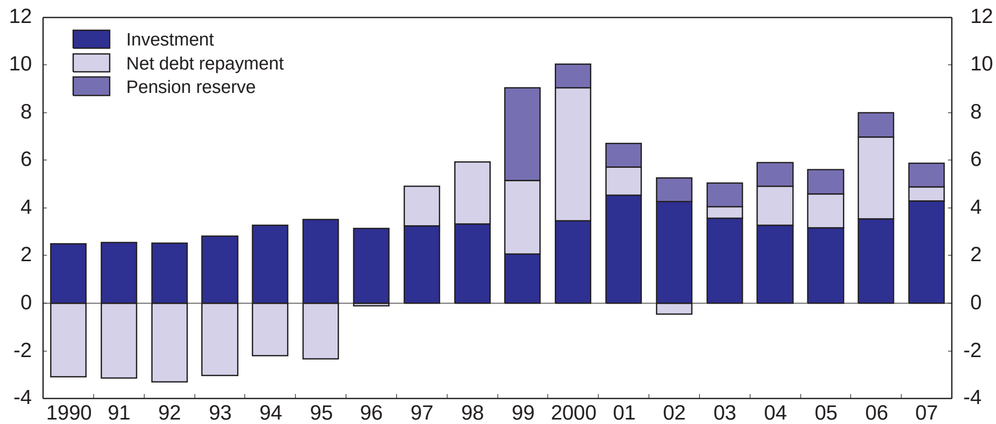
Source: Central Statistics Office, *Annual Income and Expenditure Tables*; Department of Finance, *Budget 2008* and OECD calculations.

Fiscal performance has remained sound but is weakening

In recent years and up to 2006, there was an operating surplus of receipts over current expenditure that has largely been used to improve public infrastructure (Figure 4.4), although some was paid into the National Pension Reserve Fund (NPRF) to cover future pension costs (Chapter 5) and a small part was used to pay down government debt. The fiscal surplus narrowed by around 2 percentage points of GNI in 2007, as revenue growth slowed sharply but expenditure increased at a double-digit rate. Spending growth is anticipated to moderate in 2008 but will remain well above the increase in receipts. The Budget for 2008 anticipates a deficit in coming years of around 1% of GNI. The increase in the deficit is stronger than implied by past relationships which suggest that the primary budget surplus would fall by around 0.4-0.5% of GNI for each 1 percentage point reduction in output relative to potential (Girouard and André, 2005). This shortfall is partly due to an unexpectedly sharp fall in revenues related to property. Although recent Budgets have been prepared on conservative assumptions about economic growth and have included a sizeable General Contingency Provision to deal with an unexpected deterioration in the fiscal balance, the sharp rise in expenditure in 2007 was ill-timed given developments in revenue and the targeted slowdown in expenditure for 2008 only closes part of the gap to the growth rate of receipts. It is important to ensure that spending increases in line with nominal growth of GNI. While elements of a multi-annual approach to managing current expenditure are in place, there is scope for strengthening this framework along the lines of the systems in many other countries to avoid sharp changes from year-to-year and excessive spending growth at times of buoyant revenues.

Figure 4.4. **The government balance sheet has been strengthened**

As a percentage of GNI



StatLink http://dx.doi.org/10.1787/285288247265

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

The updated *Outlook* projection shows a further weakening in the fiscal balance in 2008 to a deficit of 1.2% of GNI: receipts continue to fall as a share of national income over the forecast horizon but expenditure growth does not fall below income growth until 2009. As with any fiscal projection, the scenario of a manageable deterioration of public finances is surrounded by major uncertainties. These risks underline the importance of slowing the growth of current expenditure as planned (Box 4.1).

Box 4.1. **Uncertainty around the fiscal balance as the economy slows**

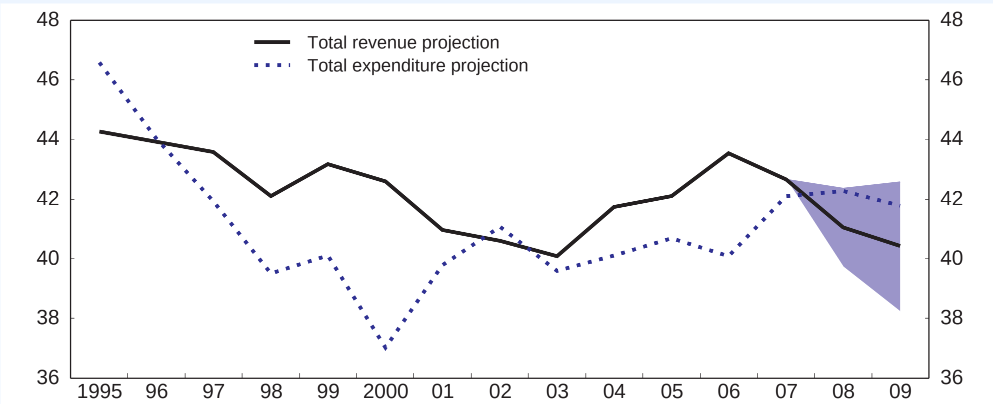
The budget balance is inherently hard to predict. During a slowdown, the lull in economic activity leads to a slowdown in tax revenues but spending tends to rise as more people claim social benefits and as discretionary fiscal policy is used to stimulate demand. Forecasts often miss the scale of such effects. This can lead to a large and unexpected deterioration in the budget balance.

There are a number of standard approaches to assessing the outlook for government finances. It is common to try to identify "structural" and "cyclical" components of the fiscal balance, either based on a "bottom-up" evaluation of how different tax revenues vary with the cycle given how the tax system is constructed (Girouard and André, 2005) or using "top-down" econometric analysis of how tax receipts have varied with GDP or the relevant tax base (Morris and Schuknecht, 2007).

Projections show that tax revenues are likely to decline as a share of national income (Figure 4.5), leading to a fiscal deficit as the share of expenditure does not contract. This slowdown in revenue is broadly in line with Girouard and André (2005), although the exact timing is influenced by the particular characteristics of this economic slowdown. The uncertainty around all these forecasts is large. Figure 4.5 gives an indication of revenue uncertainty based on a simple econometric model that allows for the difficulty of forecasting several different taxes and their respective tax bases. For example, a forecast of housing transactions is used to predict stamp duties but there are unknowns in predicting both the tax base and the resulting revenue. This basic approach suggests that there is a substantial risk that revenues will fall more sharply than anticipated and that there will be a larger-than-forecast deficit if expenditure does not adjust.

Figure 4.5. **A larger fiscal deficit is a risk**

As a percentage of GNI



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Note: The shaded area shows indicative one standard error bands around the revenue projection.

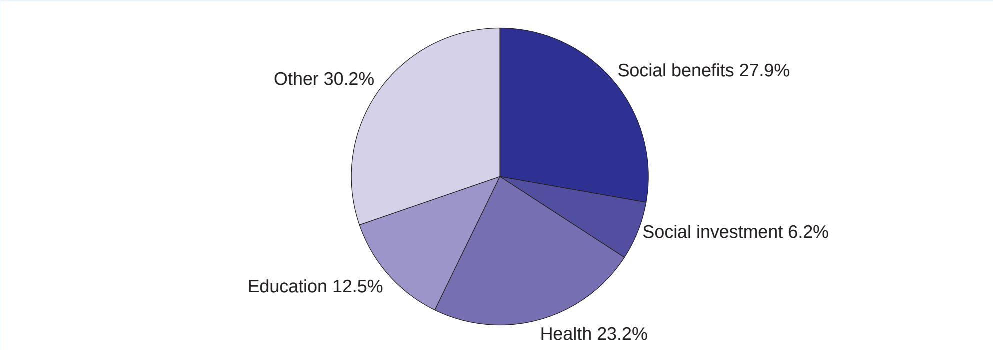
Source: Department of Finance, *Budget 2008*; OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Box 4.1. **Uncertainty around the fiscal balance as the economy slows** *(cont.)*

Such a shortfall in receipts would weaken the fiscal balance. The overall impact would depend on how government expenditure is managed. The government is committed to capital spending as part of the five-year envelopes and has said that the NDP will have priority in terms of government spending in coming years. Public expectations for better healthcare and education are running high. Figure 4.6 suggests that there is little room for manœuvre on the spending side because the share of spending that is not related to major government priorities or commitments is small. A relatively large change in other elements of government spending would be needed to offset the growth in these priority areas. Furthermore, as in many other countries, the wage bill is around two-thirds of current spending which highlights the importance of controlling public sector wages. Given the vulnerability of government revenues and the size of commitments on public expenditure, great vigilance is required in setting fiscal policy.

Figure 4.6. **Spending is heavily committed to priorities**[1]

Per cent of total spending, 2005



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1. Social benefits include social security and welfare payments and housing (excluding investment). Social investment includes capital formation for transport, health, education and housing. Health and education refer to current spending. Shares of government spending exclude debt payments.

Source: Central Statistics Office, National Income and Expenditure Tables.

Ireland is committed to the EU Stability and Growth Pact as the medium-term fiscal framework to ensure sustainability. The anticipated fiscal deficit in the coming years would not compromise Ireland's commitments under the Pact, either in terms of the 3% of GDP limit for the actual deficit or the 1% cyclically-adjusted deficit that it is allowed because of strong government investment. The Budget for 2008 anticipates a cyclically-adjusted deficit of 0.6% of GDP in 2010, giving some limited room for manœuvre under the Pact. It is particularly important for Ireland, as a small member of a much larger monetary union, to maintain a sound medium-term fiscal position to allow the automatic stabilisers to operate freely as its particular circumstances will have little impact on how monetary policy is set. The cyclically-adjusted fiscal position has been relatively volatile compared with other OECD countries, which suggests the discretionary use of fiscal policy.[4] The Budget for 2008 usefully contributed to mitigating the impact of the slowdown in housing construction by reducing stamp duty, bringing forward infrastructure investment and raising social benefits. By contrast, the Budget for 2007 was overly expansionary and put additional pressure on the supply capacity of the economy over the past year when aggregate demand was already strong and which may eventually limit the room for manœuvre in future years. Given that Ireland has a very open economy and a relatively low share of government activity in national income, which requires larger proportional changes in revenue and expenditure to achieve a given change in the government deficit as a share of GDP, the scope of discretionary fiscal policy to be effective is relatively narrow.

The medium-term position can be assessed with the cyclically-adjusted fiscal stance, which takes into account the estimated gap between actual output and the economy's long-run supply potential. Nevertheless, the rapid pace of economic growth in past years and the unexpectedly large inflow of migrants make the structural supply capacity of the economy hard to assess. Labour productivity growth of around 3% per year over the past five years offers a very different outlook for sustainable public spending growth than the average of over 5½ per cent annual growth in the late 1990s. Expansionary fiscal policy should not be used to stimulate demand if supply has in fact slowed. The 2007 Agreed Programme for Government, which runs to 2012, gives priority to keeping low income earners out of the income taxation and average earners below the higher band, but also commits to abolishing the cap on Pay Related Social Insurance (PRSI) contributions and lowering the rate of employee contributions from 4% to 2%,[5] subject to the overall economic and fiscal framework. This would lead to a more rational and fair system. Once these commitments are met, the government aims to lower the standard rate and higher rates of income tax to 18% and 40% respectively by the end of the term of the current parliament if conditions allow. These tax cuts were not made in the Budget for 2008 and should only be considered if medium-term economic circumstances allow.

The long-term outlook for the public finances is relatively strong as Ireland has a very low level of public debt compared with most other OECD countries. The current fiscal settings would, however, eventually become unsustainable due to the pressures from ageing as shown in the 2007 Actuarial Review of the Social Insurance Fund (Department of Social and Family Affairs, 2007). As discussed in Chapter 5, there are a number of options for dealing with the rising budgetary cost of pensions. These include greater pre-funding, increases in taxes and cutting back on other forms of spending, but changes to the pension system itself and encouraging adequate private pension saving must play a major role.

Additional resources should be used effectively

Despite the anticipated slowdown in government spending, the rate of public investment will remain high and the increases in government expenditure will be substantial compared with most other OECD countries. This makes it particularly important that additional resources are well used. The scale of additional government spending in past and future years puts pressure on the public sector's ability to manage the resources effectively and the economy's ability to deliver the additional services.

It is clear that Ireland has a need to improve its public service and infrastructure but it is important that the overall level of spending and the projects are a good use of limited resources. It is of concern that the NDP set overall spending at a higher level than recommended by the Economic and Social Research Institute's (ESRI) *Ex ante Evaluation of the Investment Priorities for the National Development Plan (2007-2013)* on the basis of its assessment at the time of how much additional investment the economy was able to deliver. In the event, the subsequent downturn in house-building has eased this constraint but specific bottlenecks may remain, for example with respect to some skills (ESRI, 2007).

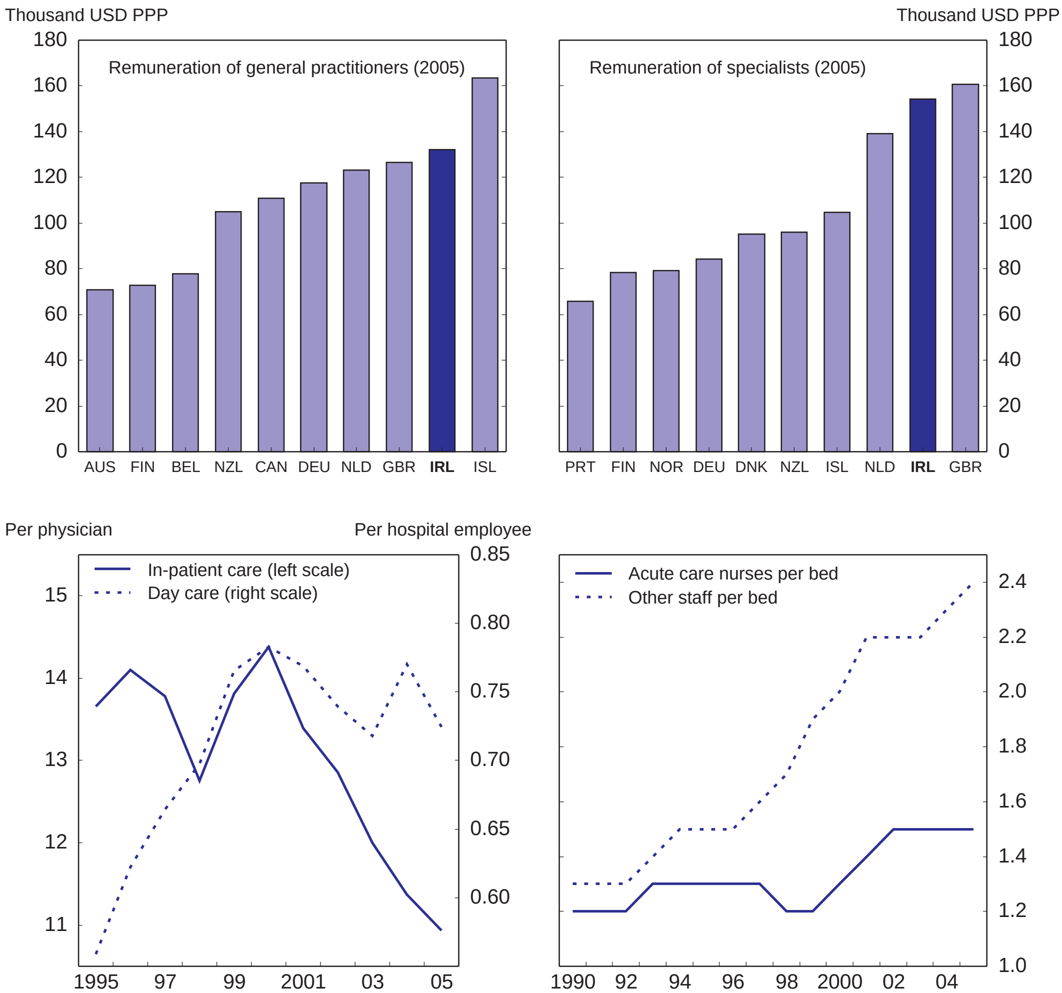
Non-residential construction has remained firm and Ireland faces competition for construction capacity from the boom in the North and major projects elsewhere such as the London Olympics.

Higher wages have absorbed much of the increased funding in the past. In particular, the first Public Service Benchmarking Body (PSBB) report in 2002 recommended an overall increase in public service pay costs of 8.9% (PSBB, 2002), leading to a sharp relative increase in public sector wages. These pay increases were tied to the elimination of many inefficient working practices, such as the system of linking pay in different parts of the public sector, and a greater volume of output. In practice, progress is hard to evaluate: although reports were published that show compliance with the agreed changes in working practices, no evidence was made available to demonstrate that better outcomes had been achieved and changes in working practices were found to be acceptable in almost every case. Furthermore, doubts were raised even at the time about whether public sector wages were actually out of line with the private sector (O'Leary, 2002). The first benchmarking report did not produce clear evidence to justify its conclusions and the generosity of public sector pensions was not taken into consideration (Chapter 5).

By contrast, the second PSBB found that "in general public service salaries compare well with the private sector" and recommends a limited number of specific pay increases representing just 0.3% of overall pay costs. This is based on a wide-ranging and transparent analysis of how public sector wages compare with the private sector. It confirms other recent evidence, such as an estimated 7% public sector wage premium for recent graduates, even after allowing for underlying differences in the two sectors and more extensive use of bonuses in the private sector but without taking into account pensions or job security (O'Connell and Russell, 2006). Public sector pensions are estimated by the PSBB to be worth 12% of salary more than the private sector equivalent. The challenge now is to ensure that this is reflected in the next pay deal under the *Towards 2016* social partnership agreement. Locking-in high pay commitments would be risky given uncertainty about future revenues and the need to improve competitiveness.

Public spending on *healthcare* rose by 64% in real per capita terms between 1999 and 2005.[6] Staff numbers have increased by around a third, with salary levels and capital investment accounting for the remainder.[7] The health system has treated more people, with a 50% increase in the number of hospital day cases and a small increase in the number of bed days. There have been significant improvements in life expectancy at birth and mortality. But there is a large gap between the additional expenditure and the growth of outputs. This could be explained by some combination of a change in the composition of treatment towards more expensive activities and a rise in the cost of performing the same activities. The high cost of some new drugs, for example, could explain a shift towards more costly activities, although technological advances that require less time in hospital act in the opposite direction to reduce costs. But some crude measures of productivity such as the number of procedures per physician or the number of staff per bed have worsened in recent years (Figure 4.7). The proportion of procedures carried out as day cases is below the OECD average, and this too can be a sign of inefficiency. Clearly, these indicators are simplistic and it would be unwise to draw any strong conclusions from them alone. They do, however, point to a need to analyse in greater depth whether the additional spending on healthcare has delivered all that it could have done in terms of the amount and quality of healthcare provided to patients. Investment is needed to produce statistical information to track changes in costs and the volume of health services more closely. One

Figure 4.7. **Indicators of healthcare efficiency**



StatLink http://dx.doi.org/10.1787/285431373608

Source: OECD, *Health Data 2007.*

notable result of the increase in health spending is that Irish healthcare professionals are among the most highly paid in the OECD. Of course, Ireland competes for medical staff with the United Kingdom and any inefficiency there will drive up costs in Ireland (OECD, 2004), but there are also risks to health sector pay from inefficiency and large increases in spending within the Irish system.

The additional resources for healthcare have been provided at a time when the organisation of the health service is in a state of transition. A major reform of the structure of Ireland's health system was undertaken in 2004. This replaced the previous system of regional Health Boards with a single national organisation, the Health Service Executive (HSE). The HSE operates some hospitals directly, while most are owned by trusts/foundations. Pouring extra money into the system at such a time, before the new organisation has been shown to work, is a risky strategy. The HSE overspent its budget for 2007 by € 216 million, which has led to a cost-containment plan and temporary recruitment freeze. Financial incentives and control in the health system should be improved to avoid such short-term emergency measures. The newly established Health Forum provides a mechanism whereby the social partners can engage with each other to improve the operation of the health system.

Improving public sector management

Stronger public sector management is crucial to delivering a better public service from existing and additional resources. Previous *Surveys* in 2003 and 2006 (OECD, 2003 and 2006) included extensive discussions of the steps Ireland had taken and could take to get better value for money from public expenditure in line with the Strategic Management Initiative launched in 1994 and the subsequent Developing Better Government programme. Public sector management and procedures have again been strengthened since the previous *Survey*, but the needs of Irish society have also evolved. There has been systematic steady but incremental reform in some areas. Further reforms are necessary to improve how policies are implemented, to raise the agility of the public service, and to make reforms to the public sector more coherent. A review of the Irish Public Service by the OECD, commissioned by the Irish government, is currently underway.

The overall management of public expenditure has been improved. The new unified budget brings together spending and revenue decisions. The Pre-Budget Outlook, published around two months beforehand, provides an update of the economic context and the fiscal position to provide a basis for discussions during the budget round. Expenditure projections are based on the cost of maintaining the existing level of service (ELS), which tends to increase in real terms as population growth and other factors increase the demand for public services. However, by taking current practice as the reference point, the ELS approach does not achieve the tight budget constraints that would encourage departments each year to seek efficiency gains or prioritise more effectively between different activities. In addition, the Pre-Budget Outlook includes an Indicative Unallocated Provision which amounted to 0.75% of GNI for 2008. This is intended to make the overall fiscal projections more realistic by including an indication of likely spending increases over and above the ELS. There is a risk, however, that this creates an undue perception of scope for additional expenditure or tax measures, particularly as the Provision includes the cost of indexing tax brackets and social welfare payments which is common practice. A more effective starting point for negotiations with departments would be a top-down publicly-stated, rather than internal, target for actual overall spending increases without reference to the ELS. This would be a tighter constraint on departments and encourage greater efficiency. Similar measures have been found to be helpful in countries such as Australia and Sweden. The multi-annual budgeting framework should be strengthened to provide a clearer sense of direction for current spending in the medium term.

The newly-introduced Efficiency Review requires each department to submit specific proposals to maximise administrative savings by March 2008, which may help to counterbalance the ELS approach of the budgeting process. Departments that do not engage sufficiently with this process face a lower settlement in the 2009 spending round. This type of incentive could be extended to public spending more generally. It could be made more effective if there were more explicit targets for savings and a clearer benchmark against which outcomes in the 2009 round could be assessed. The effectiveness of this process should be monitored.

Management of public spending should focus on outputs and outcomes, rather than on spending and inputs. Resources should be aligned with the NDP and other major government commitments. The introduction of Annual Output Statements, a list of outputs and objectives submitted to parliament by each department, is an important step towards best practice in this area. These provide clear information about what services government plans to deliver and the cost of delivering each element, in addition to raising accountability and parliamentary oversight. Progress is being made in linking output statements to departmental statements of strategy and improving the overall process, which should help to ensure that the focus is on how key objectives can be achieved rather than simply on what will be done. The 2008 statements will be crucial as these provide the first evaluation of actual performance against the stated objectives. There is scope to improve output statements to make them clearer and more quantifiable. This framework should be extended to cover government agencies. The output statements and evaluation should have a real impact on where spending is directed in future years, including re-directing funds where necessary.

The focus on outputs to improve performance could also be raised by changes to the relationship between departments and agencies. The current system uses strong input controls but there is little emphasis on the level of performance delegated bodies achieve. OECD experience shows that the benefit of agencies lies mostly in their ability to focus on delivering specific results. Efficiency could be increased if agencies had greater managerial autonomy and if departments developed a greater capacity to provide effective oversight of the outcome. A clear rationale needs to be established for the creation, role and accountability of the plethora of different agencies.

Further progress should be made to tie analysis into the decision-making process and use it more actively to decide the effective allocation of resources. The Management Information Framework (MIF) is intended to address this in part. The system has been rolled out across government but further action is needed to exploit its full potential. Staff should be better trained in the use of the system and departments need to take ownership of the process. Furthermore, the MIF should be better integrated with other performance initiatives so that the operational data produced meets the needs of the output statements and strategic plans. This would both make it easier to integrate this information into decision-making and reduce the administrative burden on departments. Given the difficulties experienced with rolling out this programme, pilot studies could be used to develop the approach to be taken.

The expenditure review process should be further strengthened. The Value for Money (VFM) circular letter of 25 January 2006 toughened the existing guidelines for appraisal of capital projects, effectively requiring full cost-benefit analysis for all projects worth more than € 30 million. Separately, Value for Money and Policy Reviews which examine departmental spending were introduced in 2006, replacing the Expenditure Review Initiative. Ninety reviews covering a minimum 10 to 15% of each department's budget have been approved for the period 2006 to 2008. The effectiveness of this approach may be weakened by the fact that departments themselves are mostly responsible for choosing which areas of expenditure to review and evaluating their own performance, although the Department of Finance must approve the choice of areas to be scrutinised and all of a department's spending would fall for review over a period of several years. A best practice guidance manual has now been published to help departments (Department of Finance, 2007). In line with recommendations in earlier *Surveys*, a centralised Efficiency Unit has been established in the Ministry of Finance and this should help to strengthen the evaluation process for VFM Reviews, as well as capital projects, by building up centralised expertise. This role should be strengthened. It is important that evaluations produced under this initiative actually have a substantial impact on budgeting decisions: VFM Reviews should systematically be taken into account in resource allocation decisions.

The accounting framework for public expenditure should be improved. The Exchequer accounts are calculated on a cash rather than accruals basis.[8] Departments are not charged for the cost of capital, making it difficult to allocate capital efficiently and creating few incentives to minimise on capital such as office space. An opportunity to remedy this is presented *via* the inter-departmental working group which is reviewing the structure of the annual Departmental financial statements, in particular the notes on assets, accruals and liabilities, including pension and contingent liabilities. Although consistent with Eurostat national accounts guidelines,[9] there is no fully comprehensive statement of all future government liabilities accumulated under Public-Private Partnerships (PPPs). This would be useful for understanding the fiscal position, even if there are many other implicit government liabilities that are also excluded from the accounts, because one potential risk with PPP funding is that the legal contract to purchase services from the provider may be less flexible than other forms of funding if needs change or spending needs to be cut.

The ability of the public service to provide services effectively depends on a well-motivated and well-equipped workforce. The share of the workforce employed in the general government and state-funded sectors is not high among OECD countries, despite recent increases, and a lack of capacity has sometimes been apparent. Ireland's exceptional level of ex *ante* controls on personnel numbers and costs hinders flexibility to hire appropriately. These should be rebalanced as the stronger requirements on departments to report on their output performance come to the fore. There is also a lack of mobility across the public service. A unified labour market would help to create more opportunities for individuals to develop within the relatively small public-sector labour market, as well as allowing skills and experience to be allocated more widely. In terms of attracting talent from outside the public service, open recruitment procedures have been extended and now include middle and senior management positions. This, however, has resulted in very few external hires. Pay is determined according to centrally-determined pay scales and this reduces the flexibility of individual departments to set salaries as a function of their needs, in particular for staff with specialist skills such as IT, finance and project management. There has been substantial progress through the now well-developed Performance Management and Development System, although this should be better integrated with decision-making about human resources policies. There is a need to professionalise human resource functions, making more use of specialists rather than relying on generalists to carry out these activities.

The decentralisation programme aims to move eight full government departments and a range of other civil service functions and public service agencies (some 10 000 posts) out of Dublin into the regions. Although the original deadline of 2007 was shown to be unrealistic, projections for progress towards the new goal of 2009 have consistently been revised down. The number of staff transferred was approximately 2 000 by the end of 2007. Progress so far appears to have been evaluated in terms of the process of decentralising-acquiring property, construction and persuading staff to move. When the implementation of the programme has progressed substantially, the programme should be evaluated in terms of its overall benefits and costs. Now that substantial numbers of staff are moving, there is a new challenge in terms of making the new locations work and avoiding any fragmentation in government operations.

The search for value for money needs to go wider than central government. Inefficiencies at the local government level are also a concern, especially when rising costs are passed on to the business sector. Local government monopolies could become more efficient by contracting out service delivery and by making more use of full-cost user charges while ensuring they are levied fairly on the households and businesses that actually use the services. Incentives could also be improved by using *ex ante* estimation of standard costs, increasing co-financing of earmarked grants by local authorities and moving towards block grants for projects without spill-over effects. Local government finances will be reviewed by the Commission on Taxation.

The use of outsourcing is relatively limited, partly because the lack of information makes it hard for government to evaluate the cost of providing services itself. A central unit should be established to share good practice and provide technical assistance to departments in contracting out services that would benefit from this type of procurement.

Public-Private Partnerships

Public-Private Partnerships involve the private sector in the provision of public services through a number of different mechanisms. Ireland is making extensive use of these arrangements to deliver improved public services and infrastructure. The importance of this mechanism should not be overstated as it still represents only a small part of spending on infrastructure under the NDP (Table 4.3), where it is mostly concentrated in road building. PPPs have also been used for projects such as new schools and prisons. The recent experience of PPPs for road construction, where many projects have been delivered on budget and ahead of schedule, indicates the benefits of this method of procurement.

Table 4.3. **Spending on economic infrastructure under the National Development Plan**

Total spending from 2007-13 as a percentage of GNI

	Exchequer	PPPs	Local authorities and other state bodies	Total
Transport	1.4	0.5	0.4	2.4
Roads				*1.3*
Public transport				*0.9*
Air transport and ports				*0.2*
Energy	0.0	0.0	0.6	0.6
Environmental services	0.3	0.0	0.1	0.4
Communications and broadband	0.0	0.0	0.0	0.0
Government. infrastructure	0.1	0.0	0.0	0.1
Local authority development	0.0	0.0	0.2	0.2
Unallocated capital reserve	0.1	0.1	0.0	0.3
Economic infrastructure, total	2.0	0.7	1.3	4.0

Source: National Development Plan 2007-2003 (2007), OECD (2007), *Economic Outlook 82 database* and OECD calculations.

Ireland has moved towards best practice with respect to PPPs (Box 4.2), having made similar mistakes to other countries such as Australia and the United Kingdom when this type of procurement was initially used. A Central PPP Policy Unit has been established at the Ministry of Finance. Its key function is to develop the legislative framework, technical and policy guidance to support the PPP process and to disseminate best practice in PPPs. It is not directly involved in projects which are a matter for the procuring agencies. In the

Box 4.2. **OECD principles for private sector participation in infrastructure**

First, the decision to involve the private sector has to be guided by an assessment of the relative long-term costs and benefits and availability of finance, taking into account the pricing of risks transferred to the private operators and prudent fiscal treatment of risks remaining in the public domain.

Second, authorities need to ensure an enabling policy framework for investment.

Third, the success of private involvement in infrastructure depends on public acceptance and on the capacities at all levels of government to implement agreed projects.

Fourth, the public authorities and the private sector need to establish a working relationship toward the joint fulfilment of the infrastructure needs.

Fifth, insofar as they are not rooted in formal legal requirements, governments' expectations regarding responsible business conduct need to be clearly communicated by governments to their private partners.

transport area PPP procurement is managed by two procurement agencies: the National Roads Authority (NRA) and the Railway Procurement Agency (RPA). In addition, a centre of expertise to procure PPP projects on behalf of ministries and agencies funded directly by central government has been established within the National Development Finance Agency (NDFA). State authorities are expected to obtain financial advice from NDFA on all public investment projects over € 30 million, including PPPs.

Conclusion: Fiscal policy must adapt to a more challenging environment

Strong revenue growth in the years leading up to 2006 allowed Ireland to maintain a sound fiscal position and repay debt while substantially increasing public investment, social spending and welfare benefits. The rapid turnaround in revenue growth in 2007 has led to a deterioration in the public finances and expenditure growth will need to slow as the Budget projects. There are substantial risks around future tax revenue, both in the short and longer term. The slowdown in revenue growth implies that the need to improve public services and infrastructure will have to be met by raising the performance of the public service. A wide range of measures has already been taken to improve the management of public resources and value for money but much remains to be done.

Box 4.3. **Summary of recommendations on fiscal policy**

Public spending growth should slow to reflect lower revenue growth. Upgrading infrastructure should be given priority over current expenditure.

Further steps should be taken to reconsider the large number of tax expenditures and those that are shown to be inefficient by cost-benefit analysis should be eliminated. This includes phasing out tax distortions that favour housing (Chapter 2).

Expensive commitments on public sector pay should be avoided. The conclusions of the second Public Sector Benchmarking Body report should be implemented in the next pay deal under the *Towards 2016* social partnership agreement. The link between higher pay and improved performance in the public service should be more explicit and transparent.

Box 4.3. **Summary of recommendations on fiscal policy** *(cont.)*

A transparent, top-down budgeting process should be adopted to strengthen the emphasis on value for money, building on the potential of the new Unified Budget approach. Multi-annual budgeting should be strengthened for current spending in line with the existing approach to capital expenditure. A balance sheet for the government should be produced.

Public sector management should be improved:

- Improve the flexibility of human resource management, enhance mobility within the public service, and make human resources management more professional.
- Move further from input control to output management. The output statement framework should be improved and extended to cover agencies. The Management Information Framework (MIF) should be developed further and the information it produces integrated with other initiatives.
- Use analysis more systematically for decision-making. The Value for Money initiative should be strengthened and the outcome of the process should be systematically applied in setting budgets and lessons learned applied to future decisions.

Notes

1. The main figures produced by the Department of Finance for the budget and other documents are presented on an Exchequer basis. This differs from the national accounts basis used in the *OECD Economic Outlook* and there are differences in the headline numbers from the two sources, including the fiscal balance.
2. Based on budget estimates.
3. In December 2006, 604 830 working-age people were receiving a weekly social welfare payment.
4. However, this could also reflect the relatively volatile nature of government revenues that is not accounted for in standard methods of cyclical adjustment.
5. The rate of PRSI contributions paid by the self-employed would fall from 3% to 2%.
6. See *OECD Health Data 2007*.
7. Employment in hospitals increased by 35% over this period. The remuneration of general practitioners increased by 64% in real terms (compared with a 12% real increase in the manufacturing sector and financial sectors). Salary figures for specialists and nurses in 1999 are not available. Increased investment spending accounts for 5.3% of the total increase in public expenditure on healthcare over that period.
8. The Exchequer account is cash based, but some Budget documentation is produced on an accruals basis in accordance with the European System of National Accounts ESA 95 standard.
9. If risk is transferred to the private sector, the guidelines do not require the government's liabilities under the contract to appear on the government's balance sheet.

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Chapter 5

Setting the pension system on the right track

Ireland currently has a relatively young population but faces similar, if more distant, long-term pressures from population ageing as other countries. The pension system is founded on a basic state pension but relies heavily on private saving to provide adequate replacement incomes in retirement. Large increases in the state pension have reduced poverty, although many pensioners still have low incomes. There is a large retirement savings gap for many households between the close to flat-rate state pension and a reasonable replacement income in retirement. Private pensions saving may be too limited to close this gap for many low- and middle-income earners. There are large tax incentives to save for retirement, but these are poorly targeted and the overall effect on saving is likely to be limited. Against the background of the pressures that ageing will eventually impose on public finances and the wider economy, this chapter outlines options for pension reform.

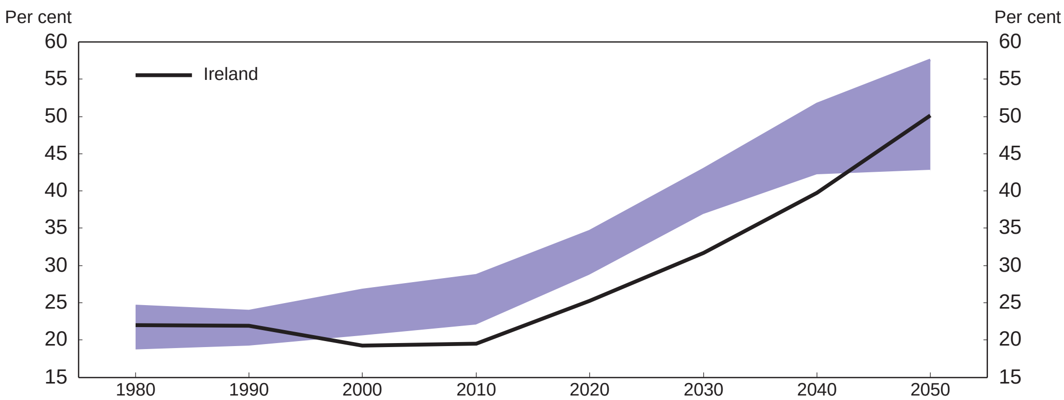
The pension system combines a basic state pension with an important role for private saving. The government in effect provides a universal, flat-rate pension from age 65 or 66.[1] Second-tier private provision is available to close the gap between the modest state pension and the income necessary to sustain a defined level of consumption in retirement. Voluntary private pension saving takes the form of funded defined-benefit (DB) or defined-contribution (DC) occupational schemes, Private Retirement Savings Accounts (PRSAs) and private pensions. There is a very generous system of tax incentives for pension saving and favourable tax treatment for those aged over 65.

The 1998 *National Pensions Policy Initiative* (NPPI) set out objectives for the coverage and adequacy of the pension system: a minimum level of retirement income from the state pension of 34% of Gross Average Industrial Earnings (GAIE) and a target post-retirement income of 50% of pre-retirement income before tax, subject to the minimum basic pension. In relation to coverage, a target was set of 70% of those in work between the ages of 30 and 65 by 2013. Progress has been made to achieving these goals, which are not official government policy. The state pension has now reached the minimum level envisaged by the NPPI, with a commitment under the 2007 Agreed Programme for Government to increase it further to approximately 38% of GAIE by 2012. Coverage has increased in recent years and now stands at 62% of the target group. The NPPI targets were confirmed in 2006 by the Pensions Board (Pensions Board, 2005) under the National Pensions Review (NPR), with a reservation from the representative of the Minister for Finance.

The impact of the pension system on the wider economy today is relatively small as Ireland has a young population: almost 45% of the workforce is aged under 35 and government spending on pensions as a share of GNI is consequently among the lowest in Europe. But the old-age dependency ratio will rise substantially over the coming decades and be close to the OECD average by 2050 (Figure 5.1). Pensions in Ireland therefore present

Figure 5.1. **Old-age dependency will eventually match other countries**

Population aged over 65 relative to working-age population



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

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

a slightly different policy challenge from that in most other developed countries. The problem is not how to fund an immediate increase in the number of retired people, but rather that ageing will require a large long-term change in the way resources are allocated. Decisions taken now about the role of the state pension and how to encourage Irish people to save sufficiently to meet their retirement income objectives, taking account of the associated risks, could make it easier for the economy to adapt.

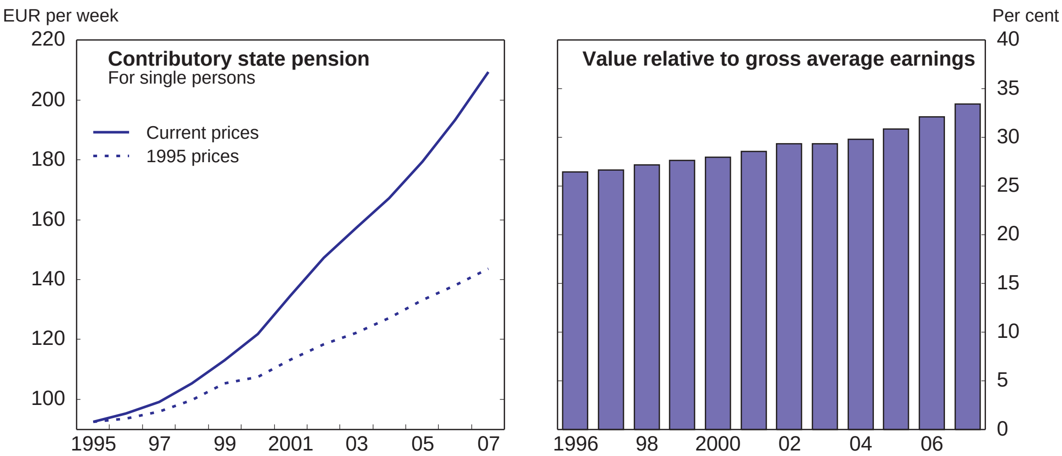
The basic state pension is the foundation of the system

The state pension is similar in effect to a universal payment to those of retirement age. It is the foundation of the system, providing the main source of retirement for many pensioners, and it is typically integrated with the funded DB pension schemes run by some employers.[2] Although the basic structure of the pension system has remained unchanged for decades, its *de facto* impact has been substantially modified in recent years by the continuing increase in the real value of the state pension facilitated by the economic boom. The system has been broadly moving away from providing minimal pensions funded by social security contributions towards paying a more substantial retirement income, which will become dependent on financing from general tax revenues and the National Pension Reserve Fund (NPRF) if contribution rates are not eventually raised.

More generous pensions have reduced pensioner poverty

The value of the contributory and non-contributory state pensions is around € 220 per week for a single pensioner and € 440 for a pensioner couple.[3] There are additional cash payments for some groups such as the Living Alone Increase and the Over Age 80 Allowance. There are also in-kind benefits worth around € 1 000 per year for each household aged 70 and over, means-tested for those aged 66 and above, and a Fuel Allowance worth around € 500 per year for pensioner households. Paying benefits in this way is inefficient and undermines consumer choice, although it may contribute to other social objectives and these schemes have public support (Quinn, 2000). It would be simpler to replace these allowances and raise the state pension by an equivalent cash amount. The value of the state pension has increased rapidly in recent years both in real terms and relative to average earnings (Figure 5.2). This has

Figure 5.2. **State pension**



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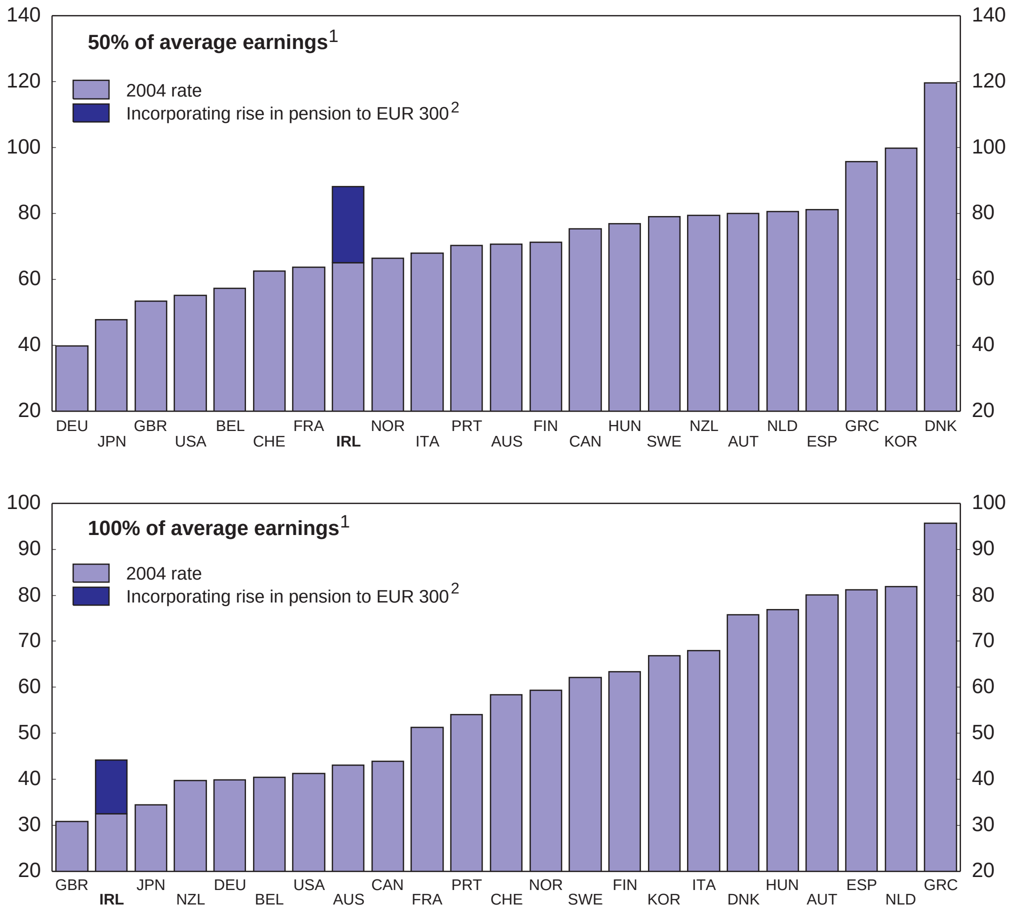
Source: Department of Social and Family Affairs; Central Statistics Office; Eurostat Pensions Indicators.

substantially reduced the proportion of older people living in households in the poorest quartile of the income distribution. The at-risk-of-poverty rate for pensioners has fallen and the share of those aged 65 and over in "consistent poverty" at the 60% of median income threshold dropped from 5.8% in 2003 to 2.2% in 2006, although by some measures the proportion of older people living on relatively low incomes is still fairly high by European standards.

The government's commitment to raising the state pension for a single person to € 300 per week by 2012 implies a further large increase in real terms. Building on previous increases, the replacement rate from the state pension will switch from being among the lowest in the OECD to being relatively high for those with below-average earnings (Figure 5.3).

Figure 5.3. **Gross replacement rates**

2004



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1. Average earnings based on OECD data and not the Gross Average Industrial Earnings (GAIE).
2. The impact on gross replacement rates of raising the state pension to EUR 300 is estimated by assuming that average earnings increase with nominal GDP from 2007.

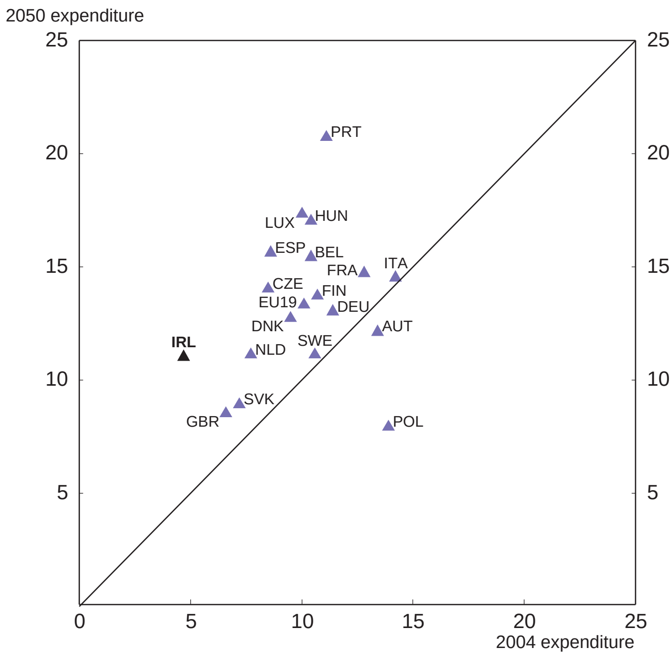
Source: OECD (2007), *Pensions at a Glance: Public Policies across OECD Countries* and OECD calculations.

Government spending on pensions will rise

The budgetary cost of the state pension system is currently around 5% of GDP, the lowest in the EU19, reflecting the young workforce and relatively low level of the state pension. This is projected to rise substantially by 2050 as the population ages, even before taking account of the increase in generosity programmed by 2012 (Figure 5.4). The peak of expenditure in Ireland would come after 2050, later than in most other EU countries. As the old-age dependency ratio rises, the burden of financing would shift away from social security contributions (PRSI contributions) towards general taxation if contribution rates are not raised.

Figure 5.4. **Public expenditure on pensions**

Per cent of GDP



StatLink http://dx.doi.org/10.1787/285550648381

Note: EU19 excludes Greece.

Source: EPC (2006), "Impact of Ageing Populations on Public Spending on Pensions, Health and Long-term Care, Education and Unemployment Benefits for the Elderly", ECFIN/EPC(2006)REP/238 final.

The National Pension Reserve Fund (NPRF) was established in 2001 to build up reserves so that the fiscal costs of ageing could be smoothed through time. By law, the Exchequer contributes at least 1% of GNP each year and *ad hoc* contributions have been made from the sale of government assets. At the time of its establishment, it was envisaged that the fund should cover around one-third of the projected increase in pension costs from when the fund can first be accessed in 2025 to 2055 when the scheme ends, and a lower proportion if some reserves are held back to meet liabilities after 2055. The asset allocation strategy relies heavily on investment in equities and other risky assets, which are expected to yield a higher rate of return than government bonds. This allowed the accumulated reserves to rise to almost 13% of GNI by 2006, but the greater risk associated with these assets should also be taken into account when evaluating the likely contribution of the NPRF to meeting pensions-related costs in the long term.

Although government spending on pensions as a share of GDP will be around average for the EU19 in 2050 on current projections, the change for Ireland will be relatively large. This implies that, under the current pension system, Ireland would have to make very substantial changes, either by reallocating large parts of government expenditure from other activities or by substantially raising taxes. This would occur even allowing for additional funding from the NPRF. The reduction in government investment as the upgrading of infrastructure is completed, as well as the increase in national income derived from this investment, will only meet part of the increase in pension costs. In addition, the demand for medical and social services is likely to rise in tandem with the greying of the population.

The long-term objectives for the state pension are unclear

A Green Paper on Pensions (Department of Social and Family Affairs, 2007) has recently been published with a view to establishing a framework of long-term objectives and commitments in relation to pensions policy. A clear framework is important to assess the fiscal sustainability of the system, to evaluate how government aspirations for pension coverage and adequacy are likely to be met, and to allow individuals to plan their retirement. It can be argued that there are two major gaps in existing practice. Firstly, there is no formal commitment by the government about the long-run value of the state pension. Whether the promise to raise pensions to € 300 by 2012 turns out to be reasonable depends on inflation, and the impact on the replacement rate depends on future wage developments over the next five years. Over the very long term, there is no explicit commitment to reach the NPPI targets for pensions. Formal indexation of pension benefits or a commitment to an objective in terms of average earnings would make clear the projected value of future pensions and help clarify the associated fiscal liability. This is common practice in other OECD countries. Indexing the value of the pension to prices aims to guarantee the purchasing power of older households but means that their incomes will tend to fall relative to those of the working population. Recent gains in reducing pensioner poverty would therefore be eroded as the relative value of the state pension declined over time. Although it is more costly, some form of indexation to earnings would avoid this. Many countries have adopted some hybrid form of indexation that weighs these considerations together, although such long-term commitments do present some risks in terms of affordability over the long run if circumstances change unexpectedly.

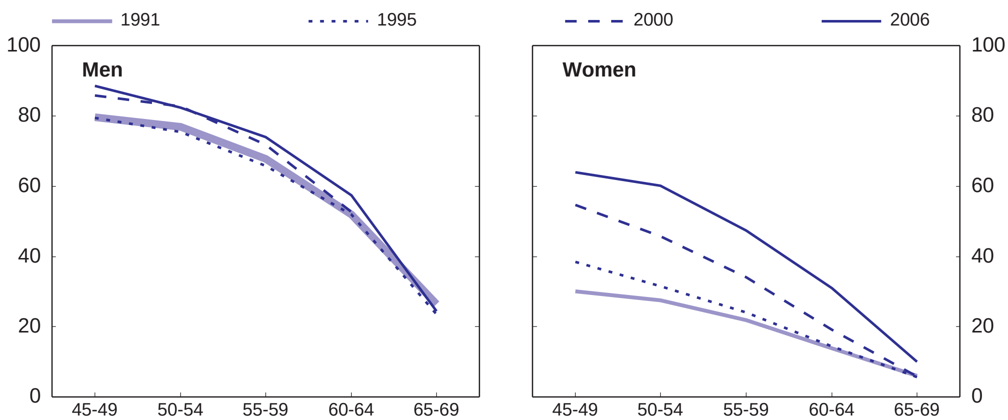
The second aspect for which long-term objectives should be considered is the statutory retirement age. This is currently fixed at the age of 65/66, which is at the upper end of standard retirement ages in OECD countries. However, the number of years that people are likely to enjoy in retirement is rising. The average life expectancy at 60 rose by 3.6 years between 1995 and 2005. This is a major risk for the pension system: the increase in longevity has been consistently underestimated in demographic projections. With its young population, Ireland is particularly exposed to this risk as mortality rates are less predictable further into the future. Indexing the retirement age to longevity over the longer term would provide a way of managing this risk by tending to reduce the time over which benefits are paid and increasing overall contributions. Raising the retirement age would also reflect the increased number of years of good health that is likely to accompany higher life expectancy. Combined with a clear objective for the level of benefits, this would give a clear signal to workers about the value of their retirement income and the possibility of having to work longer as life expectancy increases. Pension reforms in Denmark and France have linked pension eligibility age or the required number of years of contributions to increasing longevity in this way, and other countries such as Germany and Sweden have made a more general link between benefits and life expectancy. The recent Green Paper on Pensions has laid out options for reform and the Government has committed to producing a long-term framework for pensions following a consultation process.

Work incentives could be improved

The effective (or average) retirement age in Ireland is almost 65, having increased by around one year since 2001,[4] and the employment rate of those over 65 is above the OECD average. But high employment at older ages is partly the legacy of a past pattern of rural life and employment rates fall sharply above the age of 55 (Figure 5.5), reflecting in part the low average level of education of older people in Ireland. The incentives to work to the standard retirement age are strong as the state pension cannot be claimed at a younger age. The State Pension (Contributory) provides good incentives to work after age 66 as it is paid regardless of whether the individual continues to work or not. As the level of the pension is relatively low for many people, there may be little impact on the willingness to work from the extra welfare benefits and continuing to work can provide a way to earn additional income for those with limited other resources.

Figure 5.5. **Employment rates by age**

Per cent



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Source: OECD (2008), *Labour Force Statistics – online database* (January).

A number of policies can be used to encourage the employment of older workers further. These include improving their employability through lifelong learning and more employment services to help them find a job. These were discussed in the *Ageing and Employment* review of Ireland (OECD, 2005b). Regarding pensions policy, some progress has already been made towards the elimination of remaining incentives to retire before the age of 65 by phasing out the PRETA, which allowed some currently outside the workforce to retire from age 55. Extending active labour market policies to target older workers through the preventive process of unemployment assistance has also removed a channel from unemployment into effective early retirement. Means testing of labour income under the non-contributory pension has been relaxed but further progress would be desirable.[5] Offering an actuarially-equivalent increase in the state pension for deferred retirement would make it easier to stay in the labour force and the 2007 Agreed Programme for Government includes commitments to raise the state pension for each year worked beyond the age of 66.

With more restrictions on older workers leaving the labour force, it is important to ensure that disability does not open up as an alternative channel into effective early retirement as has happened in several other OECD countries. Although there are safeguards in place such as assessment of new claimants by doctors appointed by the Department of Social and Family Affairs, the number of recipients of a broad range of disability benefits has increased by three-quarters since 1990. The upward trend can be partly explained by the widening of qualifying conditions in the mid-1990s and a move from short to long-term payments. Almost three quarters of Invalidity Pension recipients are aged 55 to 66 (Department of Social and Family Affairs, 2006). The strong work disincentives for those on benefits are a major policy concern. Disincentives can arise for some from the loss of secondary benefits, such as the loss of the Medical Card that guarantees free health care for the whole family, when taking up work. While it is now possible to keep the Medical Card for three years, other secondary benefits will still be lost. In addition, the assessment process puts little focus on work capacity and active labour market policy does not do much to help the disabled to find a job. A pilot in one region is developing a customer-oriented intensive engagement upon claim application, but there is no conditionality so the chances of success are relatively low. In the United Kingdom, for instance, the Pathways to Work programme is compulsory for new incapacity benefit claimants.

Public sector pensions will become increasingly costly

There are currently 90 000 pensioners in public service DB pension schemes. These schemes are financed on a pay-as-you-go basis. The increase in payouts from public sector pensions will account for less than one-third of the overall rise in pension spending by the government by 2050, and will partly be financed by some of the accumulated NPRF reserves. Reforms in 2004 partially addressed the problem of public service workers retiring before the age of 65, although the increase in the minimum pension age from 60 to 65 only applies to those who joined the public service after 2004 and so will take a long time to take effect. In addition, employees now make some contribution to pension costs. Other elements of the system, however, remain relatively generous and will place a burden on future taxpayers. In particular, pensions in payment to existing pensioners are uprated in line with the wages of workers currently doing jobs similar to those previously undertaken by the retired person (pay parity), rather than prices as is typical in private DB schemes. There is scope to bring the uprating of public service pensions more into line with other pensions and thereby reduce the future cost.

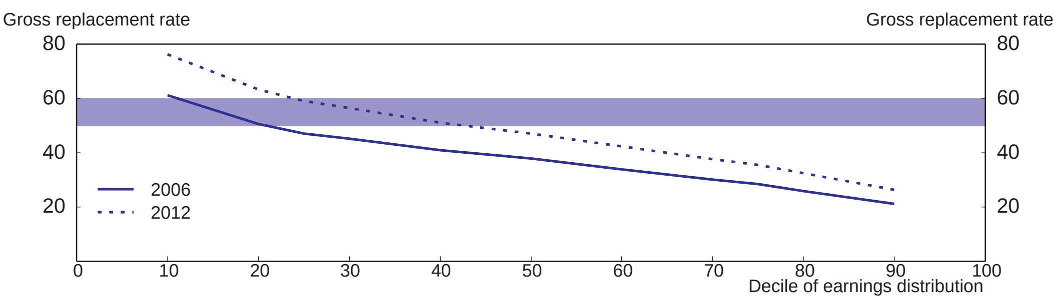
Private pension saving needs to increase

Private savings are required to fill the retirement savings gap

There is a substantial gap between the flat-rate state pension and the level of retirement income needed by most people to replace a sufficient proportion of their pre-retirement income. The pension system relies heavily on private pension saving to close this gap. In aggregate, there is substantial saving by households: the net saving ratio is almost 10% of disposable income, which is not far behind the economies with imminent ageing pressures such as France, Italy and Germany and way above the United States and the United Kingdom. Private pension assets are also larger in relation to GNI than in most OECD countries and similar in size to some other countries where second pillar private pensions are important such as Australia and the United Kingdom. But the healthy picture for the household sector as a whole masks the problem that many people may not be saving enough to fill the gap between the state pension and a decent retirement income. Data on aggregate household wealth and its distribution in Ireland is limited at present, although owner-occupation of houses among older households is very widespread. This implies that a high proportion of pensioners do not have any rent to pay and that, in aggregate, pensioners own a considerable stock of wealth.

Occupational pensions are the most widely used mechanism for closing the retirement savings gap. Together with personal pension provision, the coverage of private pensions has risen to 62% of employed persons aged 30-65. However, such limited coverage is well below the NPPI target of 70% coverage by 2013. This suggests that some low- and middle-income earners, those who are not fortunate enough to have a private pension and for whom the state pension is less than half their pre-retirement income, will not achieve the targeted replacement rate of at least 50% of their pre-retirement income as they lack pension coverage (Figure 5.6).[6] Furthermore, even workers with DB pensions may struggle to reach the 50% target if they have an incomplete history of pension contributions or have changed employers.[7] But the 50% target itself is not an ambitious goal as it would provide a replacement rate below the OECD average from mandatory pensions alone and be considerably below the maximum two-thirds replacement that is typically targeted under an occupational DB scheme. Evaluation of the extent of the retirement savings gap is difficult as there is limited evidence of what replacement rate future pensioners are currently likely to achieve. Furthermore, the assessment is very sensitive to the targeted replacement rate as many workers earn at around the level that the state pension would replace 50-60% of their pre-retirement income. For everyone to have a replacement rate of at least 60% would require a large increase in the number of low- and middle-income earners making private retirement provision, even with the effect of the state pension rising to € 300 per week.

Figure 5.6. **Gross replacement rate from state pension**



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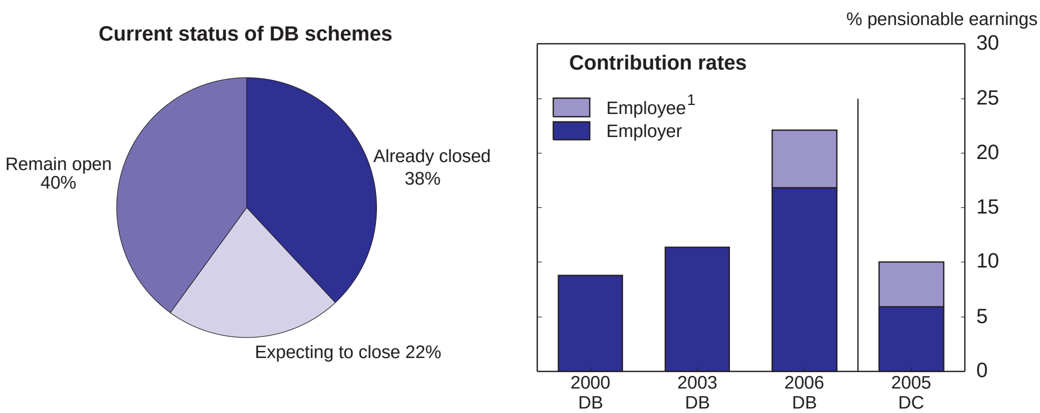
Note: The shaded area represents a target replacement rate of 50 to 60%.

Source: European Community Household Panel (ECHP) Survey (2001); Central Statistics Office and OECD calculations.

It is important that private pensions are adequate to help close the gap between the state pension and the desired level of replacement income in retirement. Most members of public sector and private DB schemes should receive pensions in excess of 50% of their pre-retirement income. However, there has been a marked shift towards DC schemes for those currently saving for retirement (Figure 5.7). Average contribution rates in DC schemes are on average around 10% of pensionable earnings, which is often contrasted with the higher average contribution rates of DB schemes. But is this rate of contributions inadequate? This is difficult to assess. Estimates in *Pensions at a Glance* suggest that this rate of contribution would be consistent with closing the retirement savings gap if annual real returns were 3.5% and a full contributions record is achieved, although this would require people to save for a pension from an early age (OECD, 2007a). Furthermore, there are large risks around these estimates depending on future unexpected changes in longevity and investment returns. It may be that DC contribution rates do not need to match the very recent rise in the contribution rates to DB schemes brought about by lower investment returns and rising longevity that lead to gaps in the funding of these schemes (Mercer, 2005, 2006). On the other hand, there is a substantial risk that 10% contribution rates will be too low to deliver the expected retirement income. Unlike DB schemes, all of the life-expectancy and investment risk is carried directly by the individual in DC schemes. It is important that workers properly understand this implication of the move from DB to DC pension schemes. This risk is particularly salient in Ireland as the flat-rate state pension is not particularly generous for those with above-average earnings and for whom a relatively large share of anticipated retirement income must therefore be generated from private saving.

Figure 5.7. **Occupational pension schemes**



StatLink http://dx.doi.org/10.1787/285620707110

Note: DB: Defined benefit; DC: Defined contribution

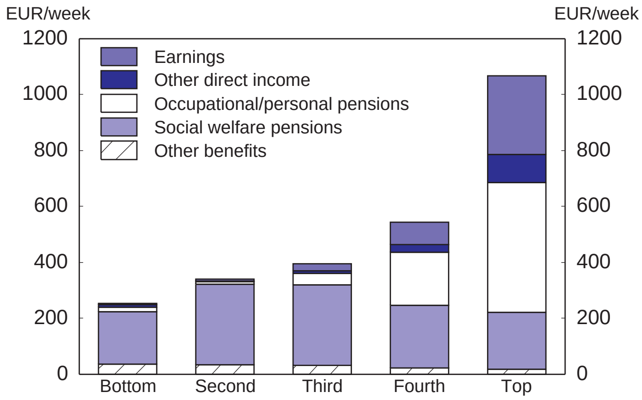
1. No available data for employee's contribution for 2000 and 2003.

Source: Mercer Human Resource Consulting (2005), *Defined Contribution Benefits Survey for Ireland.*

It is unclear how far non-pension resources may contribute to providing adequate pension incomes in old age. Many of these additional resources appear concentrated among richer households who already have sufficient resources (Figure 5.8): saving by employees appears to be concentrated in the top quartile of the earnings distribution (Moreno-Badía, 2006). Owner-occupation rates are high, partly as a result of favourable tax treatment, and this could provide a considerable stock of wealth for pensioners. However, this wealth cannot necessarily be easily converted into retirement income. The home equity release market is poorly developed and it may not be easy for pensioners to release cash by trading down to a dwelling of the appropriate size in the same area.

Figure 5.8. **Sources of retirement income by quintile**

Gross income of pensioner couples, 2005



StatLink http://dx.doi.org/10.1787/285646541208

Source: Department of Social and Family Affairs (2007), *Green Paper on Pensions*, Stationery Office, Dublin, Table 4.4, based on CSO analysis of 2005 EU-SILC Survey.

Raising pension saving

Current private pension saving seems unlikely to close the retirement savings gap for some low and middle-income earners, particularly in industries with low coverage of occupational schemes, and there is a risk that some DC scheme members are not saving sufficiently or for long enough. Raising the state pension is a blunt instrument to tackle this problem: large increases in the flat-rate pension have relatively little impact on the replacement rate for those with above average earnings and increased public provision may crowd out private saving. There are also deadweight losses from transferring additional income to those whose pensions are already sufficient.

The current system emphasises voluntary pension saving. This has only a limited ability to raise pension saving further: voluntary pension saving at present is scarce and most private provision takes place as part of employer-based schemes, where joining the pension fund can be a condition of employment under Irish law. Low rates of coverage appear to be concentrated in certain sectors where employers are less likely to offer an occupational scheme. These sectors are characterised by low wages, small firms, part-time work and high rates of female employment. Where employees do not have the possibility to contribute to a work-based scheme, employers are required to facilitate the provision of PRSAs. There is no obligation on employees to join these schemes nor for employers to make contributions. The take-up of PRSAs since their introduction in 2002 has grown steadily but slowly, and only accounts for a small part of the rise in coverage. Survey evidence suggests that the main reason for not having private pension coverage is "never [having] got around to organising a pension" (CSO, 2006). Even in the 55-65 age group, this explanation is offered by one-fifth of those without coverage, ahead of not being able to afford a pension. This suggests that the number of people with private pensions could be increased by making PRSA arrangements "opt out" rather than "opt in". Behavioural economics has found that default options in retirement saving schemes strongly influence behaviour in countries where these have been studied such as the United States (Beshears *et al.*, 2006). This requirement could be imposed on those who are not already part of an occupational scheme and whose income is above the threshold for which the state pension would replace an adequate share of pre-retirement income. At a minimum, an "opt out" system would provide a clear signal to those low- and middle-income earners who need to save but are not doing so. The relatively high fees of PRSAs, typically a 5% entry charge and a 1% annual management fee, could also be lowered if the state acted as an intermediary between pension savers and the investment institutions in a similar way to private employers offering DC schemes. More generally, occupational DC schemes and PRSAs should be made more uniform and transparent to help individuals assess the future value of their pensions and the associated risks, particularly where contribution rates imply benefits that are lower than past DB schemes.

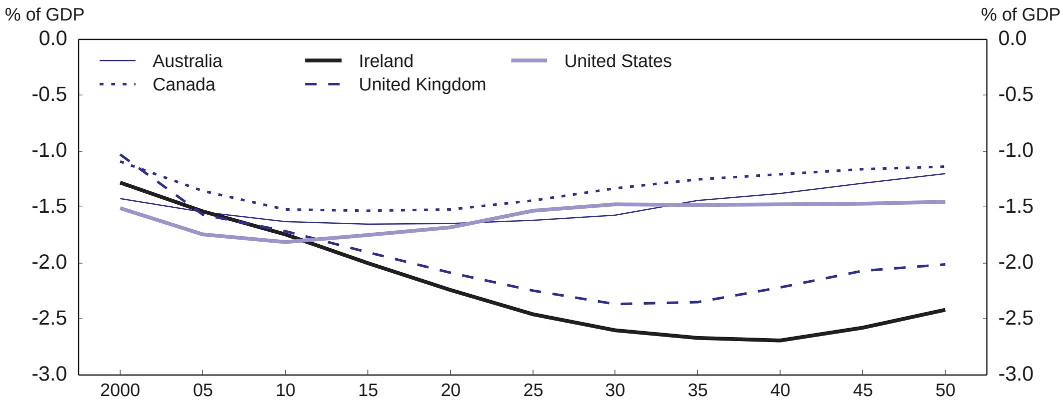
Tax incentives to pension saving are large but poorly targeted

Tax incentives may provide a useful mechanism for raising pension saving, although it is important that they actually raise the overall amount of saving rather than simply diverting funds from other types of investment. International experience suggests that tax incentives are likely to be more effective at raising overall savings if targeted at low- and middle-income earners and if designed so that the incentives are easy to understand (Hawksworth, 2006). The tax incentives to pension saving in Ireland are very large. Pension contributions are deductible at the marginal rate of income tax and PRSI contributions are calculated on earnings excluding pension contributions. Capital gains on pension investments are not taxed. Some pensioners qualify to receive part of their private pension as a tax-free lump sum at age 65.[8] The foregone revenue from these tax subsidies is already very large at around 1.5% of GDP. Although pension income is in principle taxed, the tax exemption limit for those aged over 65 is € 34 000 for a couple. This implies that few older households will pay any income tax and many of those who do will pay less than younger people with the same income. As a result, a tax system that aims for pension savings, returns and income to be subject to an "exempt-exempt-tax" (EET) regime is in effect fairly close to being an "exempt-exempt-exempt" (EEE) system where income channelled through pensions is unlikely to be taxed at any point of the life-cycle.

This system of tax incentives does not provide an effective way of achieving adequate private provision, despite the generous level of support. Marginal tax relief on pension contributions is worth more than twice as much to the minority of high-income households paying the higher-rate of income tax of 41% than for those paying the marginal standard rate of 20%. Similar effects arise for the other forms of support. As richer households are more likely to save and to be covered by generous occupational schemes anyway, it is inefficient to target tax subsidies at this group. Furthermore, some people may find it difficult to understand the incentives to save created by these tax concessions. Experience in Australia, Canada and the United States shows that households respond well to incentives presented as matching contributions from the government for each amount paid into retirement savings accounts. The high take up of Special Savings Investment Accounts (SSIAs) suggests that households in Ireland might respond to a system of matching contributions, although it is unlikely that the same take-up rate could be achieved for retirement accounts as for the SSIAs because pension funds must be committed for much longer periods.[9] Given the generous level of current support, these incentives should replace rather than add to existing tax subsidies.

The overall level of tax subsidy for pension savings should also be reconsidered. These already absorb a large share of national income, but this is projected to rise very sharply as the population ages and people build up retirement savings (Figure 5.9). Indeed, Ireland is projected to have the largest share of income committed to these schemes in 2050 of any

Figure 5.9. **Projected net fiscal revenues from tax-favoured retirement savings plans**



StatLink http://dx.doi.org/10.1787/285664667886

Source: Antolin, P., A. de Serres and C. de la Maisonneuve (2004), "Long-term Budget Implications of Tax-Favoured Retirement Plans", *OECD Economics Department Working Papers*, No. 393.

OECD country.[10] Reducing the level should be accompanied by a better targeting of subsidies. Consideration should be given to reducing not just tax subsidies to pension contributions and returns, but also the generous taxation exemption limit for those aged over 65. Whereas tax relief on paying into a pension essentially redistributes from non-savers to savers within a cohort of the population, this favourable taxation for the old redistributes between the old and young, which will become more costly as the old-age dependency ratio rises.

Rules on private pensions should encourage adequate provision

The design and regulation of pensions should make it simple for firms to provide employment-based schemes and encourage individuals to save sufficiently. The current system accords an important role to annuities: pension funds are required to meet a Funding Standard that is partly based on hypothetical purchases of annuities, and some individuals are required to make purchases of annuities with pension savings at the age of 65. This makes it important for pension provision that the annuities market works well. This is hard to assess as it requires judgments about a reasonable assessment of the risks around long-term investment returns and demographic developments. It is notable, however, that very few people in Ireland purchase annuities by choice (Indecon/Lifestrategies, 2007). This could be due to preferences or a lack of understanding by individuals of the real risks, but it might also reflect the limited number of firms competing in the Irish annuities market. It could also be that people already have sufficient guarantees of retirement income through public and private DB pensions. Such issues raise the question of how appropriate it is to give annuities such a central role in the pension system, even if the insurance against longevity risk provided by annuities should in principle be a good policy to ensure that retirees do not exhaust their funds while they are alive.

The Funding Standard for private sector DB schemes is defined on a discontinuance or "wind-up" basis: to avoid any shortfall if the sponsoring employer were to become insolvent, pension funds should be able at all times to arrange for an insurance company to pay the benefits of existing pensioners and to pay a transfer value for the pension liabilities of those who are not yet retired. This provides a high degree of protection for the current liabilities of the scheme towards its members but is not the most appropriate requirement in other respects. Firstly, if funding were calculated on a continuing or on-going basis, pension schemes would have to take into account future rises in salary that will increase the already accrued rights of current employees. Secondly, the link to annuities raises the cost of providing pensions if annuities are not competitively priced. Thirdly, the "wind-up" standard creates incentives for pension funds to invest in low-yielding assets with low-variance returns to meet the rule consistently rather than to purchase higher-yielding, more volatile assets such as equities, although Irish pension funds do currently hold around two-thirds of their assets in equities. In the long run, these incentives could imply that pension assets would grow more slowly and that more needs to be invested to achieve a given expected level of benefits than would otherwise be the case. The "wind-up" funding standard may be particularly inappropriate for a country such as Ireland, where the population is relatively young, because this should increase the focus on the long-run growth of pension assets rather than protecting the, on average, relatively few scheme members drawing pensions or being close to retirement. As a young population means that pension liabilities lie further into the future, this would allow more time to take corrective action if returns were lower than anticipated.

The Funding Standard is currently under review by the Pensions Board. Adopting the standard that schemes should be sound on an on-going basis would be compatible with the OECD *Guidelines onFunding and Benefit Security in Occupational Pension Plans* and is the practice in several other countries. Alternatively, the interpretation of the "wind-up" standard could be further eased so as to remove the constraining hypothetical requirement to purchase annuities. There is already some flexibility built into the system as the regulator can allow pension funds to be underfunded for up to ten years, one of the longest periods in the OECD. Although it is important that private pension provision is sufficiently well-funded, the apparent strength of the guarantee currently embodied in the Funding Standard is in any case misleading given that a large number of the schemes covered do not currently meet it.

At retirement, private pension wealth is accessed either as a lump sum, through purchase of an annuity, or placed in a post-retirement Approved Retirement Fund (ARF) which is similar to a pension fund in that capital gains are not taxed. Pay-As-You-Earn (PAYE) workers with DC pensions are required to use most of their pension fund to purchase an annuity.[11] Annuities provide insurance against the risk that people outlive their resources. However, if the annuities market is inefficient, pensioners would have a higher level of retirement income in the absence of this requirement. This requirement is a distortion given that it does not apply to Additional Voluntary Contributions, non-PAYE workers and other private pension arrangements such as insurance policies. The requirements to purchase annuities on retirement should be reconsidered, although it is important to maintain some minimum level of annuitisation and that people are aware that the annuities market may take a more realistic approach to assessing likely longevity than their own or actuarial assessments; the higher apparent cost might actually be a better reflection of the true cost. Retaining some element of compulsion may be helpful to address adverse selection effects. Allowing all retirees to invest in an ARF or similar instrument would also increase flexibility about when pensioners draw down their retirement income, allowing people to defer their pension or, for the financially sophisticated, to choose a more desirable time profile for their retirement income.[12]

Private pensions should contribute to labour market flexibility

Regulation of private pension schemes should help workers move between jobs and stay in employment beyond the age of 65 if they wish. As in other countries, private schemes often make it difficult to integrate entitlements from the pension scheme of a previous employer with that of the current employer. Occupational pension schemes and PRSAs should be encouraged to allow members to defer the standard retirement age and receive an actuarial-adjustment to their future benefits. Changes in the tax system should be made to allow workers to stay with the same employer after the age of 65 and enjoy favourable tax treatment.

Options for pension reform

Ireland is well-placed to cope with the challenges stemming from ageing. Given the favourable demographics, pension payments will start to surge later than in most other OECD countries. Ireland is among the few OECD countries with very low government debt, and it is accumulating assets in the NPRF. Moreover, taxation is relatively low, while the sizeable public investment programme will eventually be scaled back when the public capital stock reaches the targeted level. But these favourable conditions should not lead to complacency. When ageing starts in earnest, the rise in pension payments will be especially sharp, while spending on health and elderly care will also rise considerably. Moreover, changes to the pension system need to be phased in and clear long-term commitments are needed to guide decisions on private savings.

A Green Paper on Pensions was published in October 2007 (Box 5.1) and the government is committed under the *Towards 2016* social partnership agreement to making

Box 5.1. **Green Paper on Pensions**

The Green Paper on Pensions, published by the government in October 2007, provides a comprehensive and detailed overview of all elements of the pension system including the contributory state pension, incentives to private saving, public sector pension and pension regulations. It defines the objective of the pensions system as:

- Adequacy – to achieve an adequate level of income in retirement relative to pre-retirement income.
- Sustainability – to restrain the cost of the pension system in the face of demographic change.
- Modernisation – to adapt to changes in the labour market such as rising female participation.

The options for reform of the social welfare pension include indexing the state pension to prices to limit costs, raising the pension age and introducing means-testing. A wide range of detailed changes to the social security pension are discussed including: maintaining the current arrangements; moving to a universal standard rate payment; backdating the Homemaker's Scheme introduced in 1994 for those with contribution histories limited by periods outside the workforce to look after children or incapacitated people; replacing the average contribution test with a total contributions test as a simpler and fairer way of determining pension benefits; and other changes to the parameters of the system.

Box 5.1. **Green Paper on Pensions** *(cont.)*

Four approaches for closing the gap in retirement saving are set out:

1. The current voluntary system but with enhanced incentives to save through matching contributions.
2. Mandatory pension saving for workers without adequate alternative arrangements. Contributions would be 15% of eligible income including a 5% contribution from the Exchequer in lieu of PRSI and tax relief.
3. A soft mandatory system with employee contributions of 5% supported by employer contributions and a capped government contribution. Workers would be able to opt out of this scheme under certain conditions.
4. Enhancing the social welfare pension so that there is less need for private saving.

It is important in assessing the merits of different options to compare like-with-like in terms of the pension benefits delivered for a given level of cost. The options in the Green Paper, based partly on a mix of proposals from previous studies, do not always do this. Although the cost of some approaches is shown as being higher, this is in some cases because the benefits are also higher and this does not provide a good basis for judging the relative effectiveness of different systems rather than different levels of pensions. It is vital that comparisons adequately take the different risks into account.

proposals within a year. Despite an on-going debate and several substantial reports, Ireland has not succeeded in carrying out a major reform over the past 15 years, unlike most other OECD countries. The current opportunity to reform the pension system should be seized. The rising demands of an ageing population will require substantial changes to the state pension and public finances. The cost of the pay-as-you-go state pension will have to be met by some combination of reducing the entitlement, higher saving through the NPRF, raising taxes or lower government spending on other activities. Although the NPRF will help and it is reasonable that government spending on pensions should rise from its current low level, measures to manage the overall level of pension spending are likely to be required. One option is to raise the retirement age, preserving the replacement rate of income once people do retire. Given that people will live longer and healthier lives, it seems natural the retirement age should rise to reflect this.

The retirement savings gap between the current state pension and a decent replacement income in retirement needs to be addressed. Raising the essentially flat-rate state pension would be an expensive and wasteful way of achieving this. It is therefore important to ensure that individuals make sufficient retirement saving to close the retirement savings gap. The existing system provides decent private pensions for a large number of people, but leaves many low- and middle-income earners without adequate savings. There are several options for addressing this problem: mandatory, "opt out" or voluntary schemes. The current system of voluntary saving supported by sizeable tax expenditure is not effective at raising pension coverage of low- and middle-income earners. It needs to be reformed and better targeted. Alternatively, some degree of compulsion may need to be considered to raise pension saving and close the gap.

Box 5.2. **Summary of recommendations on pension reform**

Use the opportunity provided by the Green Paper on Pensions to establish long-term objectives for the state pension. In particular:

- Set an official long-term target level for the state pension (in terms of the average wage) to provide more certainty.
- Link the standard retirement age to longevity.
- Replace in-kind allowances with an equivalent cash increase to pensions.

Offer an actuarial-equivalent increase in the state pension for deferred retirement and consider making the value of the contributory pension more sensitive to the number of years of contribution to increase the incentives to work longer. Further limit the means-testing of labour income in the non-contributory pension.

Eliminate incentives for older workers to exit the labour market through disability schemes, improve the assessment of work capacity for new claimants and improve active labour market support for the disabled.

Reconsider the basis for up-rating of pensions in payment under the public service pension scheme. Ensure that public-sector pensions evolve in line with changing needs and practice in other sectors. Phase in more rapidly the increase in the minimum retirement age to 65.

Make Personal Retirement Savings Account (PRSA) membership "opt out" for workers not covered by appropriate occupational schemes and with income above a threshold where the state pension offers a high replacement rate.

Replace tax breaks for pension contributions with a system of (capped) matching contributions. This would allow the level of subsidy to be lowered and targeted better. Tax breaks for households aged 65 and over should be reduced as part of the same package of reforms.

Consider changing the funding standard for defined-benefit (DB) pension schemes to a continuing basis.

Reconsider the requirement to purchase annuities with retirement savings by allowing access under all schemes to Approved Retirement Funds (ARFs) or similar instruments.

Increase the flexibility for working past age 65 in occupational pensions and change tax rules to allow people to continue to work for the same employer.

Notes

1. More precisely, there is 1) the flat-rate State Pension (Non-Contributory) and 2) the State Pension (Contributory). Although different conditions apply, the value of the two pensions only differs in 2008 by € 11.30 per week and only a short contribution history is needed to draw the full contributory pension, so the system is approximately a flat-rate payment (OECD, 2005a). Most pensioners qualify for the contributory pension. The two pensions are referred to throughout this survey as the "state pension" where no distinction is necessary. Both pensions are available from age 66, although the state pension (transition) is available from 65 for those who retire and meet similar conditions to those for the contributory pension.
2. In an integrated scheme, the benefits under a defined benefit scheme take into account the value of the state pension so that an increase in the state pension reduces the amount that needs to be paid by a DB scheme with no effect on the overall level of retirement income.
3. These figures reflect the average rates under the two state pensions for those aged 66 to 79 years of age. For couples, the calculations assume that both spouses qualify for that type of pension. The rates for couples are lower if both do not qualify and also if the other person is under the age of 66.

4. 2005 European Union Statistics on Income and Living Conditions (EU-SILC).
5. Disregards in the means-testing of labour income were doubled to € 200 in the Budget for 2007.
6. The target is for 70% supplementary pension coverage for those aged 30-65 in employment. The target for 35% of persons in employment aged under 30 to have private provision is currently being met (CSO, 2006).
7. Because the pension is based on the final salary in each job, changing jobs reduces pension entitlements (OECD, 2005a). The average length of a job in OECD countries is around seven years.
8. Although tax relief on earnings is now capped at an income of € 254 000 and the maximum allowable pension fund for retirement for tax purposes is limited at € 5 million, these imply large tax concessions up to a very high level of wealth compared to the average citizen.
9. The National Pensions Review discussed such a system of matching contributions but the proposed rate of a one-for-one matching contribution seems excessively generous. This was derived on the basis of extending the same level of subsidy currently available to higher-rate tax payers but it is not clear that this is an appropriate objective.
10. Assuming no change in the use individuals make of the system of tax advantages.
11. PAYE workers, which excludes proprietary directors and the self-employed.
12. Changes in the 2006 Budget partly addressed the tax aspects of ARFs by introducing a 3% annual deemed distribution, although the favourable treatment of bequests to children made from ARFs could be reformed as it is not a necessary part of helping people to save for old age.

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Chapter 6

Integrating migrants: Learning from OECD experience

Immigration has soared in recent years. The immigrants tend to be young, well educated and work. But they often work in basic jobs. Immigration policy should thus focus on better integration. This chapter reviews Irish immigration policy in the light of international experience. It also highlights the uncertainties about future migration flows and the challenges they pose for infrastructure planning.

For most of its history Ireland has been a country of emigration. An astounding 5 million people emigrated in the 150 years since the end of the famine, though emigration was the normal state of affairs even before then. This changed dramatically in the mid-1990s. The economic boom of the Celtic Tiger years put a break on emigration and led to a substantial pick-up in immigration. The diaspora came home and foreigners hitched on to the economic bandwagon in large numbers. Immigration received another massive boost after 2004 when Ireland opened its doors to the new members of the European Union.

Migration brings benefits and challenges. The gains for the Irish people have been substantial. Put simply, the boom would not have lasted without immigration. It has boosted growth, helped alleviate labour shortages and has been an essential part of the policy package that makes Ireland attractive to multinational companies. Compared with experiences in other OECD countries, there have been few problems so far. The majority of migrants are young and employed, so they have not been a drain on the public purse or put major demands on public services and the welfare system. It has also been helpful that the cultural and religious background of most immigrants is similar enough to the Irish themselves, keeping a lid on the types of social tensions that have been seen in other countries. Perhaps the most visible negative impact has been that rapid population growth has added to infrastructure bottlenecks, especially transport but also private infrastructure such as housing.

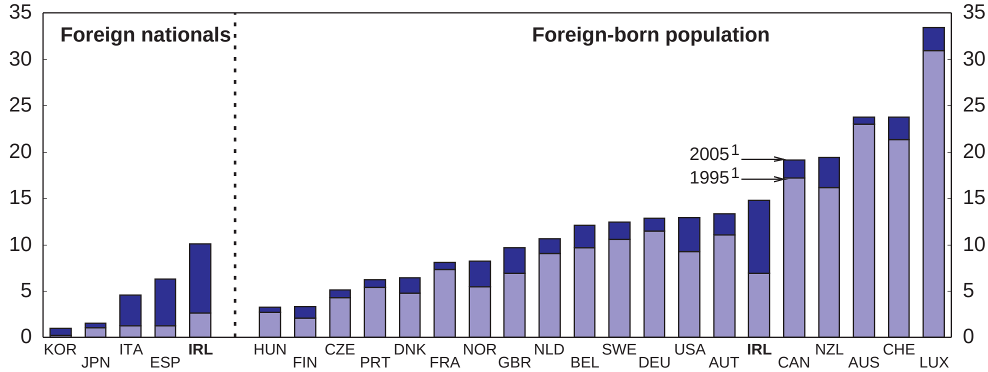
While the side-effects from immigration have been minor so far, the honeymoon may not last forever. As more migrants settle permanently and bring over their spouses and children, public services such as education and healthcare will continue to face even greater challenges. Immigration is more likely to have adverse impacts during an economic downturn and, while the economy is expected to slow only mildly over the next year or two, there is a risk of a more severe downturn. With free movement between Ireland and most other EU countries, there is little the government can do to control migration flows. It therefore needs to focus on developing strategies that seek to ensure the most efficient use of this very valuable resource. This chapter reviews Ireland's migration experience and discusses the emerging policy challenges.

Migration trends

Around 15% of people living in Ireland were born outside the country (Figures 6.1 and 6.2). The proportion of foreign-born has doubled in the space of a decade, which by OECD standards is an extremely rapid change in the population mix. Ireland has now surpassed the United States, the United Kingdom and France, three countries with much longer immigration histories. The number of foreign nationals in the country is less than the number of foreign born, at around 10% of the population. The difference is mainly accounted for by the children of the diaspora who were born abroad to Irish parents, and who are entitled to Irish nationality.[1]

Figure 6.1. **Foreign-born population**

Per cent of total population



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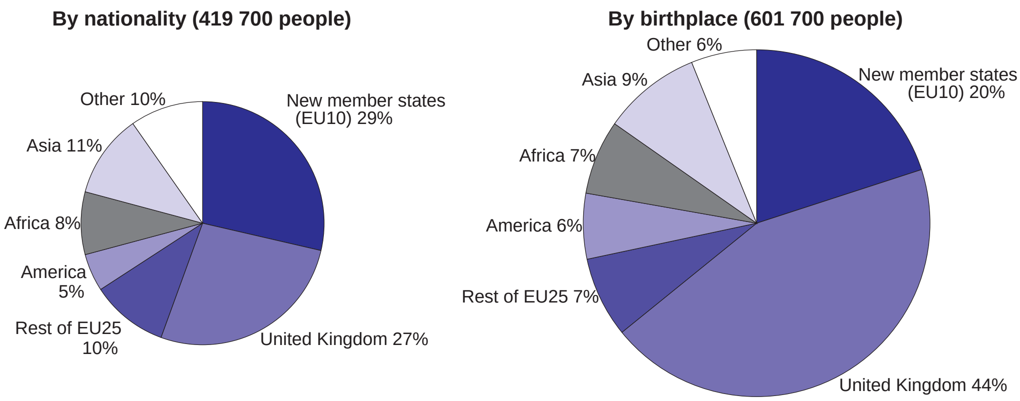
1. 1995 or earliest available data and 2005 or latest available data. Data for Ireland is 1996 and 2006.

Source: OECD (2007), *International Migration Outlook: Annual Report*, Tables A.1.4 and A.1.5; Central Statistics Office, Census.

Figure 6.2. **Immigrants by nationality and birthplace**

Number resident at time of 2006 Census



StatLink http://dx.doi.org/10.1787/285706585814

Source: Central Statistics Office, Census 2006.

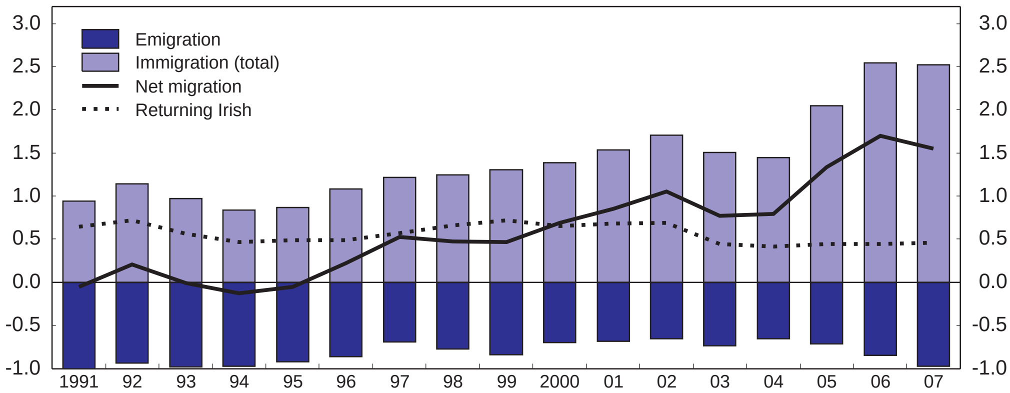
The different waves of immigration

The turning point in migration came in the mid-1990s in response to the economic boom. In 1996, net migration turned positive and has tended to increase ever since. While emigration has been fairly stable, the main change has been a sharp jump in the number of immigrants (Figure 6.3), which is very high by OECD standards.

To understand the impact of migration and the policy challenges that it brings, it is helpful to distinguish between three broad groups of immigrants. The first group consists of Irish return migrants and their descendants and British immigrants – namely, Irish emigrants who came back, Irish nationals born overseas and British nationals. This group dominated the migration wave in the 1990s: over that period, about half of the immigrants were returning Irish migrants[2] and another 18% were British nationals, reflecting the traditionally close two-way flows between Ireland and the United Kingdom. They have integrated into the labour market pretty much immediately, earning at least as much as

Figure 6.3. **Migration over time**

In per cent of population, April data



StatLink http://dx.doi.org/10.1787/285758786846

Source: Central Statistics Office; Hughes, G. and E. Quinn (2004), *European Migration Network - The Impact of Immigration on Europe's Societies: Ireland*, ESRI - EMN.

comparable "natives". One study estimated that Irish people who emigrated in the 1980s and who returned in the 1994-97 period were better educated on average than the local population and better educated than the average person who emigrated, suggesting that the best and brightest were more likely to return (Barrett, 2001). They came back with better experience, skills and knowledge, judging by their 15% wage premium relative to comparable non-migrants (Barrett and O'Connell, 2000).[3] This group provides few policy challenges.

The second group consists of migrants from the new EU member states. This cohort has dominated the surge since around 2004. The government expected perhaps 15 000 to 20 000 migrants in the first year after EU accession, and for the rate to slow down after that, but the inflow turned out to be much higher (Killeen, 2006). On census night (April 2006), around 120 000 EU10 citizens were living in Ireland, three-quarters of whom were Polish or Lithuanian, and most of these people are likely to have arrived after accession.[4] Nor has the inflow slowed down. Based on the number of social security (PSS) numbers issued, the inflow from the new member states has been steady right through to June 2007. Tax data show that about 70% of these people entered the labour force at some stage, though some would have been students working part time or people on seasonal and short-term contracts. It is not known how many have returned home. This group is well educated and has a very high employment rate but their jobs are relatively low paid. The policy challenge is to help them get jobs that better match their skill levels.

The third group consists of migrants from the "rest of the world" – that is, outside Europe and the United States. It is a group that is sometimes ignored in the public debate because it is dwarfed by the inflow from Eastern Europe. Even so, it is still sizeable by international standards: immigration from the rest of the world is about as large as the total immigration rate into the typical OECD country.[5] The group is diverse. It covers highly skilled migrants entering under one of the employment channels as well as asylum seekers and refugees. While the number of successful asylum seekers is small, they present the toughest integration challenge.

All three groups are well attached to the labour market, though to varying degrees (Table 6.1). Migrants from the new member states have an extraordinarily high

Table 6.1. **Labour force status of those aged 15 and over**

Per cent of total, April 2006

	Total	Irish nationals	Non-Irish nationals	Of which... United Kingdom	EU15 (excl. Ireland and United Kingdom)	10 new EU member states	Other[1]
Employed	57.2	56.1	66.6	56.7	74.2	84.3	54.3
Unemployed, looking for first regular job	0.8	0.6	2.8	0.6	1.4	4.3	3.0
Unemployed, having lost or quit previous job	4.5	4.2	6.4	6.1	4.0	4.5	8.4
Total participation rate	62.5	60.9	75.7	63.3	79.6	93.1	65.7
Not in labour force	37.5	39.1	24.3	36.7	20.4	6.9	34.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Total number (000)	*3 311.5*	*2 909.4*	*367.2*	*96.9*	*39.7*	*110.5*	*155.0*

1. The major sources in the "other" category (excluding those for whom no nationality is stated) are Africa (19%), the United States and Canada (8%), China (6%), other Asia (19%), Romania (4.2%) and Australia and New Zealand (3.1%).

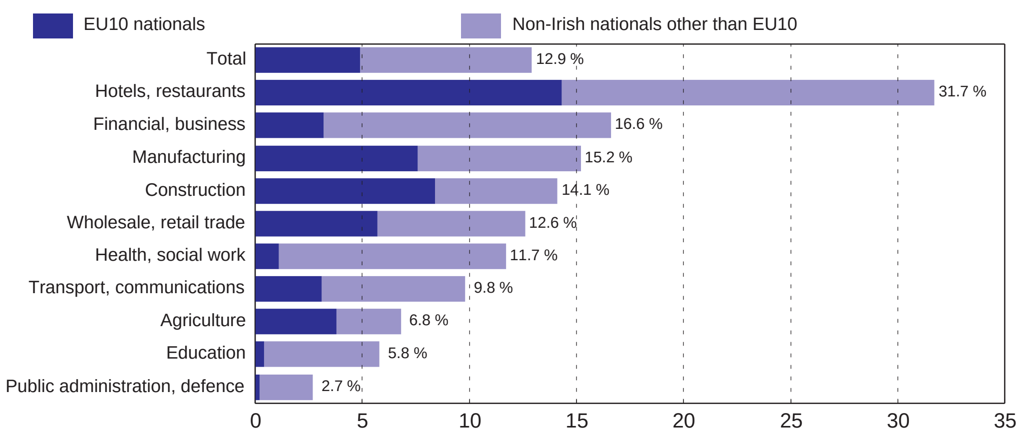
Source: Central Statistics Office, Census 2006.

participation rate (93%), while those from the United Kingdom and outside the European Union are similar to the native population (63%). Overall, immigrants are substantially more likely than Irish nationals to have a job. However, there is a wide variation in unemployment rates across migrant groups. For EU citizens, and especially those from the new member states, the difference relative to the native Irish is largely because a greater share are unemployed while looking for their first regular job, rather than having been laid off or quit their previous job. Thus, it probably reflects the fact that so many are recent arrivals, and it takes time to get a foothold in the labour market. In contrast, migrants from outside the European Union are more likely to be unemployed after having lost or quit their previous job. This suggests they may be a relatively vulnerable group. Surprisingly, UK immigrants show the same pattern.

Like in many countries, immigrants are heavily over-represented in the hotel and restaurant industries (Figure 6.4). They are slightly over-represented in finance and manufacturing but, despite the public perception, only marginally so in the construction

Figure 6.4. **Percentage of jobs in each sector held by immigrants**

2006



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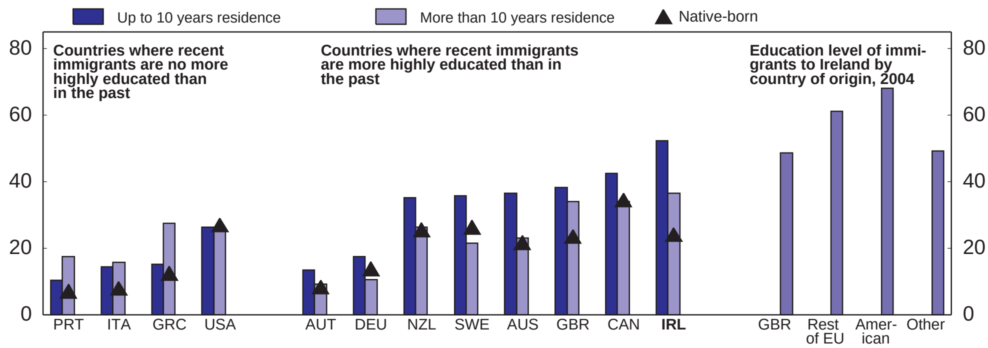
Source: Central Statistics Office.

industry.[6] Aside from the hospitality sector, immigrants from the EU10 are more likely to be found in low-skill manufacturing and construction while those from other countries are more prevalent in finance and healthcare. Overall, job quality does not seem much different to Irish nationals. While migrants are more likely to do shift work or work in the evenings and weekends, the difference compared with the Irish is small (Barrett and Bergin, 2007).

A common feature of all three groups is that their average education level is high both when compared with the native Irish, and with migrant streams going into other countries (Figure 6.5). The most recent migrants, who are mostly Eastern Europeans, are less likely than earlier cohorts to have a degree, but they are still a well-educated group on average.[7] But as noted above, they are not necessarily using those skills. It is not unusual for immigrants in OECD countries to work in jobs they are over-qualified for, especially when they first arrive, but the occupational mismatch in Ireland is relatively high (Figure 6.6).[8] Migrants from outside Europe and the United States are also likely to be over-qualified for their jobs, though the mismatch is smaller than for EU10 workers.

Figure 6.5. **Share of immigrants with a tertiary-level qualification**

Percentage of persons aged 15 and above, circa 2000



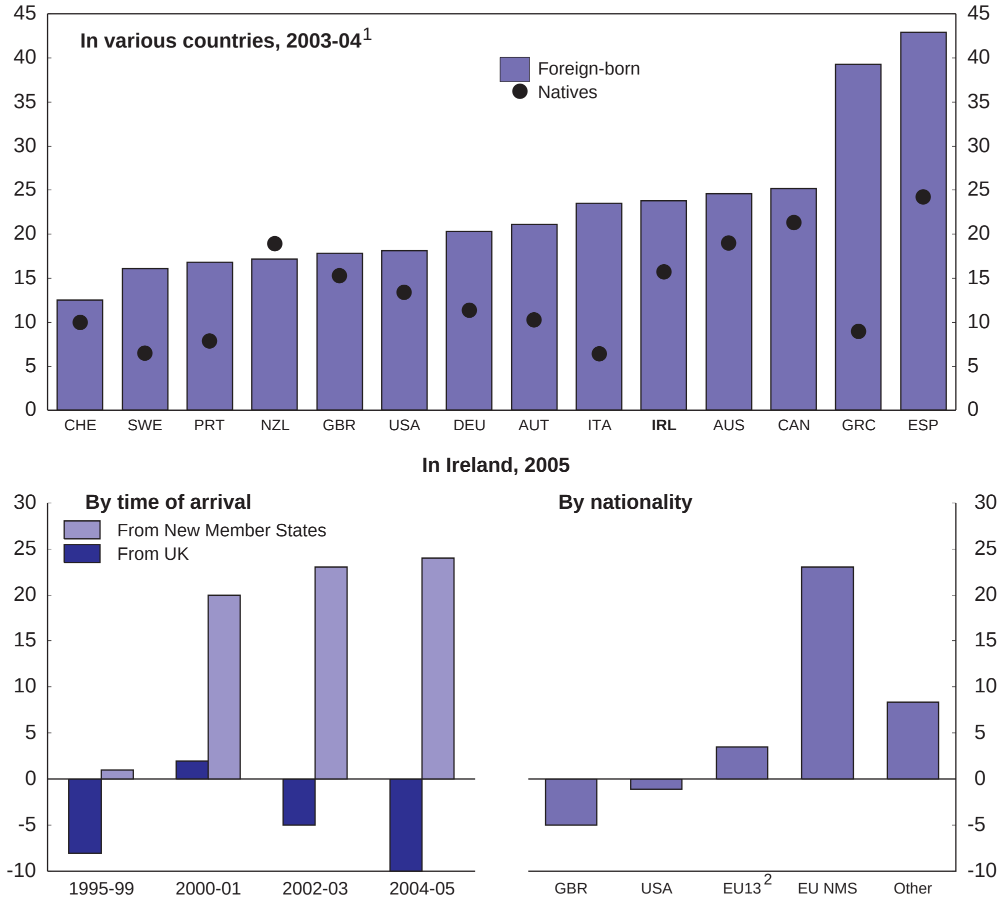
StatLink http://dx.doi.org/10.1787/285835428770

Source: OECD (2007), *International Migration Outlook: Annual Report*, Chart I.12 for the two left panels; A. Barrett and A. Bergin (2007),The Economic Contribution of Immigrants in Ireland, Chapter 5, Table 7 in B. Fanning (ed.), *Immigration and Social Change in the Republic of Ireland*, Manchester University Press for the right-hand panel.

This pattern means that Ireland is not making the best use of its migrant workforce. But it matters for source countries as well. While a brain drain is undoubtedly a problem for them in the short term, the longer-term impact can be positive if enough migrants return home with greater skills, experience and wealth. Countries with a tradition of high migration in both directions, such as Australia, New Zealand and Ireland itself, have benefited from this two-way flow. But the gains for the source country are reduced if migrants are stuck in basic jobs.

While this points to integration problems for some migrants, it may simply reflect the fact that many are recent arrivals and perhaps work in basic jobs while they improve their language skills, for example. It is also possible that some migrants from the new EU member states are seeking to learn English, travel and earn a sum of money over a short period of time, rather than trying to build a career in Ireland. The problem is that policymakers are operating with little information. Little is currently known about whether migrants become more integrated over time. One study found that the earnings gap

Figure 6.6. **Over-qualification rates**



StatLink http://dx.doi.org/10.1787/285861564204

1. Survey data, population 15-64 for all countries except Canada and New Zealand (Censuses and Population Registers, population over 15, circa 2000). For the United States, the survey data are from 2002.
2. EU15 excluding Ireland and the United Kingdom.

Source: OECD (2007), *International Migration Outlook: Annual Report*, Table II.2; Barrett, A. and D. Duffy (2007), "Are Ireland's Immigrants Integrating into its Labour Market?", *ESRI Working Papers*, No. 199, June, Tables 5-8.

shrinks with the number of years worked, which is encouraging, but the effect is small.[9] The study also found that EU10 migrants who arrived in the 1990s or early 2000s had, by 2005, a smaller occupational gap than the ones who had just arrived. Again, this is consistent with improved integration over time, but the apparent improvement is not statistically significant and, because the study is not based on longitudinal data that tracks the same individuals through time, the result may be caused by a survivorship bias (the "losers" have gone home) rather than by improving job outcomes. However, there are some optimistic signs coming out of the United Kingdom, which has had a similar experience to Ireland regarding migrants from the new member states. There are indications in Britain that migrants are moving up the occupational ladder and becoming more choosy about jobs.[10] This may be true in Ireland as well.

All in all, the evidence for improved labour market integration is weak. However, this should be kept in perspective. First, there is little evidence that analysts can draw on, which is different from saying that there is evidence integration is not happening. It may be that many migrants only intend to stay for a short period of time and are not planning to build a career in Ireland. Second, labour market integration issues in other countries can be tougher: they often refer to whether migrants have a job at all. In Ireland's case, more than 80% of immigrants from the new member states are employed; the question is whether their job fully matches their skills and whether they manage to work their way up the job ladder over time.

The policy approach and recent reforms

Citizens of European Economic Area (EEA) countries[11] except Bulgaria and Romania are free to work in Ireland without restriction. Non-EEA nationals need a work permit. There is a so-called green card for skilled migrants with salaries over € 60 000 and a more restrictive work permit regime for other occupations (see below and Table 6.2 for details). With this policy, Ireland has effectively decided to meet most of its needs for low skilled and high skilled labour from within the EEA. Green cards and work permits allow migrants to work for a specific employer, though they can change jobs after one year.[12] As in most other European countries, and contrary to Australia, Canada and the United States, there is no permanent immigration policy (*i.e.* there is no permanent visa). The Immigration, Residence and Protection Bill 2008 will introduce changes to the current system.

Table 6.2. **The main migration channels**

An empty cell means that no information is available

Category	Main features	Numbers			
		2004	2005	2006	2007[1]
EEA citizens	Under EU Treaties, most citizens of the EEA have free entry to work in Ireland. Ireland has imposed restrictions on migrants from Bulgaria and Romania until 2012.	25 600	48 900	63 600 (77 800 according to census)	
Green cards	This is the main channel for skilled migrants from outside the EEA. The applicant must have a valid job offer, usually with a salary of at least € 60 000 per annum.	1 444[2]	2 585[2]	1 045[2]	2 705
	Also available for jobs paying between € 30 000 to € 60 000, but only for certain occupations (*e.g.* in IT, healthcare, engineering, science and finance).				
	Issued to employees for two years and will normally be renewed indefinitely.				
	Immediate family reunification is possible.				
	No labour market needs test is required.				
	Since 2007, this gives faster access to long-term residence status.				
Work permits	Available for certain occupations with a salary of € 30 000 or more. Many occupations are not eligible (including clerical, retail, production and hospitality staff and most tradespeople). Can be granted for a very restricted number of occupations paying less than € 30 000 per annum.	10 020 (plus 23 246 renewals)	7 354 (plus 18 970 renewals)	6 289 (plus 14 258 renewals)	5 112 (plus 12 099 renewals)
	A labour market needs test must be met (which in practice means the vacancy must have been advertised with the Irish employment agency, the European EURES network and local newspapers and that no suitable EEA candidate was found).				
	Granted for 2 years initially, and then for a further 3 years.				
	A new permit is usually required if the migrant wishes to change employer.				
	Family reunification permitted after one year provided salary is above a certain threshold (around € 29 000 for a family with two children).				

Table 6.2. **The main migration channels** *(cont.)*

An empty cell means that no information is available

Category	Main features	Numbers			
		2004	2005	2006	2007[1]
Intra-company transfers	Allows for the transfer of senior management, key personnel and trainees from an overseas branch of a foreign multinational. The scheme was suspended in 2002 but resurrected in 2007.	376[3]			374
	Issued for two years. Can be renewed for a maximum of five years.				
	People on the scheme will not build up rights to permanent residency.				
Spouses and dependents	Spouses and dependents of those with green cards, work permits and intra-company transfer permits can apply for a work permit. A labour market needs test is not required.			1 357	1 274
Business permits	Available to someone who wishes to set up a business, provided they transfer at least € 300 000 to Ireland and employ two EEA nationals.	97			
	Available for one year, and may be renewed for a further year.				
Students	Can work 20 hours per week while studying, or full time during the vacation, without a work permit.		27 000[4]		
Graduates	From 10 April 2007, tertiary students may stay and work in Ireland for 6 months after graduation. This allows them time to find employment and apply for a work permit or green card.				
Working holiday visas	For people aged 18-30 from Australia, Canada, Hong Kong, Japan and New Zealand. Permit lasts for one year. Must not work for any one employer for more than three months.The number of permits is capped.	Unknown (but approximately 3 000 in 2003)[5]			
Asylum seekers	Not entitled to work (except for those who arrived before July 1999).	4 265	4 320	4 314	
		Accepted as refugees:			
		1 138	966		

1. Partial year figures, at an annual rate.
2. Refers to work visas and authorisations (the predecessor of the green card scheme).
3. 752 permits were issued in 2003 and 2004. This figure has been arbitrarily split equally between the two years.
4. Number of registered non-EEA students (who may or may not be working).
5. IOM Consulting (2007), *Managing Migration in Ireland: A Social and Economic Analysis*, NESC, p. 92.

Source: Department of Finance; Department of Employment Annual Reports; Department of Justice Annual Reports; Irish refugee council, *www.irishrefugeecouncil.ie/stats.html*.

Aside from the decision to open up to workers from the EU10, the main policy initiatives over the past five years include the following:

- The work permit scheme was changed to put more focus on the higher-skilled. Until 2003 the system had been largely employer driven, with few restrictions on recruitment from outside Europe except a labour market test that was designed to be an irritant rather than a major barrier. Up until then, around three quarters of permits were for relatively low skilled or low paid jobs, especially in the service industry. From 2003 onwards, the government has limited work permits to a very restricted list of jobs.
- In 2004, the constitution was amended by referendum, removing the automatic right to citizenship for anyone born in Ireland.
- In 2007, several changes were made to the various employment permit schemes:
  - ❖ A "green card" system was introduced for skilled workers, replacing the work visa and work authorisation programmes (work visas and authorisations were designed for skilled

and temporary work respectively; they differ from the work *permit* programme, which is more general). A green card is issued for two years for jobs paying at least € 60 000 per annum (and for lower paying jobs in some strategic sectors). It is more restrictive than a US green card because it restricts the immigrant to working for the employer and the site named on the card. It is an improvement on the previous regime in at least two respects. First, the duration of the first permit has been increased because employers and employees felt that one year was too short. And second, migrants can bring their spouses and families immediately and the spouse will have the right to work without having to apply for a work permit. Finally, the 2008 Immigration, Residence and Protection Bill will give faster access to long-term residence status to holders of the new green cards.

- ❖ The work permit scheme was modified. It covers occupations in the € 30 000 to € 60 000 range (and jobs below € 30 000 in exceptional cases only). As with the green card, the permit is now issued to the employee. A tougher labour market test must also be met. The employer must advertise locally and in Europe to show that the position could not be filled from within the EEA. The family can join them after one year.
- ❖ The intra-company transfer scheme, which was suspended in 2002 because it was being abused, was re-instated. It allows for temporary management transfers within multinationals.
- ❖ Tertiary level students will be able to stay and look for work for six months after graduating. They can then receive a work permit or green card depending on the salary level.

- In order to cope with the significant migration that was already taking place, Ireland decided that for a seven-year transition period Bulgarian and Romanian nationals would not have free access to the labour market after joining the European Union in 2007. They would have to apply for work permits like non-EEA nationals, though according to EU provisions, Bulgarian and Romanian nationals need to be given preference over third country nationals with respect to labour market access.

The economic impacts of migration

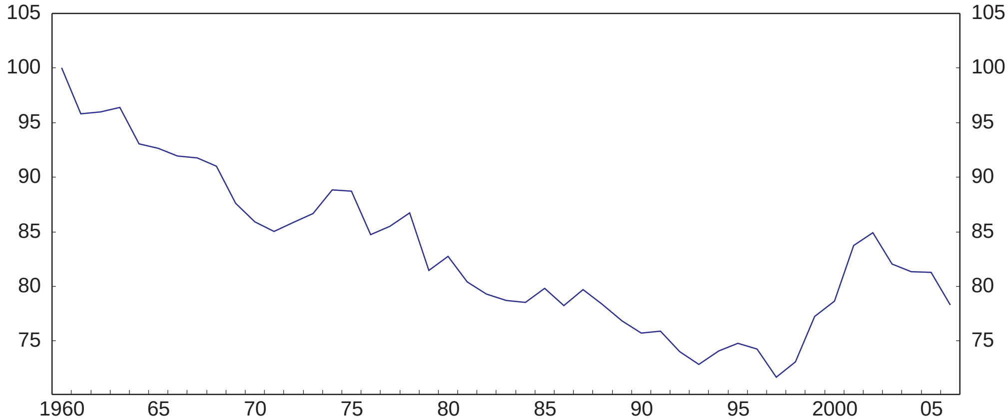
Impacts on employment, wages and the income distribution

At an aggregate level, immigration has clearly not crowded the native-born population out of the job market, considering that the unemployment rate has fallen from 16% in 1993 to around 5% at present. Instead, it has allowed a fully employed economy to continue growing. This pattern is consistent with OECD research and the empirical literature which finds that immigration generally has little influence on unemployment and wages of local workers, especially where they complement rather than substitute for the native-born population (Jean *et al.,* 2007 ; Jean and Jiménez, 2007 ; Manacorda *et al.,* 2006).

Nonetheless, there are distributional issues as some groups of Irish workers are more affected than others. Because the wave of immigrants in the second half of the 1990s were highly skilled and tended to work in skilled occupations, they are likely to have reduced, or slowed the rate of increase of, the relative wages of the high-skilled and thereby reduced earnings inequality (see Figure 6.7 and Barrett, 2001). It probably raised the demand for unskilled labour at the same time as they tend to be complements rather than substitutes (Barrett *et al*., 2006). Immigration of skilled workers has been a necessary counterpart to foreign investment. Ireland has been unable to produce enough home-grown graduates, so

Figure 6.7. **Ratio of unskilled wages to the average wage**

Index 1960 = 100



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Source: ESRI calculations based on CSO data.

some companies would have had to move their production elsewhere if they had not had access to skilled migrants. If such immigration helps keep production in Ireland, it benefits the job prospects of native-born workers as well.

The more recent wave of migration would have had different effects since immigrants are competing with less-skilled Irish workers. Recent labour market outcomes for the less-educated have been weaker than among the well educated (Table 6.3), and while this is consistent with their being displaced by migrants, the same pattern in the data would be observed as older less-educated workers retire, and it is difficult to disentangle the two effects.

Table 6.3. **Employment performance by education level**

Change in rates 2004Q1 to 2007Q1, percentage points

Highest education level attained	Employment rate	Unemployment rate	Participation rate
Males aged 15 to 64			
Lower secondary	–0.6	0.1	–0.6
Upper secondary	2.1	0.1	2.2
Tertiary	1.0	–0.3	0.7
Total	**1.9**	**–0.2**	**1.8**
Females aged 15 to 64			
Lower secondary	0.5	0.3	0.6
Upper secondary	2.6	0.5	3.0
Tertiary	2.3	–0.4	2.0
Total	**3.9**	**0.0**	**4.1**

Note: The totals are not simple weighted averages of the components because they are also influenced by compositional effects.
Source: Central Statistics Office.

However, immigration may have allowed or compelled Irish workers to change industries. For example, over the past three years the number of Irish nationals working in manufacturing and in the hospitality sector has fallen while in both sectors the number of foreign employees has risen (Table 6.4). Irish workers have shifted towards the government sector and construction.

Table 6.4. **Change in employment by nationality**

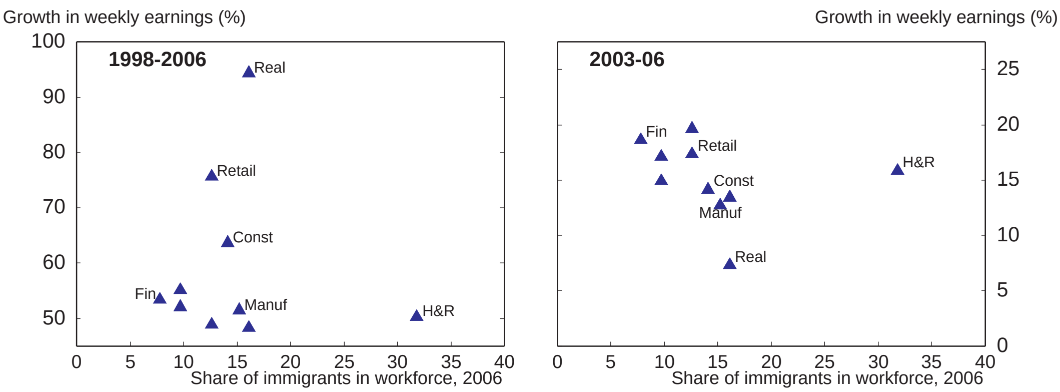
Between 2005Q1 and 2007Q1, in thousands

	Irish nationals	Foreign nationals	*Difference: Irish minus foreign*
Agriculture	3.5	0.4	*3.1*
Manufacturing	–22.9	16.6	*–39.5*
Construction	29.1	19.8	*9.3*
Wholesale and retail trade	12.2	11.5	*0.7*
Hotels and restaurants	–6.6	14.4	*–21.0*
Transport, storage, communications	3.2	4.5	*–1.3*
Finance and business services	8.0	11.8	*–3.8*
Public administration	9.2	–0.1	*9.3*
Education	20.6	1.5	*19.1*
Health	18.5	8.1	*10.4*
Other services	–1.3	4.4	*–5.7*
Total	**73.7**	**92.8**	***–19.1***

Source: Central Statistics Office, *Quarterly National Household Survey*.

Regarding the impact on wages, it is hard to imagine that migration on this scale would not have had an impact on relative earnings. It is likely to have dampened wage growth at the lower end of the income distribution, especially in the hospitality and construction industries, since that is where most of the migrants have ended up, notwithstanding their skill levels. Indeed, there is some evidence that this has been the case. Figure 6.7 shows that the long-term trend decline in the wages of the low-skilled relative to average wages was re-established around the time that migration from Eastern Europe picked up. Moreover, there is some evidence that wage growth has been lower in industries where immigrants are more prevalent (Figure 6.8). Nonetheless, any impact of immigration on wage levels has easily been dwarfed by the underlying increase in average earnings of more than 50% since 1998.

Figure 6.8. **Earnings growth and immigrant share**



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Note: Industry abbreviations are: Real – Real estate; Retail – Retail trade; Const – Construction; Fin – Finance; Manuf – Manufacturing; H&R – Hotels and restaurants. Wholesale trade, business services (excluding financial intermediation), land transport, other transport, real estate and renting are not labelled individually.

Source: Central Statistics Office.

Impacts on output and productivity

Immigration raises output as it increases both supply and demand. The effect on output per capita, which is one way of measuring how much of the gains spill over to the local population, is less obvious. Ireland is unusual in that the immigrants are not much younger than the local population (Table 6.5) and are at least as well educated. By attracting people who are similar to the native-born population, the aggregate impact is, to a first approximation and provided they integrate well, largely one of scale – *i.e.* adding to the workforce. For there to be any benefits for the local population, there must either be spillovers, such as economies of scale, or complementarities between immigrants and the native-born population. Modelling exercises that try to estimate the macroeconomic impacts of immigration typically do not take one or both of these factors into account, and therefore tend to find that the gains for the local population are modest. For example:

- Barrett *et al.* (2006) looked at the wave of migration from 1993 to 2003 and concluded it was certainly positive for GNI and probably positive for GNI per capita and employment of the native Irish. Their simulation model takes account of complementarities between low-skilled and high-skilled workers, and shows that immigration of high-skilled workers raised demand for and wages of low-skilled workers as well. The effects of immigration are not negligible, but they are pale in comparison with the underlying growth of the economy: the study estimates that, of the 93% rise in real GNI over that period, around 3.5 percentage points can be attributed to immigration.
- Barrell *et al.* (2007) used a global macro model to look at the most recent wave of migration from the new member states. Their results suggest that it may raise Ireland's GDP by more than 3% in the long term (Table 6.6).[13] Most of the gains accrue to the migrants themselves but GDP per capita rises by around 0.7% in the long term. In the short term, while the adjustment is taking place, the expansion in labour supply puts downward pressure on wages, reducing inflation and temporarily slowing growth in per capita GDP.

Table 6.5. **Age of immigrants compared with the native-born population**

In 2004, excluding migrants aged under 15

	Median age of immigrants	Median age of native-born population	Difference in age
Poland	39	36	3
Ireland	**29**	**33**	**–4**
Czech Republic	32	39	–7
Luxembourg	31	38	–7
Spain	31	39	–7
Hungary	30	39	–9
Netherlands	30	39	–9
Finland	31	41	–9
Sweden	30	40	–10
Italy	32	41	–10
Austria	30	40	–10
Germany	31	42	–11
United Kingdom	27	39	–11
Denmark	27	39	–12

Note: Figures are approximate as they are estimated from 5-year age bands. Migrants under 15 are excluded because they usually will be accompanying their parents. Data for Ireland comes from Census 2006.
Source: Eurostat and Central Statistics Office.

Table 6.6. **Possible macroeconomic impacts of immigration from new member states**

Difference relative to a no-immigration baseline, in percentage points[1]

	2005	2006	2007	2008	2009	Long run (2015)
GDP	0.2	0.4	0.8	1.3	1.8	3.3
GDP per capita	–1.5	–2.3	–2.1	–1.6	–1.0	0.7
Inflation	–0.5	–1.3	–1.7	–1.3	–0.6	0.3
Unemployment	1.7	2.5	2.1	1.4	0.7	–0.6
Productivity	–0.4	–0.9	–1.3	–1.4	–1.6	–1.3

1. Based on a modified version of the simulation in Barrell *et al.* (2007). The modification is to speed up the labour market reaction by assuming that immigrants work in jobs requiring lower than average capital stock. The impacts have been scaled up by a factor of two to account for the greater inflow of immigrants than was estimated at the time the original simulations were run.

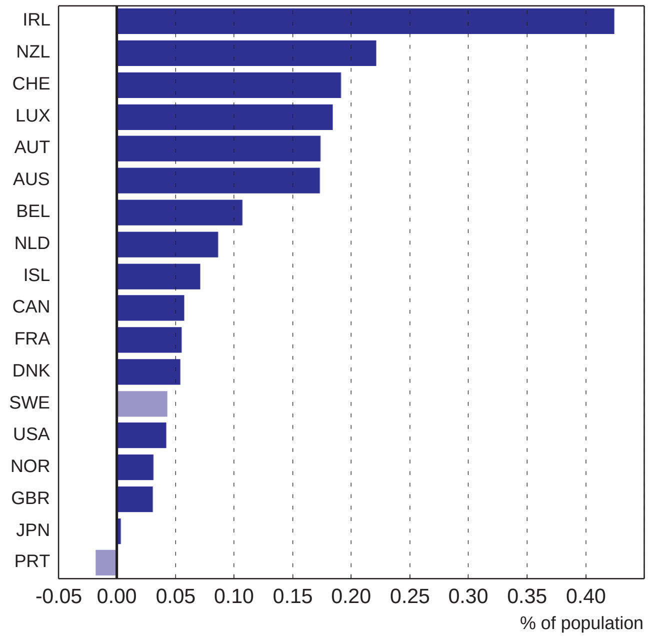
Source: National Institute of Economic and Social Research, London.

There are several reasons for thinking that in Ireland's case the gains for the native population may be larger than in other countries and larger than the modelling exercises suggest:

- As noted above, immigration has been necessary to provide the skills required by the multinational sector. This has been an important driver of income and productivity growth during the boom years.
- At least for the first wave of migration, labour complementarities are likely to have been important as evidenced by the sharp decline in structural unemployment over that period as many less skilled Irish workers were able to find employment.
- It has helped clusters to develop, such as ICT in Cork and the IFSC in Dublin. The evidence on the benefits of clusters is not clear-cut, but there is a general belief that they have positive spillovers on local firms in terms of productivity and employment.
- It can have spillover effects on trade and investment. The economics literature has found that immigrants contribute to developing trade links with their home countries.[14] One explanation is that, through their knowledge of their home country, they can reduce the transaction costs standing in the way of trade and investment.
- It can raise labour supply among the native Irish. In other countries, the extra migrant labour supply has led to an expansion of the home help sector such as cleaning, childcare and care for the elderly. This makes it easier for people to enter the workforce. This is not yet an important factor in Ireland but may become more important in the future.
- By increasing the labour supply elasticity, it can act as a safety valve for a booming economy that is unable to control demand with its own monetary policy. However, the effects here are not clear-cut. Immigration boosts aggregate demand as well as aggregate supply, and they can adjust at different speeds. Any mismatch in timing could magnify or stabilise economic cycles depending on circumstances. This issue is especially important for Ireland because swings in net migration are large and appear to be more sensitive to the state of the economy than for any other OECD country (Figure 6.9). In some countries, such as New Zealand, immigration tends to magnify cycles because migrants boost demand straight away while the increase in supply comes later due to the time it takes to find a job, especially one where migrants can work at their maximum productivity. But this may not be the case in Ireland: on the supply side, migrants have

Figure 6.9. **Link between net migration and economic growth**

Impact on the net immigration rate of a 1% increase in per capita GDP growth



StatLink http://dx.doi.org/10.1787/286011183131

Note: Light shading indicates the relationship is not statistically significant.

Source: Estimates are based on regressions of the net immigration rate on the average GDP growth rate over the previous three years over an estimation period of about 30 years. See Annex 6.A1 for details.

high employment rates right from the start; and on the demand side, the most recent migrants brought little capital with them and they send some of their earnings home rather than spending it locally.

- Migrants have had complex effects on the housing market. The increased demand for housing will have increased house prices, probably substantially, but at the same time the greater availability of construction workers is likely to have reduced construction costs relative to what they would have been. This partly explains why prices for new houses have not risen as rapidly as prices of second-hand houses. At the same time, the rise in house prices has probably reduced immigration, shifting the balance of labour market growth from employment to wages (Duffy, FitzGerald and Kearney, 2005).
- Lastly, any negative short-term adjustment effects are likely to be smaller and the long-term gains arrive quicker because of the country's sound framework conditions such as flexible labour and product markets. OECD research shows that migrant integration is more effective where unemployment benefits, the tax wedge and the minimum wage are lower, and that differences in employment protection legislation between temporary and permanent contracts can exacerbate insider-outsider problems that are especially problematic for migrants (Causa and Jean, 2007).

Nonetheless, the distribution of the gains is more complex to assess in the Irish case than it is for other OECD economies. To the extent that immigration has shifted income from labour to capital, much of the productive capital stock in Ireland is owned by foreigners and therefore a portion of the gains accrues to them. This point applies to all policies that are used to attract multinationals, not just migration policy. There is no point trying to attract foreign investment to Ireland unless some of the gains can be appropriated locally; and the presumption in Ireland, which seems vindicated by experience, is that not all the gains are captured by the foreign owners of capital.

Impacts on public finances

There has been no assessment of the impact on public finances, but it is probably positive. International studies show that the main determinants of the budgetary impact are age on arrival, employment status and the degree of redistribution in the tax-benefit system. The short-term impact is usually positive in countries that are able to select high-skilled migrants, although the initial impact can be negative but turn positive over time as migrants integrate.[15] The fiscal impact is more likely to be negative where a large proportion of the migrants are less skilled or working illegally and where the welfare system is more generous. Most studies find that the long-term impacts are positive but small. In the case of pension expenditure, migration can make the system more affordable in the short to medium term, but if the system is unsustainable to begin with then more people will make it more unsustainable in the long run.

The direct short-term impact depends on the balance between taxes paid and public services received. In Ireland's case, it amounts to the difference between two small numbers. On the revenue side, while most migrants are employed, they tend to be in relatively low paid jobs; with the lowest fifth of income earners paying no income tax, they may therefore not be contributing significantly to government revenues, though they will be paying social security contributions as well as VAT on their consumption. However, to the extent that skilled migrants are a necessary complement to the policy of attracting foreign multinationals, they enable the country to continue receiving the significant corporate tax revenues from this sector.

On the expenditure side, demands on healthcare and education are likely to have been modest on the whole so far compared with the scale of inward migration, as many migrants are young but have not brought families with them. There have been, of course, costs such as the additional € 120 million to fund 1 900 extra English language support teachers. Migrants have also not been a drain on the welfare system. In 2004, working-age immigrants were half as likely as the native Irish to be drawing social welfare benefits,[16] both because they are more likely to be employed and because they have restricted access to income support since a two-year residency requirement was introduced in May 2004.[17] There have been public concerns about the cost of child benefits being paid for children who are still in the immigrant's home country, but the overall amount does not appear to be large.[18] In any case, this is another argument for targeting child benefits on families who actually use formal childcare services, as recommended in the previous *Survey*. Lastly, the scale of the inflow has added to pressure on infrastructure such as roads and public transport. This has prompted a large publicly-funded infrastructure upgrade, though it probably would have taken place anyway with immigration simply hastening the process.

The long-term fiscal contribution is also unclear. That greatly depends on whether migrants stay in Ireland when they retire since the largest fiscal costs such as healthcare are concentrated on the over-65s. A well-educated migrant who arrives young and stays permanently is likely to become nearly fully integrated and so will not be much different from an Irish-born person except that Ireland would have got that person's education "for free". For this reason, immigration will not solve the fiscal problems stemming from an ageing society. Some countries have tried to reduce the long-term fiscal burden by imposing residency requirements of ten years or more before someone is entitled to a full public pension. In Ireland, by contrast, the pension system has the effect that, for all practical purposes, there are no substantive requirements regarding residency or the numbers of years of contributions (Chapter 5).[19] In any case, European directives mean that for EU migrants the person's full work history in the European Union is taken into account, so for this group tightening up contribution requirements will have no effect on Ireland's fiscal burden.

Policy challenges

The biggest uncertainty for policymakers is how many migrants will continue to come to Ireland. The next biggest uncertainty is how many would leave if the job market were to worsen. On the first question, the inflow may slow now that six other EU15 countries have opened their labour markets to EU10 nationals. But Ireland will remain attractive because it has a dynamic and flexible labour market, it is English-speaking and a beachhead has been established – network effects make it easier for migrants to go where their compatriots are. On the second question, a downturn would lead to some outflow as many of the most recent migrants have not yet brought their families over and Ireland is not an attractive place to be unemployed. Special factors, such as construction in Northern Ireland and for the London Olympics, could also encourage an exodus.

The question is: how many are likely to leave? Little is known about the extent to which recent migrants are putting down roots. Almost all Eastern European migrants rent their accommodation, mainly because houses are so expensive, although real estate agents have reported growing interest among migrants in buying a home. And while a surprisingly large number of Eastern European migrants are married,[20] many have left their family at home. Both these factors suggest that they are still relatively footloose. However, a recent survey of Polish immigrants found that at least half intended to stay in Ireland for at least the next five to ten years.[21] Uncertainty is compounded by poor information about who emigrates, so it is not known how many of the EU10 immigrants have since left. Internationally, there is a long history of countries welcoming workers in times of labour shortages on the presumption that they would leave afterwards, and finding that temporary immigration became permanent. For this reason, there may be major gains from an investment in integration. The importance of integration is recognised by the government, which has recently created the post of Minister for Integration to co-ordinate integration efforts across government departments, agencies and services, although actual delivery of integration services is the responsibility of mainstream government departments. A taskforce on integration will report this year and a Ministerial Council for Immigrants is being established to bring the immigrant voice to the table. Labour market engagement is the major driver of integration, but other policies play a supporting role. Ways to better integrate immigrants, and the way such integration has been achieved overseas, are discussed below, as well as the challenges to infrastructure planning posed by the uncertainties about future migration flows.

Integration policy has many facets

Several countries have introduced welcoming programmes for immigrants, though they vary widely in scope. At one end of the spectrum, Canada has a settlement and adaptation programme that aims to provide essential services for newly arrived migrants, such as reception, orientation, translation and interpretation, counselling and employment-related services. At the other end of the spectrum, Australia has a range of measures for refugees but other immigrants are directed to mainstream services such as health, housing, education and labour market access. Ireland is closer to the Australian model.

Language training is one of the most important ways to improve integration

Weak English language ability partly explains why some immigrants are employed in relatively low-paid jobs. Overall, after controlling for education, experience and gender, immigrants in 2005 earned around 15% less than natives (Barrett and McCarthy, 2007). This largely reflects the different jobs they take rather than immigrants being paid less than Irish people in the same job and this could be the result of difficulties in accessing the better jobs, as well as the kind of work migrants are seeking. There was essentially no earnings gap for migrants from English-speaking countries but migrants from non-English-speaking countries earn around a fifth less than comparable natives. The earnings disadvantage is larger still for immigrant women. The wage disadvantage is especially large (30%) for immigrants from the new member states.[22] This pattern is consistent with international experience which suggests that, across countries, about a third of immigrants' over-qualification rates can be explained by weaker linguistic skills.

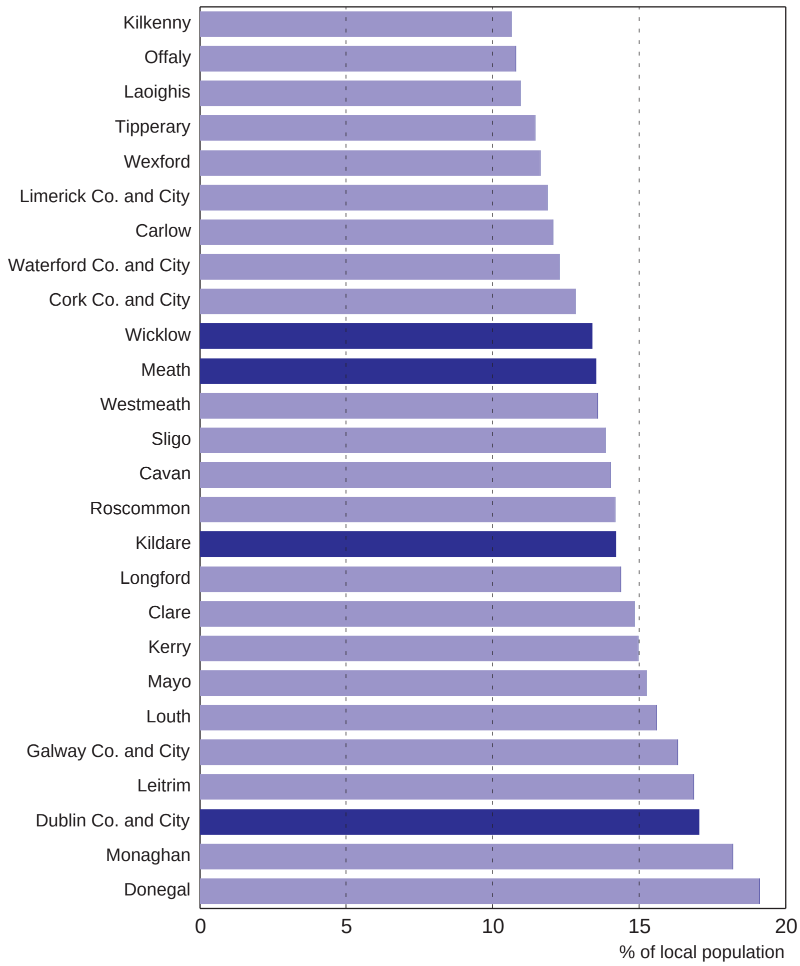
Provision of language classes for migrants is limited (MRCI, 2006; ICI, 2007). There are several publicly-funded programmes for refugees and asylum seekers made available through various providers, as well as privately-run English language colleges, NGO-lead schemes and the national network of libraries. The government provides funding for 12 000 free places in English-language classes through Vocational Education Committees (VECs), which provide further, paying classes. However, the Irish Vocational Education Association, which represents the VECs, has identified several barriers in accessing English language classes, including fees, inconvenient hours and a lack of information on what is available. The Department of Education and Science and the Minister for Integration have commissioned a wide-ranging strategic review on the "Development of a National English Language Policy and Framework for Legally Resident Adult Immigrants" and the government is expected to develop a more coherent policy in 2008.

Picking up the language is harder when migrants congregate into geographical "enclaves". It can also impede the language skills of immigrant children, harming their performance at school. Clustering has not been a major problem so far. Migrants are surprisingly well dispersed around the country (Figure 6.10), but there is an understandable and increasing tendency towards congregation in the least expensive suburbs. There are signs of employment enclaves where all employees in a small construction firm, for instance, speak a foreign language at work. There is little that policy can do to stop geographic or workplace concentration, but equally policy should not exacerbate the tendency and should instead focus on the problems that clustering may cause.

International experience suggests that language training on arrival significantly improves future employment prospects. Courses do not need to be long because the payoff diminishes with the duration of the training, and intensive full-time courses can be counter-productive if they keep people out of the labour market.[23] International evidence suggests that language training programmes are more effective if they are combined with work experience, are well tailored to the individuals and are available in the areas and times when migrants can attend (OECD, 2007b). Otherwise, dropout rates tend to be high. For employed adult immigrants, training at the workplace can be convenient, and should

Figure 6.10. **Distribution of migrants across the country**

Number of foreign born as a percentage of the local population, 2006



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Note: The dark-shaded bars show County Dublin and the counties that border it.

Source: Central Statistics Office, Census 2006.

be organised in tandem with employers. Mentoring programmes can also help immigrants learn the less formal aspects of the language.

The need to provide language support for migrant children is a recurring theme in OECD *Surveys* (Box 6.1). In many countries, the social disadvantages faced by first generation migrants can be perpetuated through the generations if migrant children receive inadequate help. Evidence from several European countries in the OECD's PISA study shows that students who do not speak the language of assessment at home are two-and-a-half times more likely to be in the bottom quarter of performance indicators. Ireland may need to further improve language support for its immigrant children. The number of special language training teachers has risen rapidly to 1 900 in 2007, up from about 250 in 2001, but there is little training so far for regular teachers. The need to step up language training further is currently being assessed by the Economic and Social Research Institute, the Inspectorate of the Department of Education and Science, and the OECD.

Box 6.1. **Recurring themes: migration issues in other countries**

The impact of migration has been assessed in several OECD *Economic Surveys*. They include Australia (in the 2003 Survey), Belgium (2005), Canada (2003), Denmark (2003), Greece (2005), Italy (2005), Luxembourg (2003), Mexico (2004), New Zealand (2004), Spain (2003) and Switzerland (2007). Several recurring themes emerged:

- Immigration is beneficial for the host country even if most of the gains go to the immigrants themselves.
- Knowing the language is crucial for successful integration.
- Foreign qualifications are discounted, especially from countries that are very different.
- Foreign work experience receives little or no reward in the local labour market.
- It is hard to find any significant impacts on the wages or job prospects of the resident population.
- The children of immigrants often have problems at school. Sometimes this applies to second-generation descendants as well.

Other countries have tried many approaches, and it is unclear what works best. In Belgium and Greece, for example, children of newly arrived migrants can attend reception classes for one year in which they learn the local language and also learn about the education system before joining the mainstream schools. Until 2002, municipal authorities in Denmark were required to provide bilingual instruction to all bilingual students, including descendants. The approach has been different in places such as Australia and Canada. There, resources are targeted on schools in areas of socio-economic deprivation rather than specifically on the children of immigrants. The evidence on all these programmes is inconclusive. In one study of 12 OECD countries, most had set a goal of having immigrant children mainstreamed into regular classes within three months to three years (Glenn and de Jong, 1996). While the countries followed many different strategies, and sometimes changed tack, none achieved clear success in overcoming the weaker school performance of immigrants relative to natives. However, the success in the United States with the Head Start pre-school programme and similar programmes in other countries, which are designed to boost school readiness among disadvantaged infants, suggests that Ireland may wish to design programmes that give a language stimulus to pre-schoolers.

Getting credit for skills and work experience

Immigrants in most countries have trouble getting their foreign qualifications recognised, and this obviously increases the chances that they end up over-qualified for their job. Indeed, OECD (2007c) shows that immigrants who gain a diploma in the host country do just as well as the native born in the labour market (so long as their human capital and literacy skills are the same). In other words, the labour market penalty is very much tied up with language skills and foreign qualifications that are not sufficiently valued by local employers. Getting formal qualifications recognised is only part of the solution since employers also value work experience but tend to discount experience gained abroad. This is especially a problem for some members of the third group of migrants discussed above – those from outside the European Union.

Several OECD governments have set up agencies to evaluate foreign qualifications. In most cases they are simple information services for businesses that want to know whether foreign diplomas are comparable to local ones. Denmark has gone further as its agency provides binding assessments that allow entry to regulated professions. Ireland has created the National Qualifications Authority of Ireland and developed the National Framework of Qualification since late 2003. The National Framework is linked in with similar developments that are taking place in other EU countries and at the EU level. The National Qualifications Authority is also the Irish centre for the recognition of international qualifications. It has established Qualifications Recognitions Ireland, which is a one stop shop for enquiries by employers and immigrants regarding the recognition of qualifications from other countries. It is building an online database that aligns a foreign degree or diploma to the corresponding Irish qualification. Comprehensive bilateral recognition agreements have also been signed with the United Kingdom and China. Regarding the regulated professions, recognition of qualifications of EEA nationals is covered by EU law. A mutual recognition system exists for most European health care workers while other regulated professions are dealt with on a case by case basis. Nonetheless, certain regulated professions have licensing requirements which often involve passing an exam. These need to be set appropriately so that excessively rigorous English requirements are not a hurdle for immigrants who would otherwise be capable of performing the job.

As well as giving more information to employers, the natural policy response when foreign qualifications and work experience are hard to gauge is to reduce the risk and cost of hiring immigrants, at least temporarily while their skills can be assessed and their language proficiency can be brought up to speed. Sweden has introduced an innovative approach that Ireland should consider. Its public employment service runs an on-the-job skill assessment programme whose purpose is to make a quick assessment – less than three weeks – of foreign credentials, individual skills and work experience. After the evaluation, a certificate is issued that can be included in future job applications. It is too early to know whether the programme is succeeding (OECD, 2007d).

In some countries, such as Denmark, temporary wage subsidies and subsidised employer-based training have been found to have favourable downstream employment impacts, despite the deadweight costs (OECD, 2007e). However, there should be little need for wage subsidies in a strong labour market when the main problem for immigrants is not employment *per se* but over-qualification. Ireland should steer clear of them, except perhaps very tightly targeted ones, unless it finds itself with substantial and persistent unemployment among certain groups of immigrants. On the other hand, policies that promote lifelong training (such as refresher programmes and language courses) and occupational mobility (for example reducing the number of regulated professions and jobs closed to foreigners) should be part of the range of tools made available to foster integration (OECD, 2007c).

Mentoring programmes can be helpful

Mentoring programmes are popular with migrants in several countries. In these programmes, an immigrant is matched with a native-born person of similar age, occupation and sex. The local person provides the immigrant with basic information on how things are done in the host country, assists them with the language, and generally helps to build social bridges and get access to networks. Mentoring programmes tend to be good value for money because the mentors are usually volunteers, though they receive special training.

Family reunification is part of the integration process

Family reunification has not been a major channel of immigration so far, though there are signs that it is picking up. But some migrants may be less willing to make the effort required to fully integrate into the job market and wider society because of uncertainty about whether their family will be able to join them. Nationals from EEA countries have automatic rights to family reunification but the situation for third country nationals depends on the type of work permit and is subject to discretionary decisions by the Department of Justice, Equality and Law Reform. Ireland has opted out of the EU's directive on the rights of third country nationals to family reunification. Those with a green card are entitled to immediate family reunification, but migrants with a general work permit have to wait a year[24] and must have a high enough salary (about 80% of the average wage).[25] Common law marriages (*e.g.* civil unions) or *de facto* relationships are not recognised. The Justice Department issued new guidelines on reunification in February 2006 that have helped clarify the policy, but reunification is not a right and decisions are still subject to discretion. For example, it is uncertain whether the policy would be tightened in the event that the labour market deteriorated.

Temporary work agencies can be helpful but some of them exploit vulnerable migrants

Temporary work agencies are good for the job prospects of migrants because they shift some of the risk away from the employer. For example, evidence from Sweden shows that temporary agencies are an important stepping stone into more regular jobs (OECD, 2007e). Nonetheless, there are concerns that some migrants in Ireland are being exploited or treated badly by agencies. There have been cases of unfair dismissals, coercion and people not being paid proper overtime rates or holiday pay. While these are probably isolated cases, there is a need for better regulation and enforcement of rogue agencies. Ireland is one of the few EU countries without a law that ensures agency workers receive the same pay and working conditions as directly employed workers doing similar jobs. Agency recruitment has also been used to circumvent legally binding registered employment agreements in certain sectors. In response, the number of labour inspectors has been increased, the social partners have agreed to create a new Office of Employment Rights Enforcement, and several agencies now provide information on workplace rights in several languages.

Housing policy can affect the social and economic inclusion of migrants

A well developed rental market helps integration, especially if Ireland wants to avoid the development of enclaves or ghettos where migrants are forced into the cheapest housing at the edge of town.[26] The rental market is also attractive for highly skilled migrants who are unsure how long they will stay in Ireland. However, the private rental sector is small by European standards (Rae and van den Noord, 2006). This partly reflects Irish preferences but it is also due to government policies concerning taxation and housing support that have a strong bias towards home ownership rather than providing rent assistance (Fahey, 2004). There are long waiting lists for social housing, and this affects immigrants disproportionately as they are more likely to be on low incomes. The previous *Survey* recommended shifting towards a more tenure-neutral approach to housing assistance, for example through housing vouchers or rent subsidies, rather than constructing new houses and controlling the system with queues.

Selection policy cannot be ignored

While better integration is the main issue, migrant selection policy cannot be ignored entirely. In countries that use a points system, it is usually not necessary for migrants to have a job before entering the country (but extra points are given if the applicant has a firm job offer). This gives highly skilled migrants the chance to look for work on the ground, which is easier than landing a job from abroad. Ireland has chosen not to go down this route for non-EEA nationals, mainly because a points system would be overly complex considering how few people it aims to attract from outside Europe. Instead, it lets the job market decide using the salary level as a selection tool. While this is probably the best approach, it has some potential drawbacks that need to be recognised. First, unless it is supplemented with numerical limits, it gives away the small amount of control that is left over the number of immigrants. Second, it may bias selection towards older people since they are more likely to be over the salary threshold. Most countries prefer young migrants as they are more adaptable. Third, by favouring certain occupations in the middle salary ranges it gets into the business of picking winners, and that is hard to do well. Overall though, the approach chosen by the Irish seems to be appropriate but it should be monitored to ensure that these potential drawbacks do not turn out to be more of an issue than expected.

The administration of the new green card and work permit system has not gone smoothly, though it has improved since the initial teething problems. Employers have had difficulties getting work permits for jobs on the list of approved occupations, with permits being refused if the job title does not exactly match the broad job description on the list or if the worker involved has a degree in a subject that does not look directly relevant, no matter what their other work experience or on-the-job training may be. Administration can also be inflexible in several respects. For example, changing positions or being promoted within a company can cause problems because it requires a new green card. In the health sector, certain staff such as junior doctors and consultants who rotate every six months or work at multiple sites must apply for a new green card every time they shift. Given the delays involved, this can be difficult.

Ireland may want to consider even more flexible visa arrangements, such as multi-use, multi-entry visas and lowering the cost of re-entry. These arrangements may be attractive to the most mobile workers and they can be helpful to the source country by encouraging two-way skill circulation rather than a one-way brain drain.

The overall quality of life is important to attract highly skilled migrants

With many countries competing to attract the most highly skilled migrants, the whole quality of life becomes important. This goes beyond the cost of living to cut across all areas of government policy. For families where both partners have careers, a system that allows the spouse to work is important. The changes made this year to the work permit (green card) scheme are helpful in this respect. Most migrant couples are at the age where they have or will soon have children. For them, the availability of reasonably priced and conveniently located childcare facilities is important. This is a problem in Ireland, as highlighted in Chapter 1 and in the previous *Survey*. In addition, highly skilled migrants are attracted by good quality healthcare and education systems that are easy to access. Ireland may also need to consider creating a permanent residency channel for the highly skilled in order to give a clear path to citizenship (OECD, 2007b). It has gone some way in this direction with its reforms to the green card scheme, as there is an expectation that a permit can be rolled over. And the 2008 Immigration, Residence and Protection Bill implies that the migrant will be granted residency faster. Lastly, migrants from some countries have become accustomed to high standards of infrastructure, so dealing with issues as diverse as public transport, congestion and high-speed internet access all affect the quality of life in Ireland, and therefore influence migration decisions at the margin. Hong Kong provides a useful warning about the importance of getting the whole package right. Despite economic factors being a strong attractor, several multinationals have left or are considering leaving Hong Kong because pollution increased to the point that expatriate staff and their families do not want to live there.

Planning infrastructure projects under heightened uncertainty about population growth

Immigration has put pressure on the physical and social infrastructure

The rapid increase in population has clearly contributed to infrastructure bottlenecks. Migrants are contributing to problems of traffic congestion and are increasing the demands placed on public transport, especially as a significant fraction of the most recent migrants live in commuter belts up to 50 kilometres from the city centres. They are also adding to pressure on waste and water infrastructure, particularly in the new housing areas which have required greenfield investment in infrastructure rather than simply connection to existing networks. However, the magnitude of the pressure from migrants is unknown.

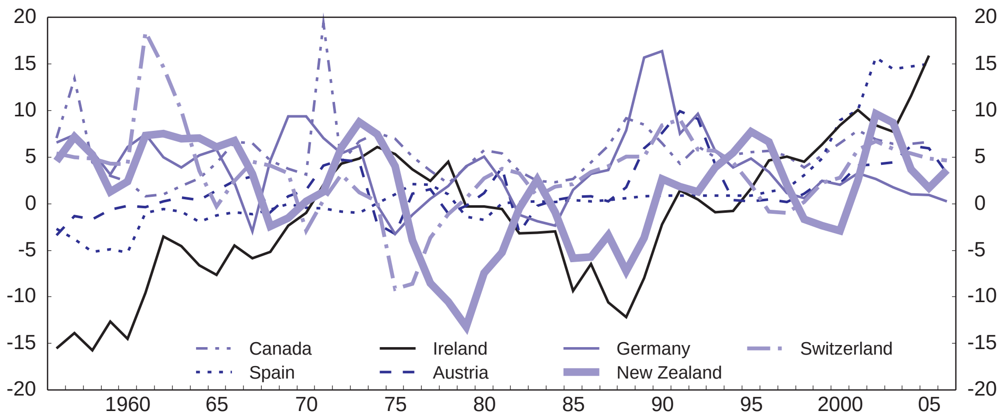
Social services such as schools, hospitals and policing are facing greater demand and diversity. In the education sector, the main issue is diversity as the number of migrant children is small – but growing rapidly.[27] Some schools have had a sudden increase in the number of foreign students for whom English is not their first language and they do not always have sufficient resources to cope, although since last year schools are allowed to have up to six English language support teachers. In healthcare, extra demand is less of an issue, and in fact immigrants are helping boost supply with around one out of every eight healthcare workers being a foreign national. But here too, diversity is creating problems as hospital staff need to communicate with patients from differing cultural and linguistic backgrounds. These issues are common abroad but new to Ireland, and it is only beginning to provide multi-cultural training for staff and to supply information leaflets in foreign languages. Ireland may like to consider a useful service offered in Australia and Portugal that uses mobile-phone technology to provide real-time translation and interpretation services for public administrators, healthcare professionals and private enterprises in their contacts with immigrants.

Migration and population uncertainty

Migration is having a substantial impact on population growth. Uncertainty about the number of migrants and the characteristics of the non-native population raises uncertainty about demographic projections, although there are also important unknowns around longevity and fertility rates (Gonand, 2004). This makes it harder to plan infrastructure projects. Despite some important qualitative differences, the present strong net inflow of migrants into Ireland is unusual but not unprecedented compared with past OECD experience; however, these episodes suggest that such rapid inflows are never sustained (Figure 6.11). Ireland itself has had one of the most volatile net inward migration

Figure 6.11. **Net inward migration rates**

Per 1 000 population



StatLink http://dx.doi.org/10.1787/286057280348

Source: OECD (2008), *Population and Vital Statistics – online database* (January).

rates of any OECD country, although in the past this was largely accounted for by net migration of Irish nationals. Hence, some of the same considerations about the population varying apply as in the past.

Migration rates clearly respond to economic circumstances and net outflows can occur as economies slow. Austria, Germany, New Zealand and Switzerland also experienced net outward migration, very often non-nationals returning home, after the slowdown of the 1970s. Equally, Irish immigrants to the United Kingdom came home to Ireland as the British economy slowed in the 1970s and then as the Celtic Tiger era created new opportunities in the late 1990s.

Uncertainties about migration flows and infrastructure planning

Net inward migration is currently well above the rates assumed in the population projections underlying the National Development Plan for 2007-2013. On average, net migration per annum over 2002-06 was 50% higher than projected in CSO (2005). Over 2005-07, estimates suggest that net inward migration, at 64 700 persons per annum, was more than double the level assumed in the official population projections (CSO, 2007).

If sustained, high levels of net inward migration will add to the existing pressures on physical and social infrastructure in Ireland. The public sector capital stock declined throughout the 1990s on a per capita basis and relative to GDP. Despite the large investment programme, the estimated per capita public capital stock still lags behind the OECD average. Surveys of business executives on the quality and efficiency of transport and energy infrastructure continue to give Ireland a low ranking relative to other OECD economies. Infrastructure deficits can also be seen elsewhere in the economy. Broadband penetration rates in Irish firms and households and average advertised download speeds are low relative to other OECD economies, as of mid-2007 (OECD, 2007f).

The OECD *Infrastructure to 2030* project has identified a number of key policy areas which could enhance the capacity of the government to meet future infrastructure needs (Stevens and Schieb, 2007). Of particular importance is the need for innovative approaches to the financing of infrastructure projects, both in terms of engaging private sector resources and capital through PPPs as is already done in Ireland, and in terms of user charges for infrastructure use. Enhanced usage of price mechanisms should not only raise revenue, but also result in more efficient use of infrastructure and help to signal where new investment is warranted. In this area, more can be done in Ireland and this would help in restraining future demand.

Bridging the infrastructure investment gap will also require careful attention to be paid to the design and flexibility of regulatory frameworks and the planning process, and also require governments to have adequate capacity for effective analysis and decision making. Project design and planning needs to allow for the uncertainty faced by potential investors making long-term infrastructure investment decisions. Potential sources of uncertainty for the private sector include regulation and planning decisions as well as the likely returns to investment (Saphores *et al.*, 2004).

Demand for infrastructure is likely to continue to strengthen in Ireland, reflecting both the present relative under-provision of infrastructure and also the general tendency for infrastructure usage to rise over time with economic activity (Eddington, 2006). But the extent and type of demand growth is uncertain, reflecting the sensitivity of demand to future population growth, especially net inward migration, the geographical locations in which demand will expand and the mix of services demanded. Such uncertainties about market conditions give firms making irreversible investments an option value from waiting to see what happens; there is a value to waiting if the option to undertake the project remains at a point when more may be known. For example, building a new road or bridge is risky, as the costs of construction cannot be recouped if there is insufficient usage made of the new facility. Equally, new schools or hospitals may turn out to be unneeded, or in the wrong location.

All infrastructure projects are subject to uncertainty. Infrastructure planning and regulation need to build in sufficient flexibility to deal with changing circumstances. Planning and evaluation of projects should include analysis of the optimal timing of projects, including the associated risks, and choose projects that have the appropriate life-span or reversibility. For example, a new bus link may be cheaper to shut down than a new rail link if there is insufficient demand. The Working Rules for Cost-Benefit Analysis in Ireland, although requiring realistic alternative ways of achieving the same objective to be considered in some cases, do not presently explicitly take option value and irreversibility risk into account, as the guidelines have begun to in a few other countries, such as the United Kingdom (HMT, 2003).

The irreversibility of many projects implies that it is easier to scale up existing projects, such as adding an additional wing to a building, than to tear down vacant school or office space. Infrastructure planning should where practicable choose projects with scope for moderating or expanding capacity at a later stage. Planning should also seek to identify other margins where additional demand could be met. As a relatively small country, excess demand in Ireland is small relative to the European supply of infrastructure-related services such as healthcare or electric power. Examples of potential adjustments if demand exceeds domestic capacity include sending some patients for treatments abroad and importing electricity from other countries.

Box 6.2. **Summary of recommendations on migration**

The primary policy challenge is to improve the integration of immigrants. In this respect, Ireland should consider:

- Providing increased support for language training for adult migrants based on the recommendations of the current strategic review on "Development of a National English Language Policy and Framework for Legally Resident Adult Immigrants".
- The level of provision of language classes for all ages of children, including pre-school children.
- Accelerating work on the recognition of foreign qualifications, including bilateral agreements with other EU countries.
- Introducing an on-the-job skill assessment programme for cases where qualifications are difficult to assess.
- Changing the delivery of housing support towards tenure-neutral policies.

Regarding selection policy and with free movement of people across Europe, Ireland is able to influence immigration only at the margins. Nonetheless, it could:

- Introduce a permanent migration channel and create flexible visas, such as multi-use, multi-entry visas.
- Monitor the recent reforms to ensure that a visa policy based on salary is able to deliver the type of migrants that Ireland wants and needs. Ensure that policy is administered flexibility and is not excessively burdensome for employers or migrants.

Planning the infrastructure programme and the size of public services is more difficult due to the uncertainties surrounding future migration flows. To cope with these uncertainties, the authorities should:

- Ensure an effective pricing of services flowing from infrastructure projects.
- In cost-benefit analysis, canvass options that will provide flexibility in the face of demand uncertainties.
- Evaluate the options to import services.

Lastly, better information would help guide policy. Better statistics on immigrants should be collected and greater funding for research into immigrants' experiences in Ireland would be helpful.

Notes

1. A small part of the difference comes from those born in Northern Ireland. Those born before 2005 have automatic rights to citizenship in the Republic while those born afterwards can acquire Irish nationality if one of their parents is an Irish or British citizen or has permanent residency on the island. Around 8% of the foreign-born in Ireland were born in Northern Ireland.
2. Between 1992 and 2005, 324 000 Irish emigrants returned home. This estimate is based on nationality, not place of birth, and includes some Irish nationals who were born overseas to Irish parents and in that sense are not "returning".
3. The 15% wage premium refers to their earnings after they had come back, and applies to males who emigrated for economic reasons. Those who emigrated "to see the world" or "for an adventure" had no wage premium when they returned.
4. Of the 122 000 people who came to Ireland in the year before the census, 53 000 (43%) came from the new member states. Of these, 33 000 were Polish nationals and 8 000 were Lithuanian nationals.

5. The immigration rate into the median OECD country is approximately 0.4% of the population (OECD, 2007a). According to census data, the number of people born outside Europe or the United States who arrived in Ireland in the year to April 2006 amounted to 0.37% of the resident population.
6. There has been some speculation that construction workers are registering as self-employed contractors rather than employees in order to circumvent collective agreements. But census figures show that only 0.9% of EU10 migrants were self-employed in 2006.
7. Barrett and Duffy (2007) estimate that 41% of the cohort that arrived in 2004 and 2005 has a tertiary qualification and 91% had completed upper secondary education. This compares with 57% and 85% respectively for those who arrived between 1995 and 1999.
8. Over-qualification is examined here with a normative-type measure based on the correspondence between level of education and qualifications for the job held. Education and job qualification levels are grouped into three broad categories: low, intermediate and high. An over-qualified individual is one who holds a job that requires lesser qualifications than would theoretically be available to him at his education level.
9. Barrett and McCarthy (2007) estimate that earnings rise by 4% for each additional year worked. While this is a small effect, it is a non-negligible proportion of the earnings *gap*.
10. "Migrant workers choosy about jobs", *Financial Times*, 22 August 2007. The article summarises a report produced by the British Home Office.
11. The EEA consists of the 27 EU countries plus Iceland, Liechtenstein and Norway. Switzerland has a bilateral agreement that is almost identical in content to the EEA agreement.
12. If this is the first employment permit then (other than in exceptional circumstances) the migrant is *expected* to stay with the initial employer for 12 months but may then change employer provided that a new application for a green card or work permit is made.
13. The simulation shown here differs from the one published in their paper. In their original simulation, the short-term impact on GDP per capita and unemployment was quite negative because the capital stock is slow to adjust, so at a given wage labour demand is unchanged. Migrants therefore have to price themselves into the market by bidding down wages or displacing local workers until the required capital is in place. This seems implausible since the recent migrants are predominately employed in hotels, restaurants and construction, where the capital stock is either largely in place or can be purchased quickly. The authors of that paper kindly ran a simulation for the OECD Secretariat which assumed quicker labour market adjustment (through a level shift to the labour demand equation); it is this simulation that is shown in the table. A second difference from the published paper is that the scale of the effects has been doubled as the latest information on the inflow rate from the new member states is considerably higher than the assumption used in their paper.
14. For example, see Gould (1994) for the United States and Girma and Yu (2002) for the United Kingdom.
15. See the OECD *Surveys* listed in Box 6.1.
16. Barrett and McCarthy (2006) show that immigrants are significantly less likely than the native Irish to be on welfare even after controlling for education, gender and years of work experience.
17. Since May 2004, citizens of any nationality must satisfy a "habitual residence" condition to be eligible for benefit payments such as social assistance or disability benefits. In practice, this means two-years of residency in Ireland or the Common Travel Area (the United Kingdom, the Channel Islands and the Isle of Man). Under EU regulations, EEA citizens who have "a history of working in Ireland" are eligible for unemployment benefit, family benefits such as the child benefit and the family income supplement.
18. In 2007, € 4.8 million in child benefit was paid in respect of 4 300 children living outside the Republic of Ireland in another EU/EEA country and Early Childcare Supplement (ECS) payments to the value of € 1.12 million were made in respect of 1 700 non-resident children under the age of 6, although these figures could rise in future years.
19. To receive the full contributory pension, people retiring before 2012 must have contributed for five years; those retiring after 2012 must have contributed for ten years. But if they are not eligible for the contributory pension, they can receive the non-contributory pension.
20. According to the 2006 census, almost a third of EU10 nationals in Ireland are married.
21. See "Half of Poles in Ireland say they intend to stay", *The Irish Times*, 5 July 2007.

22. In late 2005, one quarter of immigrants from the EU were paid € 8.00 per hour or less, compared with 8.5% of Irish employees (Nolan *et al*., 2006). At the time, the minimum wage was € 7.65 an hour.
23. See Liebig (2007) on Australia and Lemaître (2007) on Sweden.
24. More precisely, the migrant must have been in continuous employment for at least a year and have a full time job at the time of the application.
25. The threshold is a level of earnings high enough that the migrant would not be eligible to receive the Family Income Supplement. For a two-child family, that amounts to approximately € 29 000 per annum. The income threshold does not apply if the immigrant has been working in Ireland for three years or works in an occupation deemed to be subject to skill shortages.
26. According to the 2006 census, just under two-thirds of Poles and Lithuanians in Ireland rent their home in the private market; a fifth are in social housing; and just 5% own their own home. They are predominantly in new homes: just under half of the homes occupied by Poles and Lithuanians have been built in the last ten years. 78% of the Irish-born population are owner-occupiers. Overall, the private rental market accounts for 10% of the housing stock.
27. From 2000 to 2005, net immigration of people under 15 years of age was 36 000. This compares to a resident population of the same age group of around 840 000.

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ANNEX 6.A1

Do fast-growing economies attract more migrants?

People migrate for many reasons, one of which is better income and job prospects. To assess how important this is in individual countries, the net immigration rate was regressed on per capita GDP growth in an equation of the following form:

$$m_t = c + \alpha m_{t-1} + \beta(y_t - y_{t-3}) + \gamma trend.$$

where m is the net immigration rate as a share of the resident population, y is per capita GDP (GNI in Ireland's case), so $y_t - y_{t-3}$ is the three-year average growth rate; and *trend* is a time trend. The lagged dependent term captures dynamics of adjustment while the constant c and trend are included to absorb other omitted factors. Clearly this is not a full structural model of immigration, since other factors that are correlated with GDP growth (such as wage growth or employment) are not included. Rather, it should be interpreted as no more than a reduced form relationship between economic activity and net immigration.

This equation was estimated for 18 countries using annual data. The sample period was from the earliest possible date for which data was available (usually in the 1960s) until 2005. Outlier dummies were included in some equations. The regression results are

Table 6.A1.1. **Regression results**

	Coefficient on growth	t-value	Lagged dependent	t-value	Implied long-run response to GDP growth
Australia	0.85	4.6	0.51	4.8	0.17
Austria	0.73	1.9	0.58	4.7	0.17
Belgium	0.33	2.7	0.69	6.4	0.11
Canada	0.43	2.5	0.25	3.0	0.06
Denmark	0.42	3.5	0.21	1.8	0.05
Finland	–0.02	–0.3	0.58	2.2	0.00
France	0.16	2.0	0.70	6.4	0.06
Iceland	0.47	3.1	0.34	2.5	0.07
Ireland	**0.63**	**3.3**	**0.85**	**12.2**	**0.42**
Japan	0.01	0.4	0.05	0.3	0.00
Luxembourg	0.70	3.2	0.62	5.9	0.18
Netherlands	0.37	2.9	0.57	0.1	0.09
New Zealand	0.73	2.1	0.67	6.3	0.22
Norway	0.23	2.0	0.27	1.7	0.03
Sweden	0.19	1.1	0.56	4.6	0.04
Switzerland	0.77	3.1	0.59	5.5	0.19
United Kingdom	0.16	2.3	0.49	4.5	0.03
United States	0.08	2.1	0.81	10.6	0.04

shown in Table 6.A1.1. In most cases, the coefficient on per capita GDP has a significant and positive impact on net immigration.

Similar equations were estimated using different measures of economic activity. They include: GDP growth in place of per capita GDP growth (though this has the drawback that GDP growth is highly endogenous since immigration boosts GDP); the output gap; the relative output gap (the local gap minus the OECD gap); and relative GDP growth (local minus OECD). The gap measures did not explain well, which is not surprising since migrants are more concerned with absolute growth than growth relative to potential. The other GDP growth measures gave similar results to the ones reported here.

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Glossary

ARF	Approved Retirement Fund
CBFSAI	Central Bank and Financial Services Authority of Ireland
CPI	Consumer price index
DB	Defined-benefit
DC	Defined-contribution
ECB	European Central Bank
EEA	European Economic Area
EEE	Exempt-exempt-exempt
EET	Exempt-exempt-tax
ELS	Existing level of service
EMU	Economic and Monetary Union
ESB	Electricity Supply Board
ESRI	Economic and Social Research Institute
EU	European Union
EU-SILC	European Union Statistics on Income and Living Conditions
FDI	Foreign direct investment
GAIE	Gross average industrial earnings
GDP	Gross domestic product
GNI	Gross national income
GNP	Gross national product
HSE	Health Service Executive
ICT	Information and communication technology
IFSC	International Financial Services Centre
MIF	Management Information Framework
MIRAS	UK Mortgage Interest Tax Relief
NDP	National Development Plan
NPPI	National Pensions Policy Initiative
NPR	National Pensions Review
NPRF	National Pension Reserve Fund
PAYE	Pay-As-You-Earn
PPP	Public-private partnerships
PRETA	Pre-Retirement Allowance
PRSAs	Personal Retirement Savings Accounts
PRSI	Pay Related Social Insurance
PSBB	Public Service Benchmarking Body
PRSI	Pay Related Social Insurance
RAS	Rental Accommodation Scheme
R&D	Research and Development

SSIAs	Special Savings Investment Accounts
VAT	Value added tax
VECs	Vocational Education Committees
VFM	Value for Money

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1. Preliminary.
2. Based on the fixed rate of the Irish pound against the euro and the euro/dollar rate.

Note: An international comparison of certain basic statistics is given in an annex table.

This Survey is based on the Secretariat's study prepared for the annual review of Ireland by the Economic and Development Review Committee on 19 April 2001.

After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 15 May 2001.

The previous Survey of Ireland was issued in May 1999.

ASSESSMENT AND RECOMMENDATIONS

Growth has been exceptionally rapid and has resulted in pressure on infrastructure

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

The inflation differential with euro area countries has reflected a relative price adjustment exacerbated by excess demand

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

appreciation, which is likely to continue for some time to come, is an inevitable process of adjustment for a country like Ireland. Excess demand , including strong demand in the services sector, is certainly pushing up service prices and wages, but with the current account roughly in balance it would not be appropriate to characterise the situation thus far as simply one of overheating.

By early 2001 there were signs that the economy was gradually slowing to a more sustainable pace

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

Concerns about the risk of a hard landing are exaggerated but exports could weaken more than expected

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

Joining the euro area gave a strong monetary impulse to the economy while changing the policy framework

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

National wage and tax agreements, the focus of macroeconomic policy, may not be the most suitable instrument under the changed economic conditions

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

Wage issues in the public sector will have to be addressed directly

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

The budget for this year was driven by both the growth strategy and by the social partnership agreement rather than by current economic conditions

8. The budget for 2001 has been set within the framework of the government's continuation of the policy to promote growth and its strong commitment to maintaining the PPF. The process of lowering corporate taxes on activities which are not internationally traded to the unified target rate of 12½ per cent has continued. Further progress has been made in restructuring the household tax system to favour labour force participation, especially by women, and to reduce high marginal tax rates for single workers at higher levels of income. This makes tax rates now compare well with those in the UK with which the Irish labour market is closely linked via immigration. The budget decisions were also oriented to distributional

issues. with income tax cuts aimed at low-income earners, and large increases in child benefits to meet criticism following the previous budget. As part of the re-negotiation of the PPF in December the standard rate of VAT was reduced by one percentage point and some fuel duties were also cut to achieve an early reduction in headline inflation. Old-age pensions were increased by around 11½ per cent. In sum, the full-year cost of income tax cuts and changes in social security contributions is around 1.2 billion pounds (1½ per cent of GDP), following cuts of 940 million in the budget for 2000. The annual cost of social welfare improvements is about 0.6 billion pounds (¾ per cent of GDP), again about twice the level in the previous year. Current expenditures are set to rise by 10 per cent with the public sector wage bill budgeted to rise by some 12 per cent. The budget also provided for a further 28 per cent rise in infrastructure spending (after a massive increase of 38 per cent in 2000).

From the macroeconomic perspective, fiscal policy might be roughly neutral this year

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

but the risks are more apparent at the microeconomic level and in looking ahead

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

pressures in this regard are less pressing than in the majority of euro-area countries.

Financial assets are being accumulated for a national pension fund

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

The policy framework is firmly oriented to ensuring sustainable growth through the provision of better infrastructure

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

Rising house prices have been a major concern but supply-side measures are starting to have an effect

13. Rapidly rising house prices last year became an important subject in the negotiations for the PPF. The government introduced a third package of measures in July designed both to cut speculation, which it considered to be a problem, and to speed up the release and development of land. Some of these measures were subsequently amended at the start of this year in light of their impact on the rental sector. Zoning procedures have been altered to require local authorities to develop housing strategies and Strategic Development Zones are being created with fast-track provision of infrastructure and planning approval. Developers will face fines if their land is not developed within a given period, which partially addresses a concern expressed in the last *Survey* that land was not associated with any holding charge. Whether the planning capacity is up to the challenge remains to be seen, especially in view of the strains arising from the simultaneous implementation of the NDP. Despite simplifications and more restrictive rights to appeal planning decisions, the capacity of local

authorities remains a problem. The number of housing completions has continued to rise and the rate of price increase has shown some signs of slowing more recently. Nevertheless, housing demand remains high due to demographic factors and the growth of household disposable income so that pressures to acquire houses will continue for some time yet.

However, the broader concerns about urbanisation and infrastructure provision still need to be addressed

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

The provision of skills and human capital is an important component of the strategy for sustaining growth

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

The Regulatory Reform Review gives Ireland high marks for its reform efforts which now need to

16. Over the years there has been steady progress in reducing barriers to entry and entrepreneurship, and improving market openness. Indeed, the *OECD Regulatory Reform Review of Ireland* of April 2001 concluded that, in a number of respects, Ireland has a light-handed regulatory environment.

be completed in network industries and in competition policy

However, competition policy needs to be strengthened. The transfer to the Competition Authority of responsibility for mergers and take-overs is a positive move, but the Authority still needs to be made independent in its budget and in appointments. To support the goals of administrative reform, Ministries should be obliged to request the Authority's view on the competition implications of new legislation and regulations which would be made public prior to the proposal entering the legislative process. With respect to enforcement, particularly in the difficult area of hard-core cartels, the Authority should have the power to implement a leniency programme for both firms and individuals to strengthen its capacity of investigation. Steps also need to be taken to improve the familiarity of courts and judges with the application of competition law.

Management of the civil service is improving but the state sector still needs to be made more efficient and focused

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

In the network industries competition needs to be fostered, particularly in the energy sector

18. As well as opening up network-related markets in line with EU directives, Ireland has also been developing pro-market regulatory regimes. Independent regulators have been established in electricity, telecommunications and airports. More recently, the government has set about improving transparency and accountability of these regulators and in clarifying relations with each other and with the Competition Authority. These efforts are welcome and should be accompanied by periodic reviews to check on performance and in what ways the regulatory authority needs to be changed to deal with evolving circumstances. More progress is required in telecommunications where competition is weak, especially in the mobile sector. A proposed new law to extend the authority of the regulator and provide greater enforcement powers is a positive development. In the electricity sector, the incumbent integrated company remains in a dominant position and has also been awarded access to scarce gas supplies, effectively limiting entry by others to the small market for the next few

years. Although operational control of the grid has been passed to a new legal entity, ownership and maintenance responsibilities remain with the incumbent. Complete vertical separation would resolve the competition problem better than regulation of behaviour so long as incentives are also strong for the network operator to extend the grid, which is not the case at present. However, in a small economy such as Ireland the only way forward will be to continue to develop an all-Ireland market and perhaps to enforce divestiture of some generating capacity of the dominant company. Finally, the regulator for the sector might be overburdened with a number of non-competition objectives assigned to it including promoting energy efficiency. These responsibilities will need to be reviewed, particularly when broader measures are undertaken to deal with environmental issues.

Fast economic growth is creating problems for meeting international environmental commitments

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

Greater use of economic instruments will be necessary to meet objectives in a cost-effective manner

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

such as waste disposal, water supply, the control of fertiliser use and transport for externalities generated.

Summary

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

I. THE SUSTAINABILITY OF RAPID GROWTH: ISSUES AND PROSPECTS

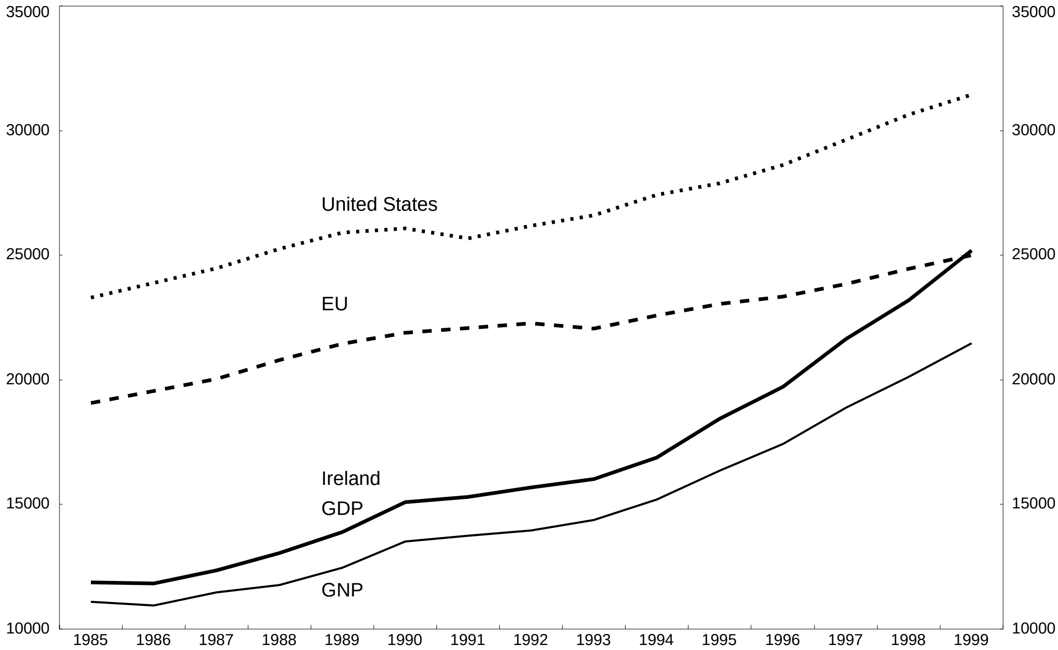
22. Between 1994 and 2000, real GDP in Ireland expanded at an annual average rate of 9 per cent lifting the standard of living as measured by GNP per capita from 67 per cent to 86 per cent of the EU average in 1999 (Figure 1). Moreover, rather than slowing as was expected at the time of the last *Economic Survey* in 1999, GDP growth accelerated last year nearly 11 per cent. Many concerns have been raised about its sustainability as with the economy "overheating", which might be followed by a hard landing. The rapid growth of house prices at rates of around 20 per cent per annum, and a marked pick up in the HICP (Harmonised Index of Consumer Prices) headline inflation rate last year to around 6 per cent fuelled such fears. More generally, questions have been raised about how the economy might (or should) slow of its own -- specifically, how and at what rate Ireland could lose "competitiveness" -- and the appropriate role for policy. What makes these questions even more difficult are the differing assessments about the level of the sustainable growth rate and the size of the output gap. This chapter first considers the foundations for rapid growth, how they might develop and the nature of recent shocks, which may have pushed growth above its sustainable level. Judgements about the current situation rely to an important extent on how the inflationary process is interpreted. The second section reviews the various forces at work including the factors driving up house prices. The final section discusses prospects for the economy and the risks involved.

The foundations of rapid growth

Recent trends: fading expansionary shocks

23. Real GDP is expected to have grown by close to 11 per cent in 2000, but this should represent the peak of the cycle, with recent indicators pointing to a slowdown. The exceptionally strong growth performance reflected to some extent temporary or cyclical factors. Especially important was the weakness of the euro and the strength of the pound sterling: the effective exchange rate depreciated by 15 per cent from the first quarter of 1999 to the third quarter of 2000 (Figure 2). OECD area demand was also exceptionally strong, with GDP growing by 4¼ per cent in 2000 following 3 per cent in 1999, while demand for technology products boomed. Thanks to these factors, exports of goods and services accelerated from 12½ per cent in 1999 to around 20 per cent in 2000 (Table 1). Industrial production rose by 15 per cent in 2000 led by the ICT sector and production was still booming in the final quarter with an annualised growth rate of some 30 per cent. FDI inflows, which more than doubled between 1998 and 1999, led to strong investment demand and also underpinned the rapid growth of exports. By the end of 2000, some of these pressures had begun to weaken with the euro recovering some lost ground and the United State economy slowing. Retail sales decelerated in the last quarter to an annualised real growth of 4½ per cent as against some 10 per cent earlier. Leading indicators such as the IBEC survey of business sentiment also pointed to sharply reduced expectations for export growth and production in the opening months of this year. Lending weight to the survey, the purchasing managers index indicated that industrial production slowed in February.

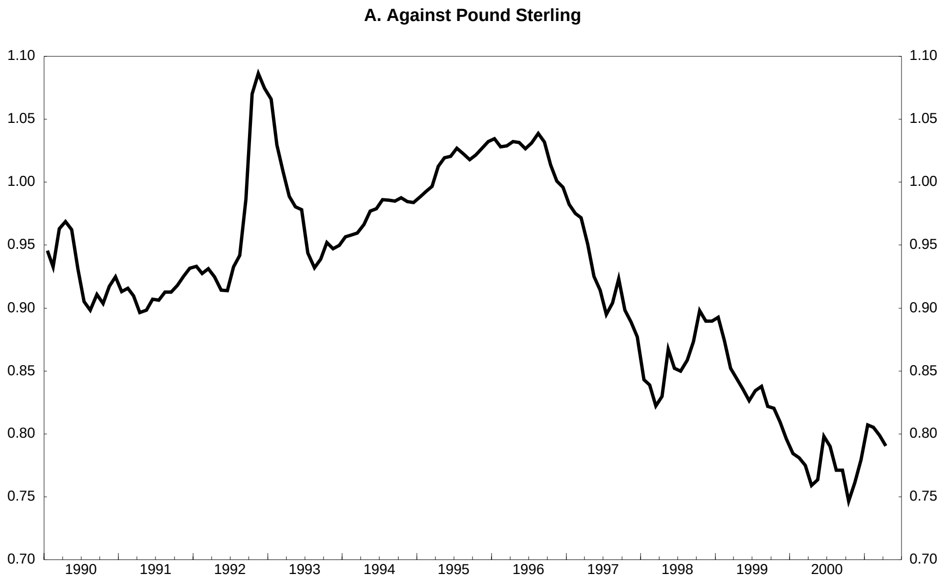
Figure 1. The catch up of income and production
Real per capita GDP and GNP, US dollars, 1995 exchange rates

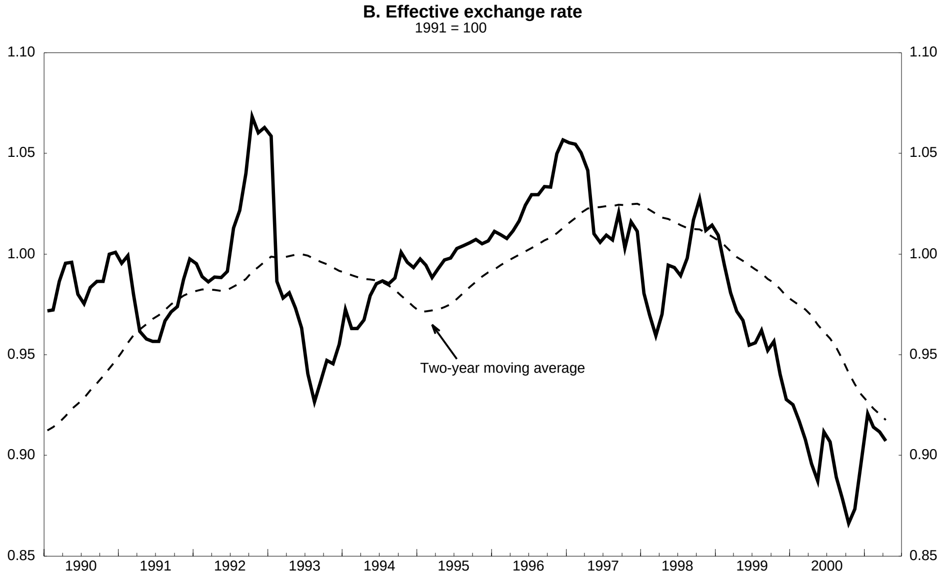


Source: OECD.

24. Private consumption was very robust last year supported by rapid employment growth, rising incomes and improved consumer sentiment. A strong catch-up effect was also noticeable with car sales and house construction and furnishing particularly strong, underpinned by the significant decline in interest rates at the time of entering the euro area in 1999. Employment increased by 4¾ per cent in 2000, following 6½ per cent in 1999 and the rate of unemployment fell to under 4 per cent by the end of the year. However, in the course of the year there was a marked slowing in employment growth due in large part to a deceleration of labour force growth (Figure 3). As a result, job vacancies have been reported across all skill levels[1]. Labour shortage has led to higher wage growth, compensation per employee in the business sector accelerating to around 8 per cent in 2000 after growing by 4 per cent in 1999. Owing in part to tax increases, rising oil prices and exchange rate weakness, consumer price inflation reached a peak of 7 per cent in November before falling back at the start of this year to 5.2 per cent by 1.8 percentage point.

Figure 2. EXCHANGE RATE DEVELOPMENTS





Source: OECD.

Table 1. **Demand and output**
1995 prices

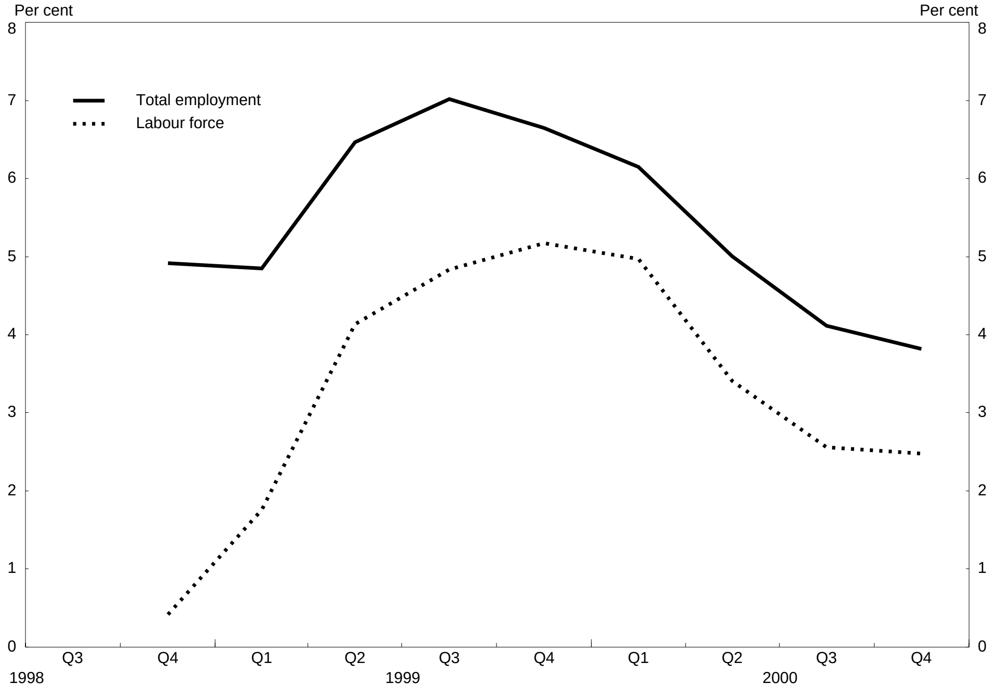
	1995	1995	1996	1997	1998	1999
	Per cent of GDP in constant prices	Percentage change over previous year				
Private consumption	56.0	4.3	6.3	7.4	7.8	7.7
Public consumption	14.9	2.8	3.1	5.7	5.1	5.2
Gross fixed investment	17.1	12.7	16.4	17.9	15.5	13.0
Building and construction	9.7	12.6	18.5	17.6	9.9	10.5
Machinery and equipment	7.4	12.9	13.7	18.3	23.3	16.1
Final domestic demand	88.0	5.6	7.7	9.3	9.1	8.6
Stockbuilding[1]	1.0	1.5	0.1	0.6	0.3	-1.9
Total domestic demand	89.0	7.2	7.8	9.8	9.4	6.3
Exports of goods and services	76.5	20.0	12.2	17.4	21.4	12.4
Imports of goods and services	65.1	16.4	12.5	16.8	25.8	8.7
Foreign balance[1]	11.5	3.9	1.2	2.5	-0.3	4.5
Gross domestic product[2]	100.0	9.7	7.7	10.7	8.6	9.8
Net factor income[1]	-11.3	-2.4	-1.2	-2.5	-1.7	-3.0
Gross national product[2]	88.7	8.2	7.4	9.3	7.8	7.8
Gross national disposable income		6.3	8.3	9.7	7.8	6.4
Memorandum items						
Household saving rate		8.5	7.0	8.0	10.4	9.0
Current account (% of GDP)		2.6	2.8	2.4	0.9	0.7

1. Contribution to GDP.
2. Expenditure base estimates.
Source: Central Statistics Office and OECD estimates.

Underlying growth factors

25. Underlying the surge in activity in recent years are strong driving forces of capital accumulation, productivity growth, technological change and a young, educated, and growing population. An important proportion of the rapid economic expansion since 1994 can be "explained" by a significant increase in inputs of capital and labour. Conventional growth accounting suggests that about 4½ percentage points of average growth of some 8 per cent has been due to the increase in capital and labour inputs, with the remainder accounted for by all other factors, *i.e.* the contribution of total factor productivity growth. These factors appear to be reasonably well established and are not likely to disappear any time soon although they may weaken somewhat in coming years. In addition, there is another factor which is of increasing importance: with entry into the euro area, interest rates have fallen to much lower levels than previously. Irish banks participate in the euro inter-bank market, and in principle Irish based enterprises and Irish consumers will now find it much easier to seek finance anywhere in the euro area[2].

Figure 3. Employment and labour force growth
Annual per cent change

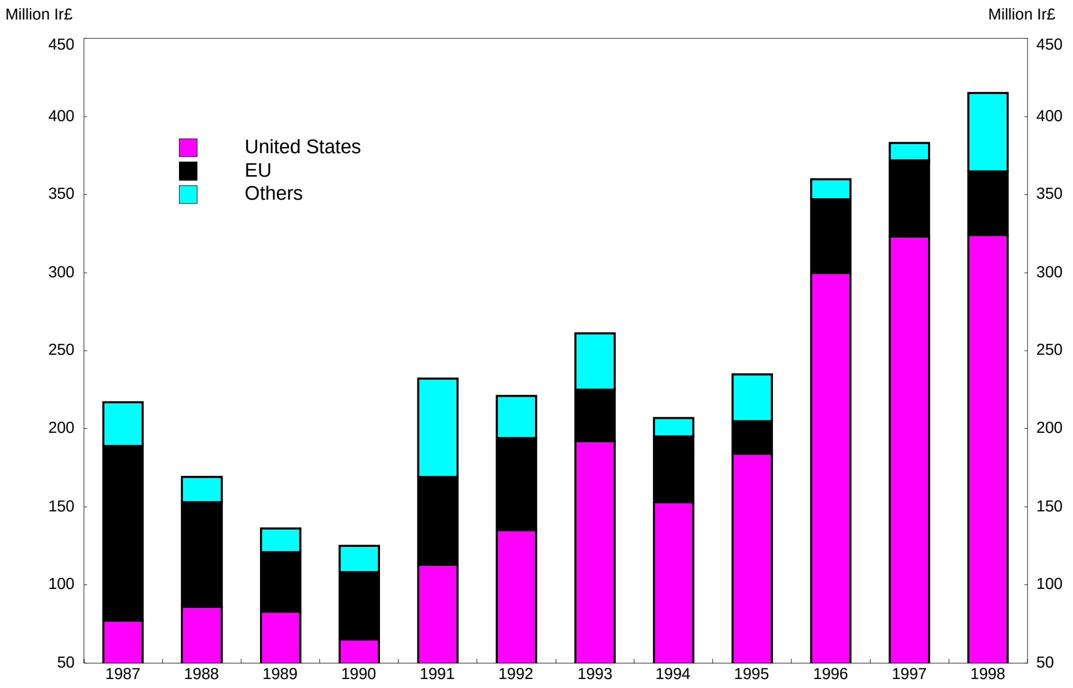


Source: Central Statistics Office.

Capital accumulation and technological change

26. Foreign direct investment has played an important role not only in providing capital but also in transforming Ireland into a modern high-tech based economy. Such a structure has led to an increased intensity of R&D which in turn is related to an improvement of productivity. Owing to the lack of sufficient information about international payments before 1998, the historical development of FDI flows to Ireland cannot be traced exactly. However, according to the Secretariat estimates (OECD, 1999), the volume of FDI inflows from OECD member countries to Ireland doubled between 1994 and 1998 (Figure 4). FDI has accelerated the transition of the industrial structure, replacing traditional industries with high-tech ones. Foreign-owned firms are producing about 80 per cent of the total output of manufacturing and employ nearly half of its workers (Table 2). An important consequence of this transition from low to high productivity activities is that relative unit labour costs have fallen rapidly, not only against the euro area but also vis-à-vis the United States (Figure 5). Although, as noted above, the nominal effective exchange rate has depreciated in recent years, by far the greatest contribution to the improvement in unit labour costs has arisen from the rapid growth of productivity.

Figure 4. Net FDI inflows from OECD countries



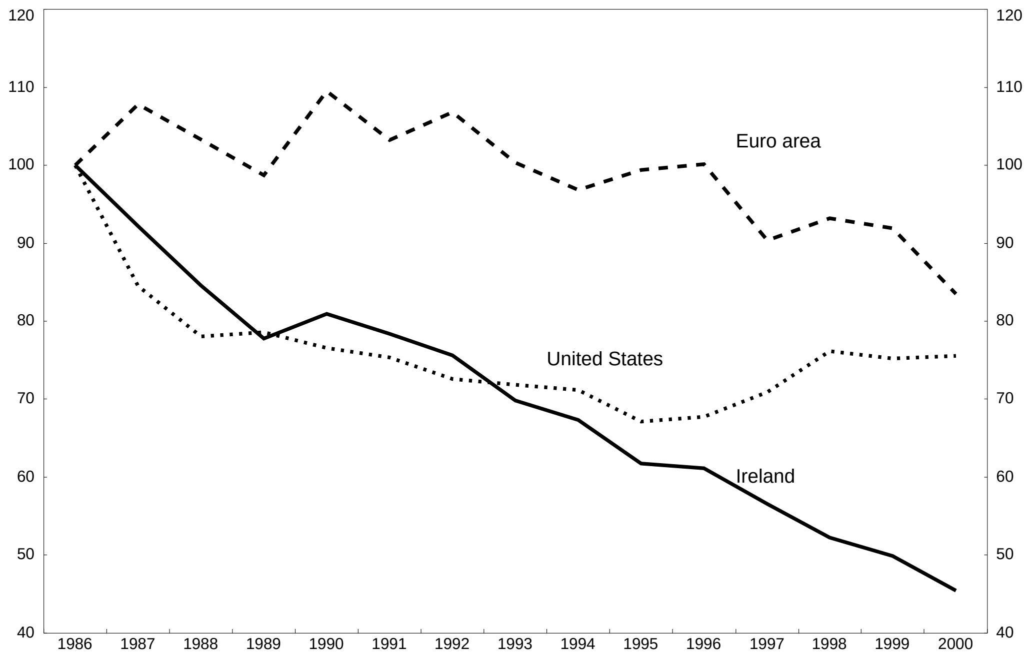
Source: OECD International Direct Investment Statistics Yearbook 1999.

Table 2. **The importance of foreign owned firms in manufacturing**
Per cent

	1983		1990		1998	
	Irish	Foreign	Irish	Foreign	Irish	Foreign
Output	41	59	32	68	18	82
Employment	61	39	55	45	53	47

Source: Central Statistics Office.

Figure 5. Competitive position: relative unit labour costs in manufacturing
1986 = 100



Source: OECD.

27. A part of FDI, which would contribute to future technological progress, is venture capital. Venture capital flows from abroad are extremely important for Ireland and in 1999 were almost four times as large as investments managed by funds in the country[3]. Although there has been a rapid increase in domestic venture capital activity, it still remains below the EU average in relation to GDP. The amount of venture capital raised has increased from Ir£ 15.8 million to Ir£ 200 million in 1999 affecting more than 250 Irish companies. The reduction of the corporation tax rate for SMEs in this year's budget to 12½ per cent should encourage the development of new enterprises and further inflows of venture capital.

28. FDI has also changed the structure of exports and their destination. Multinational firms produce high-tech goods such as computer hardware, software, chemicals and medical instruments in Ireland and export them to other EU countries, Asia and the United States. Consequently, the share of exports going to the United Kingdom has fallen sharply from 66 per cent in 1970 to 22 per cent in 1999, while that to other EU, countries excluding the UK have become dominant, reaching 43 per cent in 1999 (Table 3). The share of exports to non-EU nearly half of which are going to the US, also rose from 25 per cent in 1970 to 35 per cent in 1999. Accumulation of export-oriented FDI resulted in a massive increase in trade surplus, which rose sharply during the 1990s from around 7 per cent of GDP in 1991 to 27 per cent in 2000 (Table 4). However, the surplus on current account remains stable around zero to 3 per cent of GDP, with the trade surplus being offset by net investment income outflows.

Table 3. **GDP by sector and destination of exports**

	1970	1980	1990	1999
GDP by sector				
Agriculture	17	12	9	4
Industry	36	37	35	38
Services	47	51	56	58
Destination of exports[1]				
United Kingdom	66	43	34	20
Other EU	9	32	41	45
United States	10	5	8	16
Others	15	20	17	19

1. Figures for 1999 are for January through November and reflect new methods of gathering data.
Source: Central Statistics Office.

Table 4. **Current, Capital and Financial Account Net Balances**
Ir£ million

	1998	1999	2000	2000			
				Q1	Q2	Q3	Q4
Current account							
Merchandise[1]	13996	17903	21900	4466	5206	6019	6209
Services	-7089	-8424	-11453	-2066	-2735	-2953	-3699
Income	-7389	-9984	-11954	-2589	-2446	-3488	-3431
Current transfers	1038	951	824	268	211	-64	409
Balance on current account	**556**	**446**	**-683**	**79**	**236**	**-486**	**-512**
Balance on capital account	**661**	**441**	**952**	**237**	**151**	**11**	**553**
Financial account							
Direct investment	3483	10008	15445	2385	2665	4873	5522
Portfolio investment	-6667	-11059	38	-4459	8522	-4409	384
Other investment[2]	5874	-203	-10336	3139	-9287	1863	-6051
Reserve assets	-1796	1375	-70	30	-43	-60	3
Balance on financial account	**894**	**121**	**5 077**	**1 095**	**1 857**	**2 267**	**-142**
Net errors and omissions	*-2112*	*-1008*	*-5346*	*-1411*	*-2244*	*-1792*	*101*

1. Adjusted for balance of payments purposes.
2. Including financial derivatives and trade credits.

Source: Central Statistics Office.

29. FDI increased further in 1999 and 2000. According to the Central Statistics Office, inward FDI rose to Ir£ 14 billion in 1999 and to Ir£ 18 billion in 2000 from Ir£ 6.2 billion in 1998 (Table 5). In 1998 the inflow from the EU countries amounted to Ir£ 3.7 billion, which was slightly larger than that from non-EU countries. However, the inflow from non-EU countries, notably from the United States, exceeded substantially that from the EU countries in 1999 and 2000.

Table 5. **Current trend of FDI by instrument and region**

		1998	1999	2000	2000			
					Q1	Q2	Q3	Q4
Inward FDI	Total	6226	14013	17714	2707	3303	5336	6368
By instruments	Equity	4615	6209	7988	1711	1224	2875	2178
	Reinvested earning	3463	5767	8206	1475	1799	2941	1991
	Other capital	-1852	2037	1520	-479	280	-480	2199
By region	EU	3654	4767	4132	-274	1385	2941	80
	Non-EU	2572	9246	13581	2981	1918	2395	6287
IFSC/non-IFSC[1]								
	IFSC	3412	9230	10766	928	2048	3172	4618
	Non-IFSC	2814	4783	6946	1778	1255	2164	1749
Outward FDI	Total	2743	4005	2269	322	638	463	846
By instruments	Equity	717	1735	1748	235	443	518	552
	Reinvested earnings	1202	1465	1304	384	328	227	365
	Other capital	824	806	-783	-297	-133	-282	-71
By region	EU	885	1189	-634	-57	-51	-553	27
	Non-EU	1858	2817	2905	379	689	1016	821
Net inward investment		3483	10008	15445	2385	2665	4873	5522

1. The international Financial Services Centre (IFSC) was established in 1987 to develop a strong international financial services industry. Specific tax advantages are available to companies located in the IFSC. Their activities must be carried out on behalf of non-residents.

Source: Central Statistics Office. Original data from CSO Balance of international payments and Central bank of Ireland.

30. The key question is the sustainability of capital accumulation and especially the access to FDI. In the short run, the economic slowdown in the United States, which is currently the largest investor in Ireland, is raising a concern about the continuing inflows of FDI. Given the fact that many foreign affiliates in Ireland are producing high-tech goods for export mainly to EU countries, a slowdown of the US economy may not reduce substantially the demand for Irish exports so that investment would continue[4]. When the United States economy weakened in the early 1990's, little impact was observed on FDI inflows to Ireland. On the other hand, if lower stock prices and reduced profitability were to continue for any length of time, a decline in FDI inflows could be expected. In sum, the FDI to Ireland will be affected somewhat by a slowdown of the US economy, but its impact may be limited as long as the economic growth in the EU remains robust. In the medium term, sustainability of FDI inflows depends on a host of domestic factors including labour supply and policy settings more generally.

Increase of the labour supply

31. The labour force has increased rapidly due to a combination of higher participation rates, natural population growth and a turnaround in net immigration. The average annual rate of increase in the labour force in the period 1996 to 2000 was 4 per cent, which is more than double the average in the first half of the 1990's (Table 6, A). One reason for this was the sharp increase in the participation rate from 62.2 per

cent to 66.8 per cent which was in great part due to a higher participation of women. The female participation rate in Ireland rose from 39.7 per cent in 1995 to 47.2 per cent in 2000. In addition, reflecting a baby boom in the 1970s, which peaked only in 1980, there was a surge in young entrants to the labour force in the latter half of the 1990s with higher educational levels. Although the average educational attainment over all generations is still lower than the OECD average, the ratio of population completing upper secondary education and third level is much higher in the younger generations and the gap in the educational attainment between the OECD average and Ireland's is shrinking (Table 6, B). A large increase in net immigration since 1996 has been another important source of labour supply and has also provided important skills (Table 7). Net immigration is still positive and is thought to have reached twenty thousand in 2000, accounting for nearly a half of the year's increase in total population. The rapid growth of employment in recent years has also been due to the re-absorption of the unemployed. The rate of unemployment has fallen from 14.7 per cent in 1994 to 4.2 per cent in 2000 and that of long-term unemployed has also declined similarly.

Table 6. **Long-term trends in the labour market**

A. Labour market	1986-90	1991-95	1996-2000		
(average annual growth rate)					
Labour force	0.0	1.9	4.0		
Employment	0.9	2.0	5.8		
Unemployment	15.5	14.4	7.9		
Participation rate (average)	62.0	62.6	66.8		
B. Educational attainment	25 to 34	35 to 44	45 to 54	55 to 64	25 to 64
	Percentage of the population with at least upper secondary education by age group, 1998				
Ireland	67	56	41	31	51
OECD average	72	65	57	44	61
Gap	-5	-9	-16	-13	-10
	Percentage of the population with at least tertiary education by age group, 1998				
Ireland	29	22	16	11	21
OECD average	25	23	19	14	21
Gap	4	-1	-3	-3	0

Source: OECD.

32. Although population growth is expected to slow somewhat in the coming years, it will still remain high by OECD standards. Immigration is an important factor which will depend to some extent on policy measures. Key to the growth of the labour force, however, will be how the participation of women evolves, especially in light of rising educational levels. The participation rate is now almost equal to the average of other EU countries but it is still below the levels in the UK and Nordic countries, currently 47 per cent in Ireland compared with 65 to 75 per cent in these other countries. How closely the rate will converge to these higher levels will depend, to a considerable extent, on developments in the area of child care.

Table 7. **Population and migration**
Thousand

	1995	1996	1997	1998	1999	2000
Increase in Population	15.3	24.8	34.5	44.3	39.8	42.2
Natural increase	17.2	16.8	19.5	21.5	21.3	22.2
Net migration	-1.9	8	15	22.8	18.5	20
Emigrants	33.1	31.2	29	21.2	29	22.3
United Kingdom	13.3	14.1	12.9	8.5	10.2	6.3
Rest of EU	5.1	5.1	4.1	4.3	4.5	4.3
United States	8.2	5.2	4.1	4.3	5.4	3.2
Immigrants	31.2	39.2	44	44	47.5	42.3
United Kingdom	15.6	17.6	20	21.1	21.6	16.4
Rest of EU	6.3	7.2	8.1	8.7	10	9.8
United States	3.8	6.4	6.6	4.9	5.7	4.6

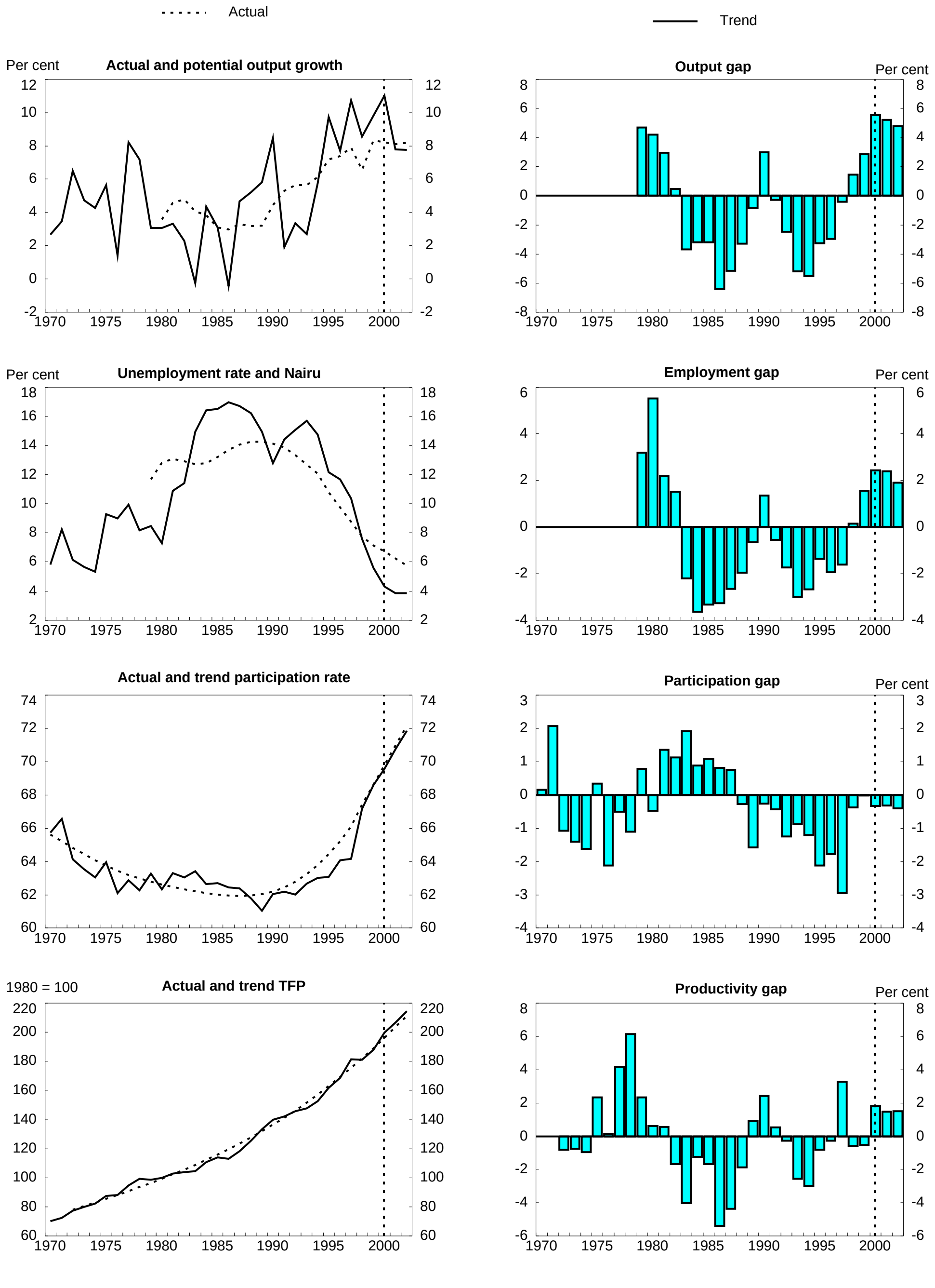
Source: Central Statistics Office.

Implications for potential output

33. In summarising the underlying forces of growth -- capital accumulation, productivity, population and labour force growth -- the Secretariat has estimated the potential output of the whole economy. This also permits the derivation of an output gap and an assessment of the current conjunctural situation. Estimates of productivity growth are based on a Kalman filter of past productivity growth while the limits on effective labour supply are calculated by deriving an estimate of the NAIRU. The Secretariat's current estimate is that the potential output growth in recent years has been some 8¼ per cent, and that this will gradually slow to some 7½ per cent by 2005. This estimate is somewhat higher than those from other institutions including the government and the Central Bank of Ireland, in part because the rate of capital accumulation is an explicit part of the OECD method. Because the estimated potential growth has been lower than the actual growth rate in recent years, the Secretariat's estimate implies a current output gap of some 5.5 per cent of GDP which is only somewhat higher than other estimates (Figure 6).

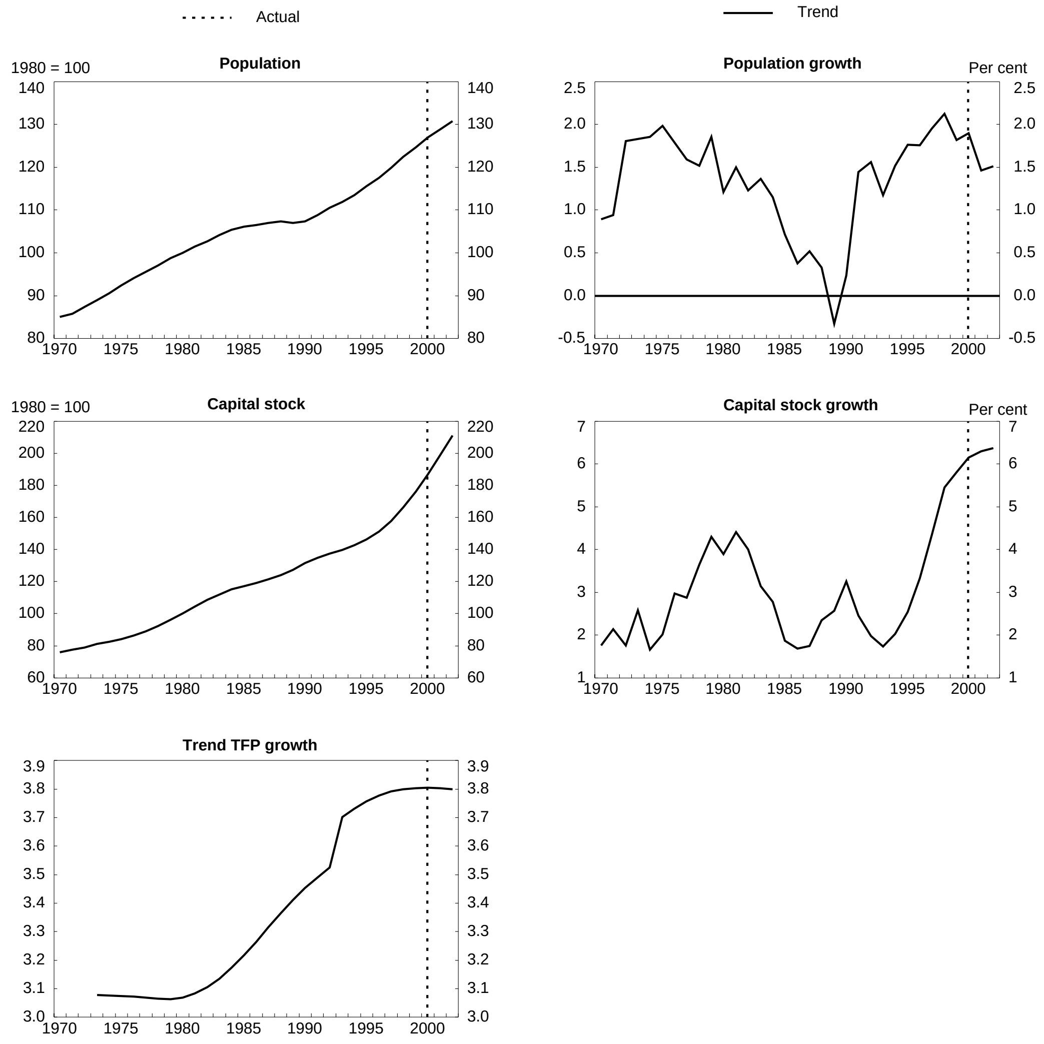
34. In assessing the situation in Ireland, however, the above estimates are associated with considerable uncertainty which is rather similar to the situation in the United States. The rapid pick up in productivity is only captured after the event by the Secretariat's method of extracting trends, so that a significant proportion of the acceleration of growth is assigned to the business cycle with a consequent rise in the output gap. Similarly, the derivation of the NAIRU, which is important in determining the sustainable labour supply (*i.e.* the level which can be reached without accelerating inflation), is subject to great uncertainty due in part to the importance of immigration. It thus has a tendency to simply track with a delay the actual fall in the rate of unemployment[5]. Another key issue in specifying a NAIRU for a small highly open economy is the difficulty in specifying a measure of price inflation. The headline CPI may not represent the domestic inflationary pressures fully because the prices of traded goods are largely determined by external factors[6]. The net effect of these considerations is that the Secretariat's estimate of "over-employment" of some 2 per cent, which contributes significantly to the output gap, could easily be very wide of the mark.

Figure 6 Decomposition of the output gap



Source: OECD.

Figure 6. (continued)



Source: OECD.

35. In sum, a great deal of the recent growth is underpinned by strong underlying forces and is not simply a conjunctural upturn in response to a series of favourable shocks. Estimates of the output gap as a shorthand way of measuring inflationary pressure or "overheating" are subject to great uncertainty, but the rise in the vacancy rate last year and the evident shortage of manpower in some occupations and sectors does suggest excess labour demand at the current wage rate. Whether there is also "excess employment" in the sense of employment which will disappear once wages and prices fully adjust is much more difficult to judge and requires a deeper understanding of the inflation process in Ireland.

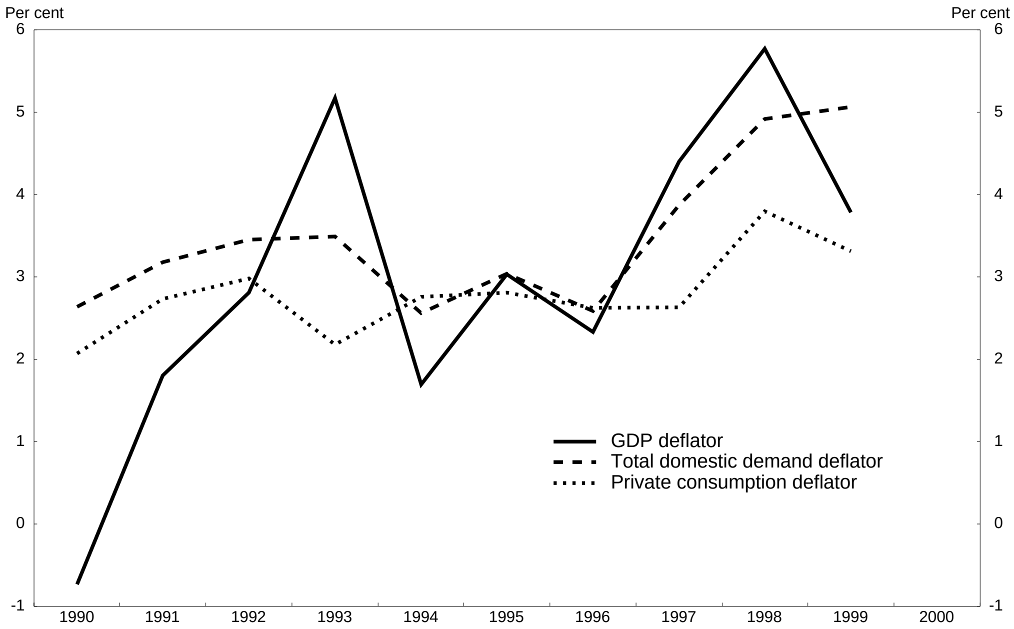
The inflation process

36. The surge in consumer prices in the course of last year, together with rapidly increasing prices for housing which has now been going on for several years, have both been taken to suggest that the economy is suffering from excess demand and is overheating. The rate of increase of the Consumer Price Index (CPI) reached a sixteen year high of 7 per cent in November 2000 (HICP, 6 per cent) before falling back to 5.9 per cent in December 2000 (HICP, 4.6 per cent) as the one-off impact of an increase of tobacco excise dropped out of the index. However, the domestic demand deflator started to accelerate already in 1996 as growth took off (Figure 7). The question could, therefore, be why consumer prices were so long in adjusting. The inflation process is, however, not simply a reflection of excess demand, which in a small open economy would spill quickly into a deterioration of the current account. Such a deterioration has not been marked till now in Ireland (Table 4). Rather more complex forces, which reflect the structural transformation of the economy, as well as some specific temporary factors have also been at work.

The changing structure of the economy

37. Total trade accounts for 160 per cent of GDP, so that the prices of traded goods, which are largely determined by external factors and the exchange rate, have an important effect on the economy. Indeed, there is a very tight correlation between wholesale prices, export prices and the exchange rate. Prices for non-traded goods, and especially for services, reflect domestic factors including the tightness of the labour market, though prices of non-traded goods are also affected by those of traded goods in the long-run. Figure 8 shows the recent development of inflation for both a narrow selection of traded goods and an approximation to non-traded goods using services from the CPI. Prices for non-traded goods increased sharply in 1999 and 2000 while for the narrow selection of tradeable consumer goods (*i.e.* foods, clothing, durable goods and others) inflation only reached a year-on-year rate of 3 per cent at the end of 2000[7]. This would appear to represent a very slow reaction to the exchange rate, which might be caused by the pattern of retailing in Ireland[8].

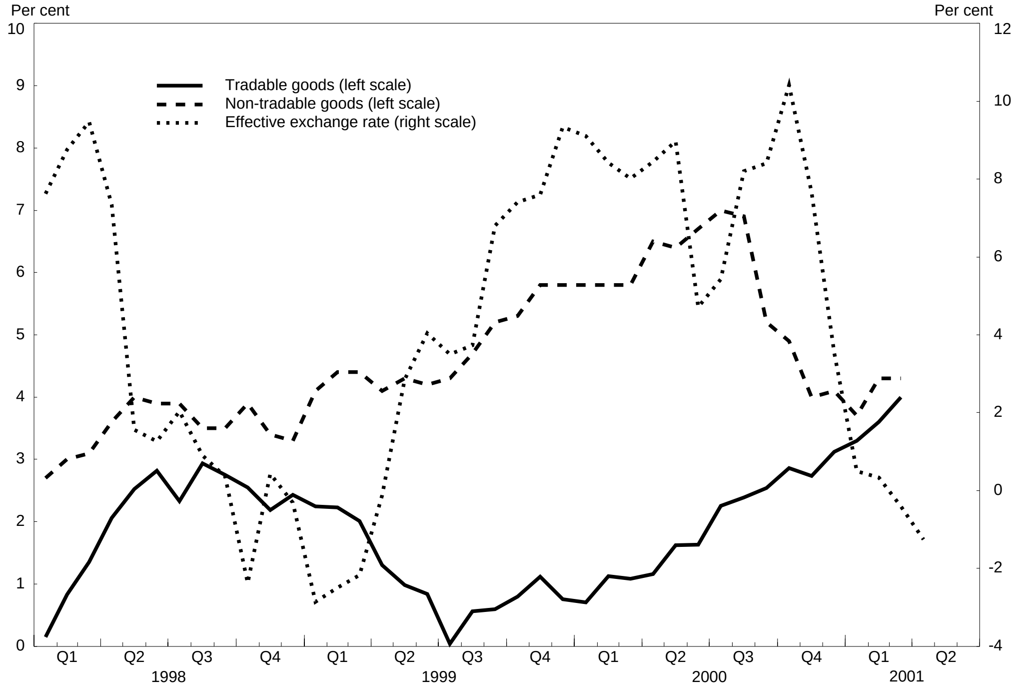
Figure 7. National accounts measures of inflation
(per annum)



Source: OECD.

38. One reason for the inflation differential between tradeable and non-tradeable goods is that labour productivity in the former is higher than in the latter (the Balassa-Samuelson hypothesis). With a common wage rate in equilibrium between the two sectors, prices for non-tradeables would tend to rise faster leading to a real appreciation. There is evidence that this process is at work. According to Sinn and Reutter (2001), the gap between the productivity growth of the traded sector and that of the non-traded sector in Ireland amounted to more than 4 percentage points in the period 1987 to 1995. More recent developments including the growth of international financial services should reveal an even stronger productivity differential. In a monetary union such differences would lead to inflation in Ireland being some 2¾ percentage points higher than in the core countries where the productivity differential is much less[9].

Figure 8. Prices for tradable and non-tradable goods
Per cent change over 12 months



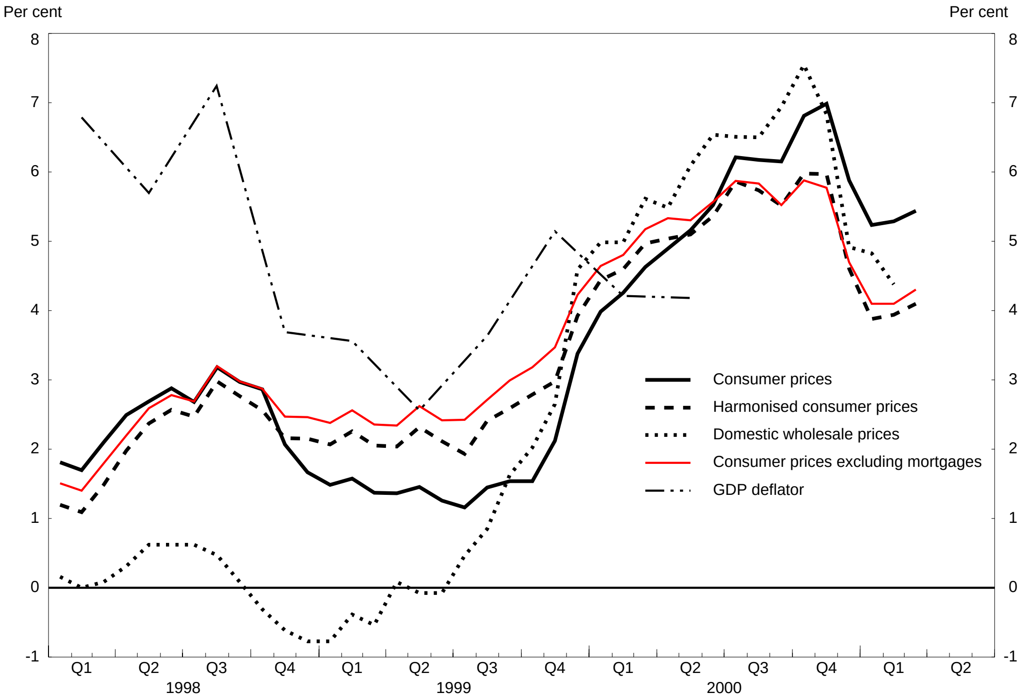
Note: Tradable goods include food, clothing, durable goods and other goods (covering 40% of CPI). Non-tradable goods reflect only prices for services. The non-tradable price index is distorted downwards in November 2000 when the treatment of child services, health insurance and tuition fees was altered.

Source: Central Statistics Office and OECD.

Other factors driving consumer prices

39. After converging to euro area inflation levels in the run up to EMU, Irish consumer price inflation diverged significantly last year, largely due to external factors, before starting to converge again more recently. In addition to the underlying dynamics caused by developments in the non-tradeable sector, a number of temporary and technical factors also need to be considered. On the external side, higher oil prices combined with a depreciation of the euro have pushed up the prices of energy and imported goods from the non-euro area. Other countries have also been subject to the same shocks. On the domestic front, the introduction of a higher duty rate on tobacco in December 1999 added about ¾ percentage point to the CPI. Mortgage interest payments have also distorted the rate of increase in the headline CPI. Since the Irish authorities use the payment approach to measuring the costs of home ownership rather than rents, the CPI tends to fall as interest rates decline. During 1999, the increase in the housing component of the CPI became negative due to lower interest rates. The increase of consumer prices excluding mortgage payments in 1999 was more than 1 percentage point higher than that of the headline CPI, while it fell below the latter in 2000 as interest rates stabilised (Figure 9). The Harmonised Index of Consumer Prices (HICP), which excludes housing costs, followed almost the same trend as the CPI excluding mortgage payments. The fact that lower interest payments pushed down the headline CPI in 1999 suggests that inflation momentum started developing in 1999 rather than in 2000.

Figure 9. Indicators of inflation
Per cent change over 12 months



Source: Central Statistics Office.

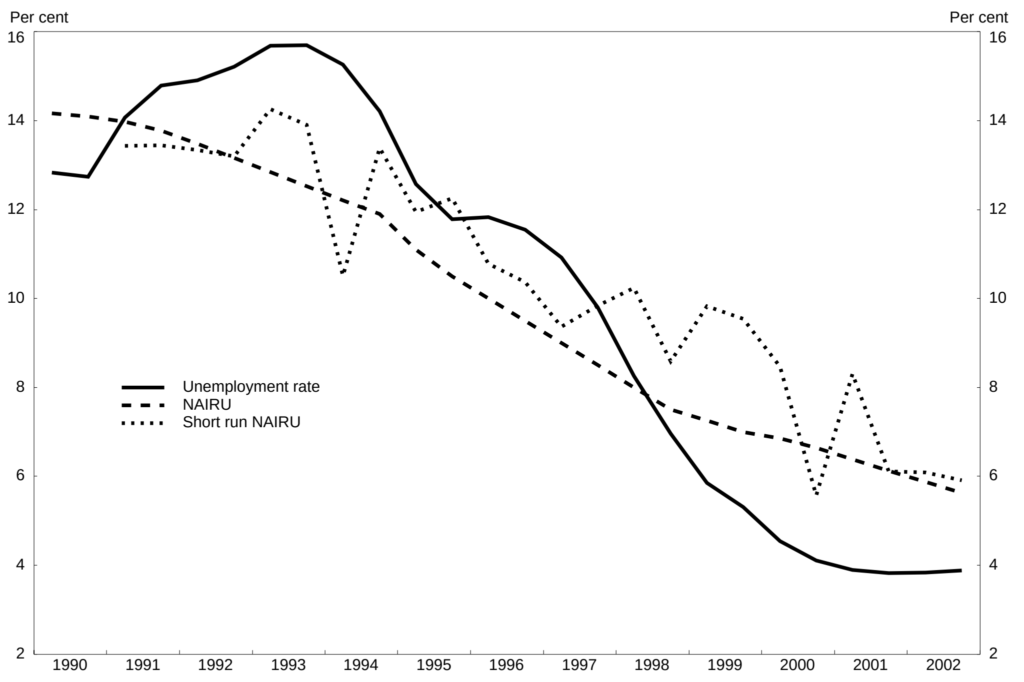
40. One way of distinguishing the forces at work is to decompose the difference between the inflation in the euro area and that in Ireland. Assuming that inflation in traded goods is almost the same within the euro area, the differences in inflation can be attributed to the influence of domestic factors. The rate of headline HICP inflation in Ireland was about 3¼ percentage points higher than that for the euro area at the peak in 2000. The Central Bank of Ireland estimated the impact of specific factors on the HICP and calculated the difference in the core inflation rate between Ireland and the euro area. According to their estimation, the greater exposure of the Irish economy to non-euro area trade partners, notably the UK and the US, magnified the impact of the depreciation of the euro and accounted for around half a percentage point of the differences in the HICP between Ireland and the euro area. In addition, they estimated that approximately 1 percentage point of the difference could be explained by higher productivity growth in the traded sector relative to the non-traded sector as noted above. This is considerably lower than estimated by Sinn and Reuter (2001). The exclusion of these factors from the inflation differential still leaves 1¾ percentage points. Since around ¾ percentage point is due to the rise in indirect taxes, the Bank argued that the remaining 1 percentage point can be attributable to the strength of domestic demand in Ireland.

Wage development

41. Another way of summarising the forces involved is to focus on the difference between the current level of unemployment and the NAIRU, although the uncertainty surrounding the concept and its measurement needs to be kept in mind. The OECD has recently reviewed its procedures for deriving

estimates of the NAIRU and introduced the distinction between a slow-moving NAIRU and a more volatile short-term NAIRU, which is affected by temporary factors such as oil price fluctuations, exchange rate movements and changes in real import prices (see OECD 2000). Figure 10 shows the recent development of the actual unemployment rate and the estimated short-run and longer run NAIRU. The actual unemployment rate fell below the NAIRU in 1998 and has continued to stay below the estimated NAIRU since then. An unemployment rate lower than the NAIRU does not necessarily suggest an immediate rise of inflationary pressure as long as favourable short-term supply conditions are serving to lower the short-run NAIRU. The short-run NAIRU in Ireland also shows a declining trend during the 1990s, which simply reflects the fact that the successive fall in the unemployment rate has not led to a significant increase in inflation until 1998. The estimated short-run NAIRU in Ireland has exceeded the actual unemployment rate since 1998, suggesting rising pressure on prices.

Figure 10. Estimates of the NAIRU



Source: OECD.

42. Extremely tight labour market conditions have led to wage rises in excess of those agreed under both the income agreement which ran to March 2000 (*Partnership 2000*[10]) and its successor (the *Programme for Prosperity and Fairness* (PPF)). The PPF agreed wage increases of 5.5 per cent in 2000, which was much the going rate at the time and considerably higher than what the previous wage agreement specified. Although statistics are still incomplete, by June 2000, wages in the manufacturing sector had risen by 7.5 per cent with hourly earnings up by 5.8 per cent. However, increases may have been substantially higher in the service sector. By September 2000, average full time weekly earnings had risen 12 per cent in distribution (probably influenced by the introduction of the national minimum wage) and 7.6 per cent in business services. A shortage of labour and an insufficient inflow of immigrant workers led

to an extremely sharp rise of wages in construction where average hourly earnings increased by 12 per cent in the year to June 2000. By contrast, average weekly earnings in the public sector (excluding health) rose by 2.5 per cent in the year to December 1999. although large increases were granted to some employees in 2000. Pressure from the public sector was a significant factor in a re-negotiation of the PPF at the end of 2000: in addition to the wage increases of 5.5 per cent and 4 per cent in 2001 and 2002 respectively, there will be an extra 2 per cent of basic payment from April 2001 and a one-off lump sum payment equivalent to 1 per cent in April 2002.

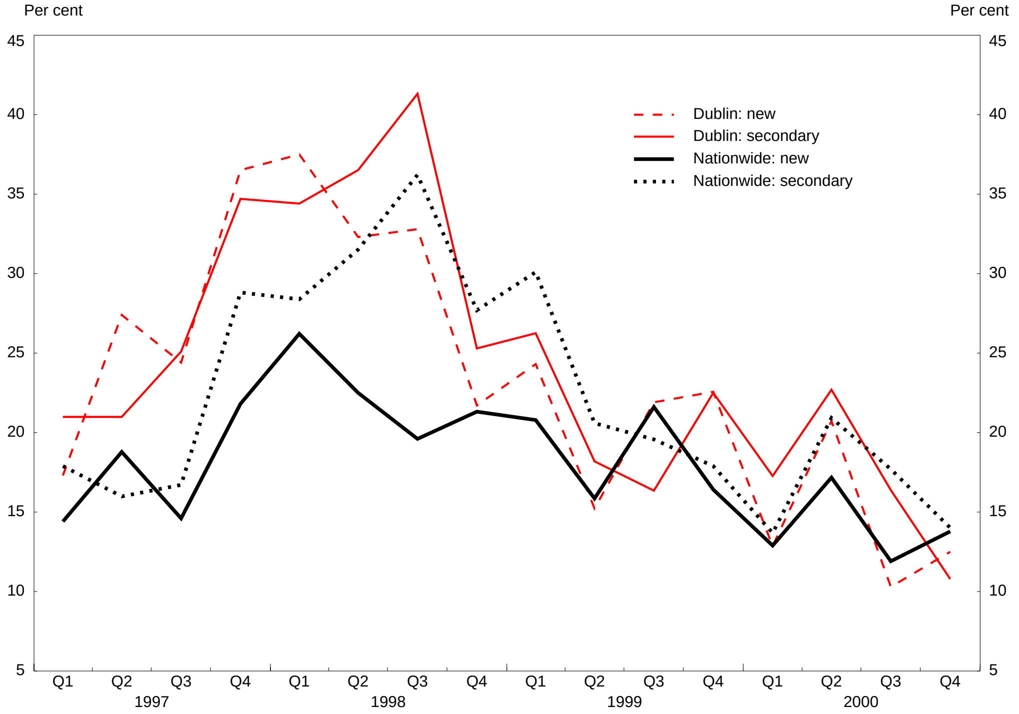
Rising property prices

43. Economic expansion over the past few years has led to a sharp rise in prices of houses and land. House prices began to pick up in 1996, but there have been signs of moderation since the middle of 1998 as the supply of new houses has increased strongly. According to the data released by the Department of the Environment and Local Government, nation-wide price increases for new houses peaked in the first quarter of 1998 at 26.2 per cent in year-on-year terms. Since then, the annual rate of increase has declined successively except for a temporary hike in the second quarter of 2000[11]. The rate of increase in prices for new and existing houses dropped to 14 per cent in the fourth quarter of 2000 (Figure 11). The slowdown of price increases for houses has been greater in Dublin than in other areas, and the auction market is also said to have cooled.

44. Slowing house price inflation reflects the steady increase in supply of new houses. The total number of completions increased by 9.8 per cent in 1999, and have continued to rise to almost 50 000 units in 2000, a further 7 per cent increase on 1999, and the sixth consecutive year of record housing output. A series of government actions to encourage supply and to raise settlement density seems to have had some effect on the increasing completions.

45. The underlying demand for houses has been pushed up by both demographic and economic factors. A large proportion of the population is currently in the household formation age group and the average household size, which is above European levels, has continued to decline. Both factors have contributed to the rapid increase in household formation and, together with net inward-migration, resulted in rising demand for housing. Strong growth in per-capita real income and buoyant consumer sentiment has also boosted such demand: the cumulative increase in per capita disposable income during the period 1996 to 1999 was 40 per cent in nominal terms and 22 per cent in real terms. Furthermore, lower interest rates resulting from the entry into EMU and increased competition among financial institutions have contributed to the property boom by reducing the burden of debt payments. Given the continued increase in immigration and rapid economic expansion, strong demands for houses will persist over the next couple of years. Although 50 000 housing units were completed in 2000, there is still a significant imbalance between supply and demand. To meet rising demand for houses, Bacon (2000) estimated that 54 000 private house completions per annum on average over the period of 2000 to 2005 are required. However, a rapid expansion of building is likely to be constrained by the shortage of both construction workers and planners (though steps are being taken to provide additional capacity in both areas), as well as by a limited capacity of infrastructure and other public services.

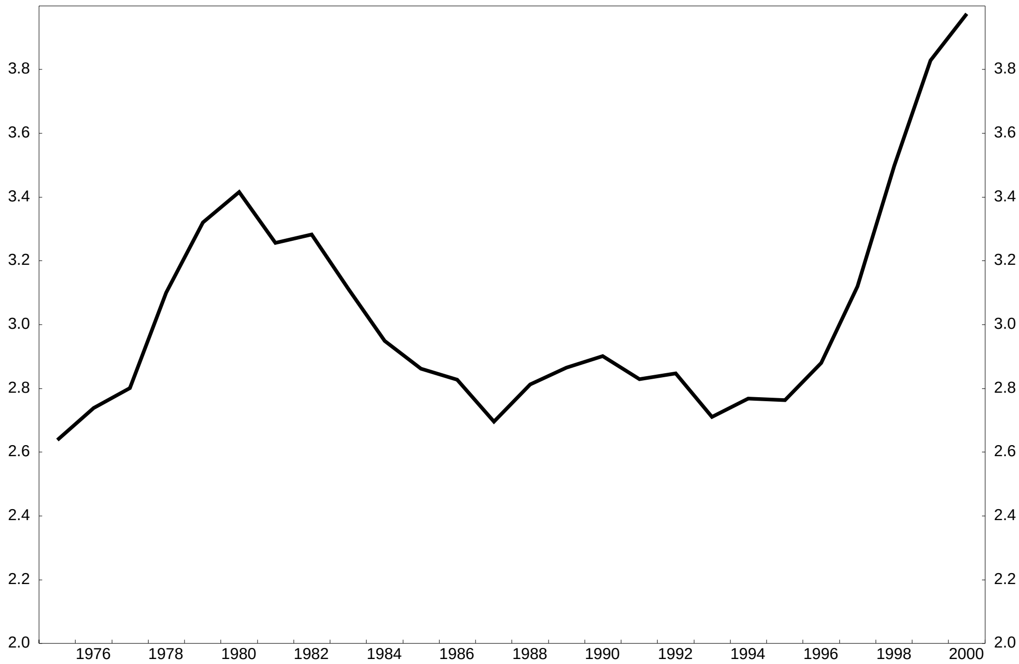
Figure 11. House prices
12 month percentage increase in average prices



Source: Department of the Environment.

46. A marked increase in the ratio of both house prices and mortgage payments to household income and possible risks of an over-shooting in house prices have raised concern about the sustainability of the current property boom and what might happen if it were to collapse. The ratio of average new house prices to average household disposable income has increased from 2.8 in 1995 to nearly 4 in 2000 (Figure 12). Another affordability index, as represented by the mortgage servicing costs divided by the net after-tax-income, also shows an increase from 20 per cent at the bottom in 1994 to 28 per cent in 2000. However, the fact that discretionary income (*i.e.* after mortgage repayments) is still increasing suggests that a higher proportion of debt payments to disposable income may not necessarily imply a serious deterioration in affordability. The question of whether house prices have overshot their equilibrium value is difficult to assess. On the other hand, such overshooting might be suggested by some empirical studies and a comparison with international experience of similar property booms. According to the estimation by Bacon (2000), the current demand for houses is extremely high relative to the prediction of their model, suggesting that a speculative or transitory factor could have contributed to the level of house prices.[12] International experience suggests that prolonged property booms on the scale of Ireland's may lead to a demand driven by self-fulfilling expectations, followed by price overshooting. According to the IMF (2000), the cases of property booms that ended with a sharp decline involved a cumulative increase in house prices during the boom of 62 per cent, followed by 17 per cent cumulative fall in the successive four years after the boom. The cumulative increase in new house prices from 1996 to 1999 in Ireland was 65 per cent, which is higher than the average of the other international episodes.

Figure 12. Ratio of average new house prices to household disposable income



Source: Central Bank of Ireland.

47. On the other hand, there also exist factors indicating a robust property market and limited exposure to any price declines. The relatively small exposure of the financial sector to mortgage lending and a low ratio of mortgages against property prices suggest that the balance sheets of both the financial sector and households remain relatively robust. The average mortgage on new and existing houses has remained almost steady at around 60 per cent of their prices and has even fallen slightly in recent years. The level of outstanding residential mortgages, which amounts to 33 per cent of GDP in 1998, is much lower than those of other European countries (Table 8). As for the commercial property market, the ratio of outstanding commercial mortgage credit to GDP remained below 4 per cent in 2000, the lowest in Europe[13]. The Central Bank of Ireland has been aware of the risks associated with the increasing exposure of banks to property lending and has taken actions to alert banks to risks posed by rapid credit growth, which is currently running at about 20 per cent. They are also checking the vulnerability of the financial institutions against falling property prices by conducting stress testing with quite stringent macroeconomic assumptions. The results to date confirm that the financial system remains sound. Nonetheless, caution about sudden collapse of property prices remains necessary. In February of this year, the stress testing was tightened yet again by demanding that banks examine more closely borrowers' sources of income and other finance. A target date of March was also set when all lending institutions will have to introduce tests to assess the ability of a borrower to repay in various circumstances including a sharp rise in euro interest rates and a marked economic slowdown.

Table 8. **Outstanding Residential Mortgages as percentage of GDP in 1998**

Denmark	69
Netherlands	65
United Kingdom	57
Germany	53
Sweden	50
Ireland[1] (1999)	**33**
Finland	30
Spain	24
France	21

1. Data for Ireland are for 1999 and are calculated as percentage of GNP.

Source : European Mortgage Federation (except Ireland -- data are from Central Bank of Ireland).

Prospects and risks

48. GDP expanded considerably above its potential growth rate in 2000 while by the end of 2000, inflation and wage growth had both accelerated and house prices continued to grow at uncomfortably high rates. A general assessment, nevertheless, points to a resilient economy. Balance sheets of both the business sector and households do not show signs of over-extension which would usually precede a "hard landing" and there is no balance of payments position to defend, which has often triggered an abrupt slowdown in other countries. Inflation is higher than in the euro area but a good part of this differential is due to the significant shift in the structure of the economy which has seen the services and modern manufacturing sectors rising in importance. Wage growth has picked up strongly but so has productivity. Indeed, Ireland has been gaining cost competitiveness rather than losing it, which suggests that it could be entering a period where there should be a real exchange rate appreciation. In other countries such as Germany, Switzerland and Japan such a development phase was associated with a strong appreciation of their currencies but in Ireland it will take the form of wage rises and shifting relative prices. On the other hand, it is also clear that the economy is suffering from tensions arising from pressure on infrastructure and that the current pace of growth is unsustainable. This is the background for the Secretariat's short-term projections and assessment of risks.

49. The projections presented in Table 9 are based on the following assumptions:

- A continuation of the current budget for 2002.
- Short term euro area interest rates are assumed to edge down from 4½ per cent with only a small change in policy rates.
- The euro exchange rate is fixed at $0.88 per euro. The oil price is assumed to be $25 per barrel in 2001 and 2002.

Table 9. **Summary of projections**

	Estimates 2000	Projections 2001	2002
	Percentage change on previous year		
Demand and output			
Private consumption	8.5	8.0	8.0
Public consumption	4.8	4.7	3.8
Gross fixed investment	11.3	10.6	9.3
Business	13.5	14.7	12.0
Housing	10.7	8.4	7.7
Government	10.0	13.0	11.0
Final domestic demand	8.7	8.2	7.7
Stockbuilding[1]	-1.5	-.2	.3
Total domestic demand	7.0	8.2	8.2
Exports of good and services	20.0	11.9	10.6
Imports of good and services	18.5	13.0	11.5
Foreign balance[1]	4.2	1.0	0.9
Gross domestic product[2]	11.0	7.8	7.8
Gross national product[2]	9.0	6.0	6.4
Inflation			
Private consumption deflator	6.5	4.8	3.8
Export deflator	5.4	1.9	1.3
Import deflator	9.0	1.3	1.2
GDP deflator	4.8	4.6	3.8
Labour market			
Total employment	4.7	3.7	3.1
Unemployment rate	4.3	3.9	3.9
	Per cent of GDP		
Current account	-0.1	-0.9	-2.6
Output gap	5.5	5.2	4.8

1. Contribution to GDP.
2. Expenditure base estimates.
Source : OECD.

50. With labour force growth now past its peak, GDP is projected to slow this year to 7¾ per cent which is close to the estimated short run potential growth of some 8¼ per cent. Labour productivity should also fall back from the exceptionally high rate of 6 per cent in 2000 to around 4-4½ per cent, still a high rate, as the economy continues to modernise by transferring resources from low productivity activities. The rate of unemployment, which has been falling rapidly in recent years, should stabilise at around 4 per cent, most of which is frictional in character. On the demand side, the contribution from net exports should fall further in response to both a decline in export market growth and to the appreciation of the effective exchange rate of around 10 per cent at the turn of the year. Investment activity is projected to slow somewhat, with an increase in public infrastructure investment as part of the National Development Plan and the continuing robust demand for housing partially offsetting a slowing in business investment. The latter is projected to be the product of both reduced FDI from the United States and slower export growth of ICT products. Private consumption should remain buoyant, fuelled by strong income growth, while household debt will remain low.

51. Buoyant domestic demand should sustain imports while upbeat growth prospects in Europe should serve to underpin exports even as the US economy slows and the ICT sector enters a correction phase. Information, communications and technologies account for some 40 per cent of total exports and grew at an average annual rate of 23 per cent between 1993 and 2000. This was about one and a half times faster than the growth rate achieved by non-ICT exports. About two thirds of ICT exports go to Europe with only ten per cent going to the United States. However, a quarter of ICT exports are bound for South East Asia and such demand might be at risk from any marked downturn in the United States. Expectations for exports in the ICT sector deteriorated markedly at the start of the year. However, growth is projected to pick up in the United States in the course of the year so that on balance export growth of some 12 per cent has been projected.

52. Prices and wages are expected to continue to rise at a rapid pace although the rate of inflation should slow as one-off factors from last year wear off. The inflation rate for tradeable goods should fall to some 2 per cent but, reflecting structural shifts in the economy, the price of services is projected to rise at a more rapid pace. As a result, Ireland should continue to experience CPI inflation well above the euro area average, though converging towards it. With the labour market continuing to remain tight and competitiveness strong, wages are expected to grow at around 7½ to 8 per cent, subsiding gradually through 2002.

53. Risks are much more balanced than in the recent past with the economy now at full employment. Nevertheless, some risks still remain. An important downside risk concerns the evolution of the world information, communications and technologies market. A longer and more pronounced decline than assumed here would depress not only exports but also FDI. Although such a downturn might be limited, it could spill over into the housing market starting a downward correction of prices with wider effects on the economy. On information currently available such a downward correction, even if it did occur, may not constitute a serious problem to the financial system, although caution is certainly required on the part of the supervisory authorities. However, it would probably trigger a sharp retrenchment of consumer spending on other items. The possibility of an outbreak of foot and mouth disease and the impact on tourism of related precautionary measures represent a further risk to the growth projection. More significant risk, however, and the one which has concerned the government most, is that recent strong wage pressures might become embedded in the economy and lead to inflation "overshooting". This would increase a likelihood of a sharper, and more disruptive, correction at some stage in the future.

II. ECONOMIC POLICY FOR MANAGING GROWTH AND CHANGE

Overview

54. The rapid growth of the Irish economy, its transition from abundance to a generalised shortage of labour, strong inflationary pressures, inadequate infrastructure and membership of the euro have all served to alter radically both the framework and the major concerns of economic policy. Monetary conditions are now set by the European Central Bank for the euro area as a whole so that there is no guarantee that monetary conditions will be appropriate to the domestic economic situation. In these circumstances, the burden of macroeconomic stabilisation has had to be placed on other policy instruments. To deal with rising wages and prices -- and unrest in the public sector -- the authorities are relying on the well established social partnership model which evolved during the long period of unemployment. The new social partnership agreement, the Programme for Prosperity and Fairness (PPF), runs from 2000 to 2003 and commits the government to large tax cuts over the next three years and also, in a new departure in such agreements, to increased social expenditures. Moreover, the PFF has also led to a sensitivity about headline inflation and to a *de facto* indexation of wages to ex-post inflation in 2000. Taken together, fiscal policy has become more tightly constrained. Yet, pressures on fiscal policy have come from two other sources. First, membership of the euro involves not only commitments to the terms of the Stability and Growth Pact but also peer group surveillance of, *inter alia*, the cyclical stance of fiscal policy. Second, with a large budget surplus, pressures on the government to address social issues, the lack of infrastructure, and the problem of wage relativities in the public sector by simply raising expenditures have become more evident. After convincing the population of the need for austerity in the late 1980's and early 1990's -- and achieving a dramatic turnaround of fiscal position from a peak deficit of over 10 per cent of GDP in the mid-1980s to a surplus of 4¾ per cent in 2000 -- it is difficult to persuade them of the necessity to maintain a high level of public saving. This is all the more so as the level of public expenditures is low in relation to national income -- at less than 35 per cent in relation to GNP compared with an euro area average of 45 per cent -- and with incomes rising, the demand for certain publicly provided services such as health care is increasing.

55. A key concern of the authorities is to ensure that the period of higher growth is not a temporary phenomenon but is firmly rooted and sustainable in the long term. This objective finds expression not only in the government's drive to improve infrastructure but also in its long standing policy of ensuring conditions for attracting and retaining FDI. But this process is seen as a dynamic one with low value-added activities ultimately leaving the country. The challenge for policy is thus to create conditions which will attract high value-added FDI, including modern infrastructure and appropriate skills and human capital. These concerns influence not only labour market policies (Chapter III) but also the social agreements, infrastructure investment and fiscal policy.

56. This chapter first discusses the new social partnership agreement which is viewed by the authorities as a key macroeconomic policy measure. It then goes on to review an ambitious investment programme, the National Development Plan, and policy towards foreign direct investment, both of which are important aspects of the government's policy package to ensure growth over the longer term. The

following section examines fiscal policy both this year and in the medium term where a number of issues arise. The final section discusses policy in the public sector, which is being modernised so as to meet evolving demands on it, including the need to match the higher wages being offered in the private sector.

The evolving policy framework

The Programme for Prosperity and Fairness (PPF)

57. The social consensus model has formed the basis of the wage determination process since 1987 and is credited by some with helping create the pre-conditions for growth by establishing good labour relations. The model included low pre-tax wage increases coupled with tax reductions to raise post-tax incomes and was implemented against the background of large scale unemployment (and under-employment) and a gradually improving budgetary situation. By the time the latest agreement was negotiated a year ago the situation had changed radically with labour market shortages more evident, raising a number of concerns about how the institution should evolve[14]. In particular, many critics focused on the tax cut dimension and argued that, in a labour shortage economy, wages should rise in order to reduce excessive competitiveness: Ireland needs a real appreciation and in a monetary union this can only be achieved by wage and price increases above those in trading partners. The government for its part emphasised the risk of wages and prices "overshooting", which could lead to a hard landing scenario, and were faced with difficult wage demands in the public sector. What eventually emerged was an agreement with the same essential structure as in the past, but covering a very wide range of additional issues broadly related to the sustainability of growth.

58. The current agreement, the Programme for Prosperity and Fairness (PPF), was negotiated in the first half of last year to cover the period 2000-2002 (actually 33 months)[15]. It is the most comprehensive yet of the national social partnership agreements. The agreement runs to some 120 pages and covers social inclusion, promotion of a dynamic economy, full employment, the information society, balanced and sustainable development and modernisation of the public sector. Moreover, it emphasises the vital importance of international competitiveness as a requirement for continuing economic and social progress. The agreement is not legally binding on employers in the private sector but it is hoped that it will nevertheless represent a norm. However, the government is a signatory so that it is much more binding for the public sector where, in addition, union representation is widespread. Indeed, many provisions of the agreement concern public sector employees and modernisation of the public service.

59. With respect to wages, the original agreement envisaged inflation of around 3½ per cent and set pay increases of 5½ per cent in both 2000 and 2001 and 4 per cent in 2002. As in the recent past (see *1999 Economic Survey of Ireland*), the agreement involves tax reductions to increase after-tax pay for the whole population. The PPF specified that net take-home pay including pay increases would rise by up to 25 per cent or more during the period up to and including the budget for 2003. Moreover, there is also a commitment to gradually increase the threshold for paying income tax towards the level of the minimum wage. Other conditions were directed to the public service, a key focus of the negotiations in the first place. In addition to the above terms, there was an "early settlers" increase of 3 per cent for certain public service employees who were paid with the first instalment of the PPF. To deal with the intractable wage relativity issues in the public service[16], a benchmarking group was established and there is also a provision for efficiency programmes (see below) to be agreed, which if met and validated will lead to the final instalment of 4 per cent in 2002.

60. Following higher-than-expected inflation in 2000, the social partners agreed in December 2000, shortly before the budget, on further wage increases of 2 per cent of agreement-relevant pay from

April 2001 and a one-off lump sum payment of 1 per cent in April 2002. Rising inflation through the year, in part due to the weakness of the euro and higher oil prices, had increased tensions surrounding the future of the PPF, and industrial relations in the public sector were a cause of concern. Achieving the agreement was regarded as a high priority for economic policy by the government, which was concerned to avoid a wage/price spiral and an over-adjustment of wages to a temporary surge in prices and a weak exchange rate. By acceding to an *ex-post* adjustment for price rises, the authorities argued that wage expectations would remain stable. Pressure to renegotiate the PPF also led the government to make some unusual policy moves during the year, such as re-introducing price controls on alcoholic drink in July, while increases in public charges have been closely controlled. Such pressure to control headline inflation carried through into the budget for this year with cuts in both VAT and in fuel excise taxes.

61. Arguments in favour of tax-based incomes policy -- albeit one now encompassing almost all areas of policy -- appeal to the record of moderate wage settlements through the 1990's which contributed to the impressive rise in employment after a long period of growth without job creation. On the other hand, low wage growth in the 1990's can also be attributed to the massive increase in labour force participation (see Chapter I) which is now expected to gradually subside. Preliminary econometric work on wage equations do not find a structural break from 1987 but sometime earlier[17]. Estimates of structural unemployment (see Chapter I) are highly unstable, trending downwards in line with actual unemployment, but this instability does not appear to be related to periods of social agreements.

62. Even though the wage agreements associated with the social pacts might have contributed indirectly (if not directly) to economic performance in the 1990's, it is quite another issue how they might function under conditions of full employment and as a policy instrument to help control inflation. Wages rose by some 6½ per cent in the year to June 2000 (the agreed rate was 1 per cent under the last social partnership agreement), and surveys of enterprises suggest that firms were continuing to increase wages to meet labour shortages going into this year[18]. In addition to recruiting difficulties, both developments have led to public sector demands for parity with the private sector. Even if the current wage agreement were to hold, the tax cuts would still contribute to strengthening aggregate demand and, *ceteris paribus*, to inflationary pressure even in such a small open economy. An overall assessment, however, needs to consider a number of wider issues. In particular, will the associated tax cuts serve to increase labour supply, thereby lowering labour market pressure, and how effective will public investment be in the short term in raising supply rather than boosting demand? It is also vital to consider the overall fiscal stance and in what manner the PPF might serve to constrain fiscal flexibility, amplifying the difficult policy tradeoffs involved. Finally, it is also necessary to examine more closely in what way the PPF will serve to resolve problems in the public sector and whether other more direct policy measures might be more appropriate. These issues are dealt with below.

The National Development Plan

63. Rapid growth has been accompanied by rising demand on limited infrastructure and by increased traffic congestion. The lack of infrastructure in both an absolute sense and relative to other countries (Table 10) is also considered to be a barrier to maintaining growth since it lowers competitiveness[19]. To tackle these issues and others such as education, which will enhance the sustainability of growth, the government initiated the National Development Plan in late 1999. Total spending over the period 2000-2006 is estimated at Ir£ 40.6 billion at 1999 prices (an average annual level of some 8 per cent of real GDP in 1999). Details are presented in Box 1. Of the planned spending, EU transfers will provide about 8 per cent of resources but with a strongly diminishing contribution over the period of the programme[20]. The government hopes to finance the remainder (around 4½ per cent) by Public Private Partnerships, especially in areas such as roads, bridges and water supply. An additional benefit from such partnerships is the possibility of introducing a rational charging scheme at the same time.

Box 1. **The National Development Plan**

The main programme of the NDP addresses the *infrastructure deficit* with spending of Ir£ 17.6 billion. The priorities are social housing which accounts for 34 per cent of the total, roads (27 per cent) water and waste treatment (14 per cent) and public transport (13 per cent).

The *employment and human resources* component emphasises entry level education, training and measures targeted at re-integrating the unemployed into the workforce. Spending is set at Ir£ 9.9 billion.

The *productive sector* programme envisages Ir£ 4.5 billion for a major extension of spending on R&D as well as a continuation of existing support schemes for indigenous industries and spending on attracting FDI.

The *regional programme* (Ir£ 5.1 billion) seeks to promote growth in less developed areas and ease urban congestion in others.

The *rural development* plan will, *inter alia*, expand rural infrastructure at a cost of some Ir£ 3.4 billion.

Not all NDP expenditure is for capital projects and a number of spending programmes are not new initiatives *per se*, but a continuation of existing spending programmes.

Table 10. **Infrastructure indicators**[1]

	ACR 1998	ACR 1999	ACR 2000
		First quartile	
Container port traffic			3 (14)
		Second quartile	
Buses and coaches per capita			7 (15)
Major airport traffic			5 (15)
		Third quartile	
Average time commuting to and from work			8 (15)
Merchant fleet			9 (15)
		Fourth quartile	
Rail infrastructure indicator	17 (18)	17 (18)	13 (13)
Road infrastructure indicator	17 (19)	15 (19)	14 (14)
Transport infrastructure investment per capita			13 (15)
Passenger cars per capita			14 (15)
Road goods vehicles per capita			13 (13)
Rail vehicles per capita			12 (15)
Goods transported by road			14 (15)
Goods transported by rail			12 (15)
Road haulage (per capita)			14 (15)
Rail haulage (per capita)			14 (15)

1. Figures in brackets represent the total number of countries for which observations are available. The figures outside brackets are the ranking of Ireland. ACR refers to the Annual Competitiveness Report.
Source: Annual Competitiveness Report, Table 21.

64. The overall structure of the plan was subject to an *ex ante* evaluation by a joint Irish/EU group. Their assessment was generally positive[21] but did call attention to the need to closely evaluate the operational programmes as they were developed, especially environmentally-related projects where there appeared to be a resort to second best policies (see Chapter IV). The objectives of the plan in education and training were criticised as lacking clarity, while planned spending in the productive sector did not appear warranted in view of rapid growth. The cost effectiveness of the main industry aid schemes was also called into question. The general concern of the evaluation, and a concern more widely shared, is that the planned

increase in investment would go beyond the resources available in the construction industry (and also in infrastructure planning) and would be inflationary. Indeed, at the start of this year it appears that tender prices were rising at up to 15 per cent.

65. In the latest Stability Programme the authorities have stated their intention to lift general government investment from around 5.1 per cent of GDP in 2000 to nearly 5½ per cent this year and next. A deceleration will only be evident in 2003 when expenditures are scheduled to decline to some 5 per cent of GDP.

Attracting foreign direct investment

66. A key area of economic policy continues to be the support and encouragement of foreign direct investment. By way of illustrating the success of the policy, inward investment on a per capita basis in the two year period 1998-99 amounted to € 6 656, second only to Sweden and compared with an EU average of € 1 380[22]. Key elements in attracting FDI in the first place included a skilled and flexible labour force, the pro-business attitude of the government and its agencies (such as IDA) and the corporation tax of 10 per cent. However, the situation is changing. Following an agreement with the EU, the rate of corporation tax enjoyed by most FDI will be lifted to 12½ per cent, and starting this year foreign companies, which often have high salary levels, will be particularly affected by the decision to lift the ceiling on the payment of social security contributions. Moreover, as expected, higher wages are already leading to an outflow of some investment to cheaper locations, often in Central and Eastern Europe. But the most important change has been the rising shortage of labour which could be expected to dampen the inward flow of investment.

67. Policy is evolving rapidly in line with these changing circumstances with the aim of preserving Ireland's attractiveness as a location for investment. Ireland has been connected to the trans-Atlantic fibre optical cable with high speed access and data storage within the Republic. To overcome skill shortages which were projected in 1999[23], companies and the education authorities have been co-operating to improve training facilities and the number of places in areas such as information technology, life science and construction. In the IT area alone there are already an additional 5 000 places at third level institutions. At the same time, the government has introduced a skills-based work permit system for non-EU nationals and retraining is becoming a more important aspect of labour market policy (Chapter III). Finally, government agencies have intensified their effort to target companies that intend to make high value-added investment and encourage such firms to locate away from Dublin: around half the new job commitments from greenfield investments last year were in the lesser developed regions and 40 per cent of the new jobs were in salary ranges above Ir£ 25 000 compared with a quarter the year before. As before, an important instrument for attracting investment is the early provision by the agencies of offices and factories.

Fiscal policy: the political economy of a budget surplus

Prelude to the 2001 Budget: commitments and outcomes in 1999 and 2000

68. After adding back prepayment of pensions to ensure comparability, the general government surplus rose to around 3.9 per cent of GDP in 1999 which was stronger than anticipated at the time of the last *Economic Survey of Ireland* in 1999[24]. Stronger than expected tax receipts associated with rapid output growth were only partly offset by spending overruns, notably in public sector wages. At the same time, the debt/GDP ratio dropped to 50 per cent, half its 1993 level. Although it is extremely difficult to measure the structural budget balance (SBB), both the OECD and the Central Bank of Ireland (CBI) calculate that, *ex-post*, the budget position was counter-cyclical.

69. The budget for 2000 appeared to represent a shift in the fiscal stance with both the OECD (*Economic Outlook 67*, June 2000) and the CBI estimating that the structural budget surplus (*ex ante*) would decline to around 1 to 2 per cent of GDP in 2000. The budget included sizeable personal income tax cuts of 1.3 per cent of GDP, reflecting lower tax rates and a reduction in the proportion of tax payers subject to the top rate (from 46 to 37 per cent). The cuts were criticised for their effects on income distribution, but they did bring the rates towards those in the UK which is important for the Irish labour market. Moreover, a partial move was made toward individualisation of the tax bands aimed at encouraging female participation in the labour force, and a commitment was made to progressively move to full individualisation of the tax band[25]. This latter step proved controversial, some groups claiming that it discriminated against single earner households. The government subsequently introduced a home carer allowance for single income families with dependants, which probably weakened the positive impact of individualisation of the bands on incentives to work. Following announcements at the time of the 1999 budget, the standard corporate tax rate was reduced from 28 to 24 per cent in line with the governments commitment to unify the rate at 12½ per cent[26]. The budget also included significant increases in spending on social services and on infrastructure.

70. In assessing the 2000 budget and the Stability Programme, the EU made three recommendations as part of its Broad Economic Policy Guidelines (BEPG 2000):

- Budgetary policy should aim to be ready, already in 2000, to be used as an instrument to ensure economic stability given the extent of overheating in the economy, and to gear the 2001 budget to this objective;

- The growth in real public consumption should be brought down from the 4.3 per cent estimated in 1999 to 2.7 per cent in 2002, as shown in the 1999 updated stability programme;

- The authorities should ensure that the objectives of the National Development Plan are accorded high priority, given the necessity of meeting the infrastructure needs of a strongly growing economy, while at the same time achieving the stability objectives of fiscal policy.

In the event, the budget out-turn for 2000 proved much better than anticipated with the actual surplus amounting to some 4½ per cent of GDP so that the structural budget balance actually increased. Part of this strong performance was foreseen in the *Economic Outlook 67* in June, but certainly not its scale. Tax revenues exceeded the budget estimate by about 6 per cent (Ir£ 1.1 billion) with marked increases in both income tax and VAT receipts. Apart from growth turning out much higher than projected, auto sales (which carry a total tax rate of some 50 per cent) were very strong. On the other hand, expenditures were some Ir£ 440 million (½ per cent of GDP) higher than the budget, increased wage payments under the PPF accounting for about half the overrun with additional health care spending also making a large claim. At the time a number of observers felt that commitments, either explicit or implicit, could lead to a strong expenditure dynamic in future budgets.

71. In sum, fiscal policy over the past few years has risked, *ex ante*, setting either a neutral or even an expansive fiscal stance (depending on the measure, see below) although stronger than expected growth and cautious forecasts of tax revenues have led to a more restrictive stance *ex post*.

The budget for 2001

72. The budget for 2001 was set against the background of commitments in the PPF, the government's own objectives for continued tax reform and the desire to push ahead in implementing the National Development Plan. It was therefore characterised by a significant cut in taxes, and by a marked

rise in social transfers, wage payments and in capital spending (Table 11); in comparison with the government's baseline (the budget white paper) the exchequer surplus this year has been lowered by Ir£ 1 billion (Table 11). Details of the budget measures are presented in Box 2. The full year cost of tax cuts and the reduction in social security contributions is around Ir£ 1.25 billion while increases in social transfers and in child benefits amount to some Ir£ 850 million. Following the PPF agreement, the public sector wage bill is expected to rise by some 12 per cent with employment set to increase by 3 per cent, particularly in the health service. There were also cuts in indirect taxes amounting to some Ir£ 350 million in a full year, one consideration being to reduce the level of headline inflation in early 2001. Based on an estimated GDP growth in 2001 of 8.8 per cent and CPI inflation of around 4½ per cent, the budget assumed an induced rise in revenues ("buoyancy effect") of some Ir£ 800 million from the tax and spending measures.

Table 11. **Summary of current and capital budgets 2000-2001**
Irish pounds millions

	2000	2001	2001
	Projected outturn	Opening as per White Paper	Closing position
Central fund	3131	3080	2680
Supply services	13303	14842	15697
Current spending	**16434**	**17921**	**18377**
Tax revenue	21500	24450	23990
Non-tax revenue	440	532	532
Current revenue	**21940**	**24982**	**24522**
Current budget surplus	5506	7061	6145
Capital borrowing	3059	3568	3607
Exchequer surplus	**2447**	**3493**	**2538**
General government surplus (% of GDP)	4.7	n.a	4.3
General government debts (% of GDP)	39.0	n.a	33.0

Source: Budget 2001, Ministry of Finance.

Box 2. **Summary of budget measures, 2001**

With respect to personal income taxation,

- The standard and higher rates of income tax were reduced by 2 percentage points to 20 and 42 per cent respectively
- The single person standard tax rate band was widened by Ir£ 3 000 to £ 20 000 with a consequential increase for double earners, and the married one earner band was widened by Ir£ 1 000 to £ 29 000
- The basic tax credit and the pay-as-you-earn allowance were increased

The social welfare package increased old age pensions by up to 11.5 per cent and other welfare payments by 10.5 per cent. Very large increases (around 60 per cent) were brought in for child benefits.

The standard rate of VAT was reduced by 1 percentage point and there were reductions in some petrol and diesel excises. The standard employee rate of social insurance was reduced from 4½ per cent to 4 per cent On the other hand, the ceiling on wages for employer social security contributions was abolished.

The standard rate of corporation tax for trading income was reduced to 20 per cent, in line with agreements with the EU. For small enterprises where income does not exceed Ir£ 200 000 per annum, the rate has been reduced to the medium term target of 12½ per cent.

73. Estimates of the general government sector for 2001 on a national accounts basis were released with the budget papers (Table 12). The surplus on this broader definition is projected to increase only marginally and to fall by some 0.4 per cent of GDP (Table 13). With the public sector wage bill rising by 12 per cent current expenditures on goods and services are set to rise 10 per cent this year. Investment outlays are budgeted to increase 28 per cent reflecting higher construction spending for the NDP, bringing the overall growth in spending up to some 13 per cent. Reflecting the attempt to prioritise spending, productive sector investment (see Box 1) is being cut, partly offsetting the rapid growth in projects such as roads and housing. Direct income tax is projected to grow by only some 8 to 9 per cent as opposed to nominal GDP expansion of some 14 per cent owing to the tax reductions. The cuts in 2001 will only be operative for 9 months as the tax year switches from the March/April period to a calendar year. The revenue depressing effects of the tax cuts (and some social expenditure) will be fully felt in 2002.

74. In assessing the budget, several aspects need to be considered: the microeconomic effects, the medium term framework, and the macroeconomic impact.

Microeconomic aspects

75. An important feature of the budget is the further progress in income tax reform (see Box 3). Over recent years the disincentives for work at both ends of the income distribution have been progressively eased, and the marginal tax rates have been lowered (Figure 13). Tax rates are now broadly in line with the UK. This is important since the two labour markets are closely linked and it will also raise incentives for cross border day workers from the North. Nevertheless, 23 per cent of earners remain in the top tax bracket. Although the tax reforms have undoubtedly contributed to the marked rise in the labour force participation of women in recent years, and might also have facilitated immigration, it may not be realistic to suppose that the growth rates can be maintained by the additional measures. Indeed, as noted in Chapter I, the growth rate of the labour force has already started to slow. Insofar as the cost of child care may be a major factor in reducing female labour force participation, the budget package serves to alleviate the problem by significant increases in child benefits and the widening of the standard income tax band.[27]

Table 12. **Budget estimates of the general government account**
Irish pounds, millions

	1999	2000	2001
CURRENT ACCOUNT			
Receipts			
Taxes on income and wealth	9324	10520	11402
Social insurance and health contributions	2910	3424	3729
Taxes on expenditure	9257	10910	12484
Total taxation (excluding taxes on capital)	21491	24854	27615
Gross trading and investment inc	741	981	1115
Current transfers from world	460	451	330
Misc receipts	1460	1620	1631
Total receipts	24152	27906	30691
Expenditures			
Subsidies	719	820	820
National debt interest	1698	1633	1687
Current transfer payments			
to residents	7225	7840	8826
to ROW	519	556	678
Current expenditure on goods & services (excluding depreciation)	4583	5225	5851
Current expenditure on goods and services by local authorities	5133	5853	6363
Total expenditure	19877	21927	24225
Gross savings	4275	5979	6466
CAPITAL ACCOUNT			
Receipts			
Taxes on capital	509	814	943
Loan repayments	3793	1355	69
Capital transfers from ROW	509	513	796
Capital receipts	494	593	711
Borrowing	-2211	-4578	-3367
Total receipts on capital account	3094	-1303	-848
Capital receipts less financial transactions	1512	1920	2450
Expenditure			
Grants to private sector	1686	550	353
Other transfer payments	365	417	640
Debt redemption	2872	418	417
Loans and purchase of share capital	179	159	185
Gross physical capital formation	2248	3123	4011
Capital payments to ROW	16	7	9
Total expenditure on capital account	7366	4674	5615
Capital expenditure less financial transactions	4315	4098	5014
Current saving	**4273**	**5979**	**6465**
Capital saving	**-2803**	**-2179**	**-2565**
Net lending	**1470**	**3800**	**3900**

Table 13. **The 2001 update Stability Programme**

	2000	2001	2002	2003
	As percentage of GDP			
General government current expenditure	25.9	25.4	24.5	23.5
of which:				
Interest payments	2.0	1.8	1.4	1.2
Goods and services	12.3	12.1	12.2	12.0
Other transfers	11.5	11.5	10.9	10.4
General government current resources	33.3	32.5	32.5	32.7
of which:				
Central government taxes	27.2	26.6	26.6	26.8
Social security receipts	4.2	4.1	4.3	4.3
Miscellaneous current receipts	1.8	1.8	1.7	1.6
Total government investment	5.1	5.4	5.5	4.9
Capital resources	2.4	2.6	1.7	1.1
Capital deficit	2.7	2.8	3.8	3.7
Current account surplus	7.4	7.0	8.0	9.2
Capital account deficit[1]	2.7	2.8	3.8	3.7
Contingency[2]	0.0	0.0	-0.4	-0.8
General government surplus	4.7	4.3	3.8	4.6
of which:				
Primary surplus	6.7	6.1	5.4	6.0
General government debt	39	33	28	24

1. This the net amount of investment that must be financed by Government after internal capital resources and EU capital transfer payments are taken into account.
2. This is a provision made against factors that may impact on the Budget but cannot be quantified at this stage.

Source: Ministry of Finance.

Box 3**. Tax reform**

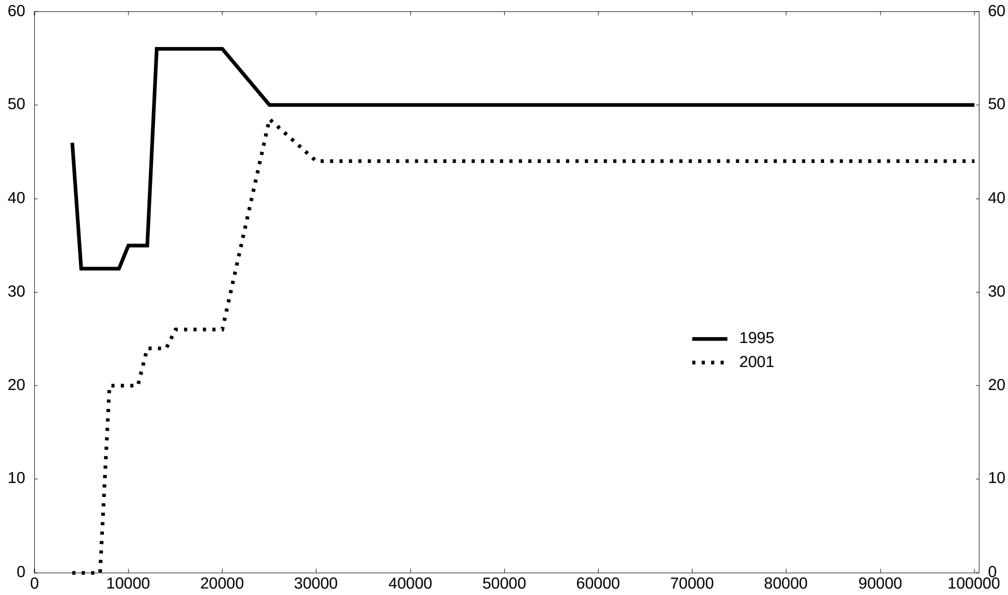
The *Economic Survey of Ireland*, 1999, noted that the tax system was transformed in 1999 from a hybrid allowance system (where non-standardised allowances were dominant) to a hybrid credit system where standardised allowances are dominant. It noted that the government intended to adopt a complete tax credit system in the future. The budgets since then have moved in this direction. Nearly all personal tax allowances have been converted to tax credits, with the initial credit being set at a level which leaves the position of higher-rate taxpayers generally unchanged and improves the position of those at the standard rate. This has resulted in a significant increase of the income level at which people enter the tax net, which is € 183 per week in 2001/2002 compared with € 90 in 1997/1998. The target is to remove all those earning the minimum wage (€ 218 per week) from the tax net.

Since 1997, the standard rate and the top rate have been reduced by 6 percentage points over the last three years and are now 20 and 42 per cent respectively. This lowers the marginal tax rate and improves the incentive to work.

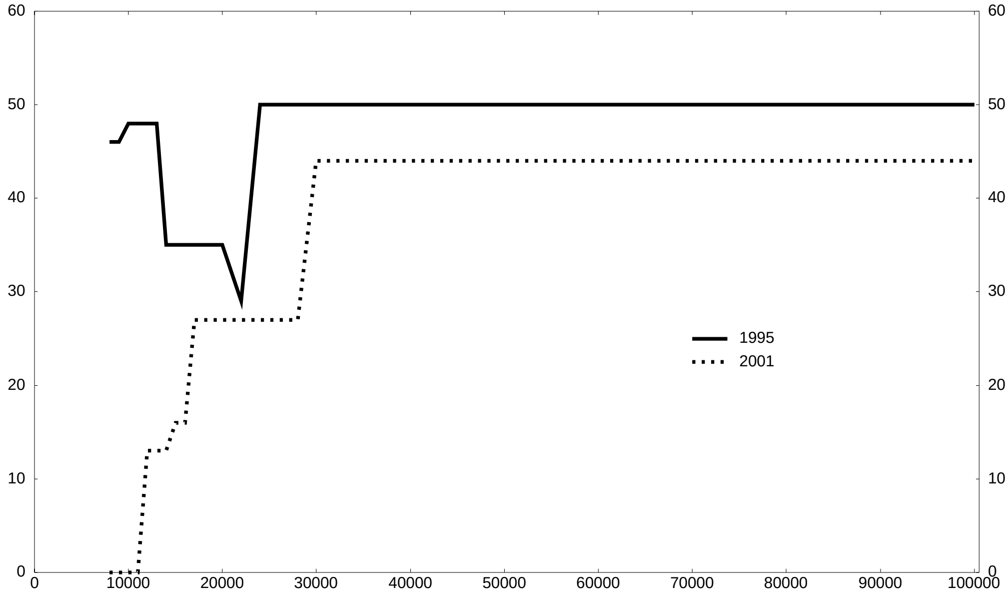
The standard rate band has been widened. From 1980 married couples had double the personal allowance and rate bands of single people, with full transferability between spouses. This often resulted in the second spouse facing high marginal tax rates on all income when taking up employment. It also meant that the width of the tax bands was held down for cost reasons, bringing progressively more single people earning less than the average industrial wage into the top tax rate. In the last two budgets, therefore, the standard rate tax band has been widened with the objective that each person should have their own non-transferrable standard rate band.

Figure 13. Marginal tax rates 1995 vs. 2001

A. Single taxpayer on full-rate PRSI



B. Married taxpayer, 1 income, 2 children



Source: Department of Finance.

76. The budget includes a sharp increase in expenditures on construction but this is an area marked by shortages and by rapidly rising wages and prices. If the authorities are to keep price rises in this sector, and hence construction spending, under control it is important that the budgetary plans be accompanied by administrative and perhaps other measures to increase the import content of construction services. The authorities are pursuing this path by increasing the size of projects being tendered in order to encourage large international firms to participate and has eased entry restrictions on their workers

The medium term perspective: the Stability Programme

77. The 2001 budget is set in the framework of a decline in the surplus this year and next. Against the background of official estimates showing an economy gradually slowing from 8¾ per cent GDP growth this year to 5¾ per cent in 2003 and inflation steadily declining from 4½ to 2½ per cent respectively, the government's Stability Plan in the context of EMU foresees an annual average surplus of 4¼ per cent. This projection takes into account a steady fall in net budgetary transfers from the EU from 0.6 per cent of GDP in 1999 to a negative 0.3 per cent (*i.e.* a net payment with contributions exceeding transfers) in 2003. The general government surplus is projected to decline again in 2002 before recovering to 4.6 per cent in 2003 (Table 13). Included in the projection is a contingency for wages at the end of the PPF period in 2003 and the payment of 4 per cent to the public sector employees in 2002 for achieving performance targets. A notable feature of the government's medium term plan is the slowdown in growth of non-interest current expenditures. They are projected in the Stability Plan to decline as a share of GDP from around 23¾ per cent this year to 22½ per cent in 2003 with the share of current spending on goods and services constant at around 12 per cent (Table 13). At the same time, the government has reiterated its view that " public expenditure policy has a key contribution to make in containing inflation by underpinning the recent agreement with the Social Partners in relation to public service provision and social inclusion" (*Ireland – Stability Programme*, 2000).

78. How the Stability Programme will be implemented, especially as regards the expenditure components, is unclear. The government has abandoned its previous plan to reinforce the multi-annual budgetary framework through publication of agreed financial envelopes on departmental spending. They have also abandoned the 4 per cent ceiling on average annual net current spending growth over the life of the current administration[28]. If they had kept to this limit, one estimate is that the baseline surplus in the white paper would have been some Ir£ 750 million higher at around Ir£ 4.25 billion[29].

Macroeconomic impact

79. The 2001 budget results in a further significant increase in after-tax household income. For a single worker on the average industrial wage, the Budget estimated that disposable income will rise this year by 13½ per cent, of which pay increases amount to 5½ per cent with a further 2 per cent in April[30]. The same worker had a 13 per cent increase in 2000 due in part to tax reductions in the 2000 Budget. One observer has estimated that household disposable income this year will rise by some 14 per cent with the current tax cuts contributing 3 percentage points. Incomes have received a further boost this year with the cut in the VAT standard rate by 1 percentage point. For many private sector workers, wage increases are higher than those set in the PPF. Looking at the situation over a longer period it seems that the tax cuts have effectively corrected for the fiscal drag associated with rising prices and wages: the ratio of direct tax revenues to personal income has remained relatively steady at 20 per cent. However, in the context of this year it is arguable whether the time is suitable to weaken what is nevertheless an automatic stabiliser.

80. The most commonly used indicator of the stance of fiscal policy is the change in the structural (or cyclically-adjusted) budget balance (SBB) which indicates the government's discretionary fiscal actions by

first estimating and removing the cyclical component. There are, however, a number of ways of calculating this indicator and there are other methods such as estimating the baseline budgets (see Box 4). In recent years the various methods have yielded conflicting results[31]. The Secretariat has adopted the SBB approach which is also used by the government as reported in its budget papers and in the Stability Programme and by the Central Bank of Ireland. Although it is hedged with numerous qualifications, the government's own calculations point to an easing of the fiscal stance this year and next with a tightening in 2003 (Table 14), a result broadly similar to that of the Secretariat.

Box 4. **Estimating fiscal stance**

The two general approaches to measuring fiscal stance are the gap and elasticities approach and the incremental method. The former approach must first estimate the output gap which involves deriving a potential output measure. Structural revenues and expenditures are then derived by multiplying actual revenue (expenditures) by the output gap weighted by an elasticity which reflects the sensitivity of that particular item to changes in GDP. In implementing this procedure the OECD first uses a Kalman filter approach to derive an estimate of productivity growth rates and the NAIRU and uses a production function to estimate the output gap. The main elasticities used to calculate the structural budget balance are presented in Van den Noord (2000).[1]

The Central Bank of Ireland focuses on the primary SBB in order to correct for the significant shift in interest rates following the launch of the Euro which has impacted on debt servicing costs.[2] GDP is corrected for net government expenditure since it is set by government and not directly affected by the private sector business cycle. For estimating potential output, they used a Hodrick Prescott filter extending the end point forecasts to 2005 while using two values for the smoothing filter lamda to test for sensitivity.

The "incremental" approach is used in Ireland by ESRI. The Hermes macro-econometric model is used to derive the budget balance which would have been observed in the absence of budgetary changes: it is an indexed budget. The difference between the actual and indexed budget is a measure of the change in discretionary policy. It is assumed that in the absence of policy change, revenues and cyclical expenditure items will grow in line with actual output growth while non-cyclical expenditure items will grow in line with trend output growth. Other techniques include the Blanchard measure which defines discretionary change as the value of the primary surplus which would have prevailed were unemployment at the same value as in the previous year, minus the primary surplus in the previous year, both as a ratio of GNP each year. Another technique involves the calculation of a structural vector autoregression (SVAR) to decompose the fluctuations in the deficit to GDP ratio into fluctuations arising from shocks to output and those arising from shocks to the deficit itself.

Kearney *et al.* have compared all measures and concluded that the SVAR was the least reliable indicator. Through the 1980's and early 1990's different techniques pointed in the same direction but in recent years the indicators diverge with the indexed approach indicating an expansionary stance and with the gaps/elasticity approach pointing either to some tightening or to neutrality. They concluded that one reason for the divergence is the high potential growth rate calculated by, among others, the EU, the OECD and the IMF.

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1. For a detailed description see P. Van den Noord, "The six and role of automatic fiscal stabilisers in the 1990's and beyond", *OECD Economics Department Working Paper*, No. 230, 2000. For a description of the Kalman method and its application in calculating the NAIRU see Economic Outlook, No. 67, 2000.

2. D. Cronin and J Scally, "Assessing Irish fiscal policy in EMU: The role of the structural budget balance", *Central Bank of Ireland*, Autumn, 2000.

Table 14. **Cyclically adjusted budget balance**
Per cent of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002
OECD									
General government balance									
Net lending	-2.0	-2.2	-0.1	0.7	2.2	2.1	4.7	4.5	4.5
Net primary balance	2.6	1.9	3.1	3.7	4.5	2.6	4.7	4.4	4.3
Cyclically-adjusted balances[1]									
Net lending	0.1	-1.0	0.9	0.8	1.8	1.3	3.3	3.1	3.2
Net primary balance	4.4	2.9	4.0	3.8	4.1	1.8	3.2	3.0	3.0
Gross general government debt									
Financial assets	87.7	80.0	74.3	65.1	55.0	50.1	39.3	29.5	21.9
NATIONAL AUTHORITIES									
Cyclically adjusted net lending				0.3	1.6	3.4	3.6	2.9	2.7

1. The structural balance was improved in 1994 by 0.8 per cent of GDP by a tax amnesty and worsened in 1995 by 0.7 per cent of GDP due to a one-off settlement of a legal award. The pre-payment of pension liabilities depressed the structural balance in 1999 by 1½ per cent of GDP. One-off receipts of payment for tax liabilities in past years increased the cyclically-adjusted surplus by ¼ per cent of GDP in 2000.

Source: OECD and Department of Finance.

81. It is worth emphasising the specific difficulties in calculating a SBB for Ireland. First, the smoothing technique results in a great deal of the recent pick up in growth rates as being cyclical, leading to a significant output gap[32]. Some of the pick up could simply be the economy moving to a higher level of output characterised by greater capital and a higher participation rate of the population. As noted in Chapter I, it is extremely difficult to estimate either the NAWRU or the NAIRU for Ireland. Interpreting the SBB in change form as done here removes some but not all of these difficulties. Second, the method adjusts changes in revenues for cyclical movements and not explicitly for policy changes. The resulting figures should therefore be regarded as cyclically-corrected budgets rather than as structural budget balances. One-off payments and receipts need to be considered. The pre-payment of pension liabilities noted above artificially depresses the calculation of the SBB by some 1½ per cent of GDP and needs to be added back to the calculated SBB in 1999 (Table 14). There were also a number of other special measures in 2000 which need to be considered. Thus Ir£ 173 million (0.2 per cent of GDP) were received in payment for tax liabilities in past years, and this year and in 2002 a change in the alcohol excise duty and a shift in the tax year result in lower income being registered in 2001 and more in 2002

82. The budget documentation suggested that, *ex ante*, the fiscal stance was set to loosen this year and would thus be pro-cyclical (Table 14). The EU also concluded in its review of the Stability Programme in January that the budgetary plans for 2001 are expansionary and pro-cyclical. Whether it will prove to be expansionary, *ex post*, remains open depending on expenditure control, which in recent years has slipped, and whether tax revenues have been under-estimated as in the past. OECD estimates, which incorporate different income projections, indicate that the fiscal stance in 2001 is only roughly neutral once the effect of one-off payments of tax arrears in 2000 is taken into account.

Broader considerations: the political economy of a surplus

83. The Stability Programme projects a continuing budget surplus through to 2003 (as do Secretariat projections), with general government debt (ESA95 basis) falling from some 39 per cent of GDP in 2000 to 24 per cent in 2003. Moreover, long term scenarios prepared by the authorities (as well as the Medium Term Baseline of the Secretariat) point to a reasonable possibility that the surplus will continue for some time to come. This situation raises a number of policy issues including:

- Why run a surplus at all rather than raise expenditures or cut taxes?
- What should be the balance between debt repayment and the accumulation of financial assets? and
- What will these decisions and their institutional form imply for household behaviour and for the political economy of running a surplus?[33]

84. From the political economy perspective, the authorities are under pressure to cut the surplus and, as noted above, it is already considerably lower than on the basis of no policy change. There are pressures to raise public sector wages (see below), to increase expenditures on health and on education (at least to levels in other countries which are regarded as appropriate examples) and to invest at a more rapid rate, in particular on infrastructure. At the same time, the government has promised further steps to individualise the tax system, thereby lowering the number of people taxed at the highest rate, which would also be expensive. Conjunctural considerations, especially the generalised excess demand for labour, would argue for a tighter fiscal stance in the short term. Tax commitments under the PPF have thus been bought at the cost of restricting the policy leeway in deciding the appropriate level of public expenditures (*i.e.* size of government). In the longer term there is a need for a sizeable general government surplus. Experience in many OECD countries shows that the increase in future spending obligations due to population ageing is

significant and likely to be underestimated. Even though the pressure from this source is less marked in Ireland than most other OECD countries, the tax burden for future generations is bound to increase, and perhaps more than expected. In this context it makes sense to maintain a large fiscal surplus for some time to come so as to alleviate the future tax pressures. Such tax smoothing over time contributes to enhancing sustainability of high economic growth in two ways, first by safeguarding work incentives of future generations, and second by reducing excessive claims on existing resources and thereby slowing the pace of real appreciation of the exchange rate[34].

85. At this stage, the government has decided to repay debt but at the same time will acquire a significant sum of financial assets in the form of an independent pension fund. Ireland will face a demographic problem somewhat later than most other OECD countries but it nevertheless has decided to set aside at least 1 per cent of GNP each year from 2001 to 2055 to help cover the cost of ageing[35]. It represents only a partial move from a pay-as-you-go system to a fully funded one. Contributions by the government are to be held by an independent fund (National Pensions Reserve Fund) managed by a commission with a strictly commercial mandate: "to secure the optimal financial return, provided the level of risk to the moneys held or invested is acceptable to the Commission"[36]. The assets of the fund can be drawn down by future Ministers of Finance from 2025, increasing in line with the growth in the share of over 65s. Thus the fund will help to smooth for a long time the financial burden arising from additional pension commitments. Additional funds may be paid in at any time by the government, and indeed the fund already has Ir£ 5 billion (6 per cent of GDP) from contributions (in part from privatisation revenues) in 1999 and 2000.

86. In some sense the economics of the decision are simple: can the government raise more from financial assets -- and especially foreign assets -- than from retiring debt? The practical question is, however, somewhat different: which structure of debt and assets and institutional arrangements will both minimise the pressure to reduce general government savings and minimise the danger that households might save less? The contributions from central government revenues to the pension fund are classified in the general government sector and are therefore a financial item (*i.e.* below the line) and have no influence on the general government surplus. However, they are above the line for the purpose of the exchequer accounts and therefore serve to make clear to the population that, on an accrual basis, the surplus is not quite so large. In addition, interest income earned by the fund will be regarded as general government income even though it will be excluded from the exchequer accounts[37]. For these reasons it may be desirable to set aside more funds to meet other future contingencies such as higher healthcare spending due to population ageing.

Restructuring the public sector

Wage setting and performance

87. Rapid rates of growth and the accompanying modernisation of the economy have placed the public sector under great pressure. This is most apparent with respect to wages and employment. The public sector is finding it difficult to recruit and to hold employees with wages considered to be below those in the business sector. The public sector itself has also been part of the problem, expanding by some 3 per cent in 2000 and with a projected further rise of 1½ per cent this year (Table 15). Nevertheless, many public departments and institutions have unfilled vacancies. Problems in recruiting and holding labour have been reflected in pressure to increase wages and industrial unrest in the health sector, transport and in teaching. Nurses gained large pay increases in the period 1994-1999, far beyond the overall wage agreement[38], but this did not resolve shortages because pay increases were concentrated on the junior nurses and not where the problem really lay: senior nurses[39]. Likewise, a key issue in teaching is the

shortage of particular skills even though negotiations are covering teaching in general. As in many other countries in the past, the issue of cross sector and historical relativities needs to be resolved and not simply suppressed via national wage agreements.

88. In dealing with the pay issue the government is addressing two areas of concern: the wage system and public service performance. With respect to wages, a body to benchmark public service pay and jobs against the private sector has been established under the PPF agreement. It will not only examine relativities with the private sector for 40 key public service groups, but also examine the jobs themselves and the conditions of employment. The Benchmarking Body is due to report by June 2002. One quarter of any increases recommended will be paid with effect from 1 December 2001 and negotiations on the implementation of the balance will commence on receipt of the report. However, it is unclear at this stage to what extent the body has the remit to recommend more far reaching changes about the determination of public service pay and the general conditions of public sector employment. At the end of the day, this is a question for the authorities to deal with in the context of modernisation.

89. Reform of the public sector has been underway for several years with the Strategic Management Initiative which seeks to improve the way the public service is managed and how it assesses its output. Regulatory reform is being addressed and the authorities have set up a group to introduce more consistent regulatory impact assessment in the formulation of regulations. Moreover, the legal system is being streamlined and expenditure reviews have been introduced[40]. Against this background, the authorities have sought to establish a clear link at organisational level between the final phase of the current round of pay increases and the public service modernisation programme. Under the terms of the current wage agreement payment of the third phase increase of 4 per cent will be dependent on specific performance indicators having been established by 1 April 2001 with progress being reported on and assessed by 1 October 2002. Once agreed by the Partnership Committee in each organisation, they will be checked by the relevant Service Quality Assurance Group to ensure that they are sufficiently challenging. The Quality Assurance Group in the relevant sector, which includes external/customer representatives, will verify that the reported progress at organisational level has been achieved. Clearly a great deal will depend on how the targets are set and the rigour of the assessment process. The need for substantially improved performance is particularly apparent in the public health sector where expenditures have risen from Ir£ 2 billion in 1997 to Ir£ 5.3 billion in 2001 without a noticeable improvement in performance (Box 5).

Box 5. **The public health sector**

Despite a large increase in budget allocations, the health sector remains subject to criticism in areas such as waiting lists and delays in accident and emergency departments. About 60 per cent of the increased spending since 1997 is accounted for by price changes including wages and general inflation. In addition, a large part of the 40 per cent residual is accounted for by support services, more defensive medicine and by altered conditions of employment. Moreover, budget increases have simply led to the uptake of new procedures and to more hospital interventions without any corresponding decline in waiting lists.

In areas where there has been an expansion in state services, a proportion is merely replacing work previously performed by the voluntary and informal sectors. The marked increases in labour force participation by women in recent years has reduced the pool of helpers available for voluntary organisations, which have had to increase the number of paid employees while recouping expenses from the state.

Performance indicators linked to a pay increase might help to improve output although as elsewhere deeper reforms are also necessary.

Table 15. **Public sector employment**

	1995	1996	1997	1998	1999	2000	2001	2002 projected	2003 projected
Civil service	**30155**	**31282**	**31030**	**30856**	**31562**	**32733**	**33583**	**33733**	**33933**
Non-industrial	28370	29491	29237	29083	29439	30610	31350	31500	31700
Industrial	1785	1791	1793	1773	2123	2123	2233	2233	2233
Garda Siochana (police)	**11372**	**11391**	**11342**	**11694**	**11931**	**12195**	**12228**	**12228**	**12228**
Gardai	10818	10825	10810	10980	11236	11500	11678	11848	11848
Recruits	437	455	428	615	550	550	500	330	330
Traffic wardens	117	111	104	99	145	145	50	50	50
Defence forces	**14355**	**14137**	**13474**	**12934**	**12610**	**12330**	**12211**	**11961**	**11961**
Military	13015	12814	12108	11674	11365	11161	11061	10811	10811
Civilian employees of the Dept. of Defence	1340	1323	1366	1260	1245	1169	1150	1150	1150
Education	**60436**	**61744**	**62100**	**63375**	**64415**	**65937**	**67217**	**68587**	**69500**
Non commercial semi-state bodies	**8540**	**8501**	**8792**	**8815**	**9219**	**9680**	**10476**	**10273**	**9517**
Health services	**63939**	**65169**	**65755**	**67895**	**69726**	**75051**	**79551**	**82551**	**83551**
Local authorities	**26540**	**26479**	**26500**	**26500**	**26900**	**27400**	**27500**	**27600**	**27700**
Officers	9646	9875	9987	10100	10300	10490	10533	10571	10610
Servants	16894	16604	16513	16400	16600	16910	16967	17029	17090
Public service	**215337**	**218703**	**218993**	**222069**	**226363**	**235326**	**242766**	**246933**	**248390**
(Growth rate)	1.6	0.1	1.4	1.9	4.0	3.2	1.7	0.6	
Comm. Bodies	**62793**	**61883**	**60459**	**58915**	**55932**	**47121**	**47249**	**47240**	**47440**
Public sector	**278130**	**280586**	**279452**	**280984**	**282295**	**282447**	**290015**	**294353**	**295830**
(Per cent of total employment)	21.9	21.0	20.4	18.6	17.5	17.1	16.8	16.4	

Figures are on 1 January each year and are full-time equivalents.
Source: Ministry of Finance.

Regional policy and decentralisation

90. With rapid economic growth in great measure concentrated around the Dublin area (see Chapter III) regional concerns have become important and these are expressed in both the PPF and also in the National Development Plan. A national spatial policy is under preparation although many of the key infrastructure location decisions have already been taken. Less attention has been given to fiscal arrangements in support of regional objectives. For the purpose of EU funding, the country has been divided into two regions —the Southern and Eastern Region which qualifies for a phasing out regime for Objective 1 funding up to end of 2006, and the Border, Midland and Western Region which has Objective 1 status for the full period. Following this designation, two new regional assemblies were established in 1999 with the primary function of managing their respective Regional Operational Programmes under Ireland's National Development Plan. In addition to the regional assemblies, there are also eight regional authorities (established in 1994) operating at regional level which complement 34 county/city councils and 80 town authorities. Local authorities derive their funding from a range of sources, including commercial rates, local charges, motor taxation and State grants (both capital and current). Funding for the administrative costs of the Regional Assemblies and Regional Authorities is secured primarily through contributions on a per capita basis from the constituent local authorities in the Region or Assembly functional area. The ongoing implementation of a major programme of local government reform has, *inter alia*, addressed a range of local government issues including funding accountability, efficiency, etc.[41]

91. The operation of local government is itself in need of reform if it is to meet the challenges posed by growth and modernisation. The *OECD Regulatory Reform Review of Ireland* noted that local government is both a producer and supplier of public services to a greater extent than in many other countries. Many areas such as the maintenance of social housing, road maintenance, engineering and architectural design of public infrastructure, waste disposal and water supply, which in other countries are provided by the private sector, are carried out in Ireland by a fragmented local government sector. Each small local government unit is responsible for both the production and supply of sanitary services to local communities[42]. The fragmentation of the industry has meant that it has never reaped the scale economies which are evident in the growth of public utilities in other countries. With respect to the supply of other services, the absence of competition, for example in housing maintenance services provided by local governments, reduces quality and raises costs. Greater use should be made of outsourcing and market testing but for this to happen local governments will need to become more proficient in tendering and in contract specification. Such procedures would serve to deal with the widespread fear that outsourcing will lead to lack of quality.

III. REGULATORY REFORM AND PROGRESS IN STRUCTURAL POLICY

92. Rapid growth has raised a number of issues including pressure on infrastructure, rising house prices (Chapter I), congestion and urban sprawl. The government's response has been to improve the functioning of the real estate market both through fiscal instruments and by changes in the regulatory environment (*i.e.* the planning system). Growth has also led to increasing tightness in the labour market and to a dramatic fall in the unemployment rate. The changed labour market regime has important implications for reorienting the active labour market policy measures which have been aimed at reducing the number of unemployed. In other areas, the demands on regulatory and structural policy represent a continuation of past trends occasioned by technological advance, EU regulatory initiatives and concern by the authorities to ensure competitiveness in the long run. There has been steady progress over the years in deregulation in terms of reducing barriers to entry and entrepreneurship and improving market openness. Indeed, the *Regulatory Reform Review of Ireland* concluded that Ireland has a light-handed regulatory environment. However, competition policy has traditionally been weak and needs to be strengthened, while pro-market regulatory regimes in some of the network sectors and in transport remain to be completed. This chapter first reviews recent policy initiatives in the housing/real estate sector and then discusses the changing policy environment in the labour market and in training. The third section covers the area of competition and network regulation and briefly reviews recent developments in financial market regulation. A summary of recommendations from both the previous *Surveys* and the *Regulatory Reform Review* and an assessment of progress is provided in Table 16.

Improving the performance of the housing and real estate market

Policy concerns

93. In addition to rapidly rising house and land prices (Chapter I), the authorities have also been concerned about the spatial dimension of growth, which includes the location of business activities as well as the spread and nature of housing. The dramatic rise in house construction in recent years has been associated with urban sprawl. Much of the dynamism in the new Dublin economy is deriving from developments along a ring motorway. This development of an 'edge city' is symptomatic of developments in many urban areas, but has happened with particular rapidity in the Dublin region. Except for some apartment development in the inner city, most housing is of the low density suburban type, and this process of urban sprawl and dispersal seems to be accelerating, with much of the development leapfrogging the established commuter belt. Between 1997 and 1998, the level of planning permissions for new housing in the outer Leinster counties (60 km+ from Dublin) grew by 40 per cent, compared with a 15 per cent growth in the Dublin region, and long distance commuting by rail and bus, but mainly by car, is becoming characteristic[43].

Table 16. **Implementing structural reform -- an overview of progress**

Previous survey's recommendations	Action taken since 1999	Assessment/recommendations
I. The tax system (see Box 3 for detail)		
- Reduce the marginal income tax rates	Both standard and top rates have been lowered, the standard rate band widened, and the tax bands partially individualised.	Improved incentives to work, particularly for women. Reduce rates further and achieve full individualisation of the bands.
- Reduce the standard corporate tax rate	Reduced in line with the scheduled unification at 12½ per cent by 2003.	Improve incentives to invest. Stick to the schedule.
II. The benefit and wage formation systems		
- None	Introduction of a home carer allowance for single income families with dependants.	Weakened incentives for spouses to work.
- Soften the impact of the introduction of national minimum wage on employment and incentives to attend the school	The national minimum wage introduced in April 2000 with lower rates for inexperienced youth.	Impact negligible given that the level was not high. Future adjustment should be prudent.
III. Active labour market policies		
- Rationalise the schemes currently in operation	Wage subsidy programmes have been dropped	A welcome step.
- Integrate the activities of the government agencies assisting the unemployed	The local employment service has been combined with the FAS. The FAS is restructured with more emphasis on guidance and placement service.	Both target groups and desired outcomes should be defined.
- Focus on targeted employment subsidy programmes	Community Employment Scheme is planned to be phased down.	Clear progression from social employment to training places and market placements will be required.
- Emphasise specific skills training programmes	The National Training Fund was established in 2000. The fund will be used to help finance costs of upgrading skills at firm.	There should be focus on certain skills visibly in short supply.
IV. Enhance product market competition		
- Reduce the role of state-owned firms	Telecom fully deregulated. The electricity supply market will be fully liberalised in 2005.	The Commission for Electricity Regulation should cover all aspects of economic regulation of the electricity and gas undertakings.
- Give the Competition Authority the power to review mergers without a referral from Minister for Enterprise, Trade and Employment (DETE).	New law will come into force in late 2001 to transfer responsibility from DETE to the Competition Authority	This will bring the Irish legistration in line with best practices in many other OECD countries. But the appointment and budget of the Competition Authority should be separated from DETE.

94. There are substantial costs implied by this pattern of development, including long commuting times for the new householders, increased pressure on transport and water infrastructure, with increased congestion, and, in the case of car transport, increased emissions into the air, and loss of amenity and landscape value in the countryside. Some development is taking place in small villages that lack the infrastructure and other capital to absorb such development so that external costs are being imposed on existing residents. In addition, increased car ownership and the concentration of activity in the Dublin area have increased congestion: average vehicle speeds in peak-time traffic have fallen by 23 per cent (from 18 to 14 km/hr) resulting in an average increase in journey times of 62 per cent. Moreover, businesses have become more and more concerned about the overall transport situation. It is estimated by the Dublin Transportation Office that congestion costs in terms of lost time in Dublin alone amount to Ir£ 500 million per annum.

95. In dealing with rising prices, the authorities have focused on measures to increase the elasticity of supply of both land and housing through both fiscal and planning measures, while seeking to control speculative demand. As noted in Chapter I, demand has been strong due to both demographic factors and rising income[44]. Urban sprawl has been addressed by changes in planning laws rather than through fiscal measures. An important factor encouraging the urban sprawl is the tax system: domestic rates (property taxes) and water charges have been abolished so that residents in new housing developments are not being charged the full cost of maintaining the extension of infrastructure and local services.[45]

Policy measures

Planning regulations and provision of infrastructure

96. Zoning procedures have been altered with a new law requiring each planning authority to draw up housing strategies by August 2001 and ensure that there is a sufficient stock of zoned serviced land to meet demand over the period of the local plans. The Act also enables local authorities to acquire up to 20 per cent of land zoned for residential development at existing value to secure the provision of social and affordable housing. The provision amounts in effect to a development tax. Strategic Development Zones for residential development with fast track provision of infrastructure and planning approval may also be specified and developers will face fines if they have not developed their land in a set period. Large tracts of land have also been zoned by the four Dublin authorities along key transport corridors. Moreover, planning has become more focused with the issuing of *Guidelines for Planning Authorities on Residential Density*, which are intended to increase the density of urban areas. Integrated area plans are also being prepared by local authorities based on criteria provided by an expert advisory panel including, urban design, sustainable land use, education, training, local economic development, environmental improvement and traffic management. In a word, there is a systematic attempt to use the planning system to internalise external costs and foster the production of external benefits although the lack of explicit local charges goes in the other direction. Finally, a National Spatial Strategy is currently under preparation. Although the regulatory environment has been changed, there is a long way to go until it is fully effective. Institutions need to be developed and the lack of capacity in the planning area addressed.

Fiscal instruments

97. At the time of the last *Economic Survey of Ireland, 1999,* house prices were already rising rapidly, leading the OECD to recommend a significant change in tax policy to reduce speculative investment and prevent inefficient use of properties. At that time, the lack of holding costs (apart from finance costs which have fallen with entry into the euro area) encouraged the advance purchase of properties for short-term gains and allowed undeveloped land to be held without any cost. An appropriate

capital gains tax and an acquisition tax, together with the introduction of a property tax were advocated to help moderate rising prices by penalising investment in properties for short-term capital gains and reinforcing the incentives for landowners to use their land more effectively. The Irish government has gone a long way in the direction of these suggestions (Box 6). As part of a wider package of measures, taxes on short-term transactions by investors have been raised, while opportunity costs of holding undeveloped land within certain areas have been introduced. Indeed, the introduction of a land-holding tax for undeveloped land in the Strategic Development Zones represents important turnaround in tax policy, which has not up till now taxed any kind of land-holdings.

Box 6. **Summary of policy actions for house prices**

Following a package of measures introduced in April 1998, house prices continued to grow at a rapid rate forcing the government to implement further steps in both 1999 and again last year. These steps followed reports commissioned by the government (Bacon, 1999, 2000). The most important steps suggested in the programme are:

Action on the Housing Market (March 1999)

- arrangements to enable the early release of up to 16 000 housing sites in the Dublin "Northern Fringe" by use of temporary sewerage facilities
- steps to ensure that the Serviced Land Initiative delivers maximum results on schedule
- additional investment to remove any significant infrastructure constraints to housing development, especially in such areas as roads and public transport
- measures, including increased staffing, to enable the planning board (An Bord Pleanála) to reduce the backlog and delays in determining appeals
- examination of the potential use for housing of lands in State ownership
- Consideration by the Minister for Finance of the amendment to the Finance Act to withdraw the requirement that, in order to qualify for the lower (20 per cent) capital gains tax on the sale of land for residential development, planning permission must have been granted
- decision in principle to establish a commission to examine issues relating to security of tenure in the private rental sector

Government Action on Housing (June 2000)

- exemption on stamp duty for first-time buyers for second-hand houses up to Ir£ 150 000, while a higher stamp duty rate of 9 per cent will apply for all housing transactions for non-owner occupiers
- introduction for three years of an anti-speculative tax of 2 per cent per annum on investors purchasing residential properties for non-owner occupation, but exemptions will apply in certain cases and to landlords in compliance with the regulatory regime
- the use of Strategic Development Zones to ensure the early development of large-scale residential developments, with a penalty land-holding tax for land owners who do not develop the land within specified timeframes
- establishment of Project Offices to drive key infrastructure projects, together with targeted investment in key water, sewerage and non-national roads infrastructure

- measures to increase the capacity of the construction industry, in particular to address shortages of professional and skilled workers
- additional 1 000 local authority housing units per annum from 2000 to 2006
- improvements to the Shared Ownership and Affordable Housing Schemes
- improved site subsidy arrangements for local authority and voluntary housing bodies
- an effective strategy and support framework for future development to ensure balance and stability in the housing market in the medium and long term, including the establishment of a cross-Departmental Team on Housing and strengthening of the housing supply function in the Department of the Environment and Local Government.

98. Tax incentives have been introduced to promote the supply of land and houses[46]. A temporary reduction of the capital gains tax on disposals of land for residential development and a land-holding tax for land owners who do not develop their land in the Strategic Development Zones within specified periods are both intended to promote the supply of land for housing and its early development. A number of targeted tax incentive schemes such as for student accommodation have also been introduced to encourage an increase in the supply of accommodation. To promote rental housing, the government is also reviewing the Landlord and Tenant legislation to address possible barriers to investment in the private rental sector. Beginning in 1986, a rolling series of tax incentives have been provided for development in inner cities and towns. This has contributed to arresting the economic and demographic decline, such that, in general, the economic and social life in many inner urban areas is now quite robust.

99. Other measures have sought to reduce excess demand arising from speculation, which has been encouraged by rising house prices. To reduce speculative or temporary demand, the fiscal incentives for investing in residential properties by non-owners have been lowered: stamp duty on the purchase of new properties by non-owner occupiers was raised, and interest deductibility on borrowing by investors has been removed. Furthermore, the government also stated its intention to introduce in 2001 an anti-speculative property tax on investors purchasing residential properties for non-owner occupation. However, after it became apparent that the moves reduced incentives to develop apartment buildings by investors, the anti-speculative tax was abandoned in March this year and the 9 per cent stamp duty was replaced with a sliding scale of up to this level for new properties bought by investors. The flat 9 per cent tax remains on second-hand investment properties.

100. To deal with the social dimension, steps have been taken to improve the affordability for first time buyers and to assist lower income households. To compensate for the deterioration in affordability for first time buyers, an exemption for stamp duty for existing houses with a value up to Ir£ 150 000 has been introduced. The scope for local authority shared ownership, which enables low income households to afford houses by sharing some proportion of their properties with the local authority, has been extended by raising the effective income limit. In addition, the number of approved local authority housing units has been increased by the government to support low income households.

101. With respect to the location of economic activity, the authorities have developed a points system by which financial support for companies will vary by region and foreign investment has been encouraged to locate in areas away from the Greater Dublin area. Although some success has been recorded, this policy is handicapped by the lack of infrastructure in a number of places. A National Spatial Strategy is under development although critics have noted that it follows and did not precede the National Development Plan which has already specified the location of a great deal of new infrastructure.

102. In sum, policy has been driven by the commitment to control rapidly rising house prices and to ensure the provision of housing. Overall, the government's housing policy since 1998 seems to have contributed to easing inflationary pressure on house prices by supporting supply. House completions have increased steadily, and the rising share of apartments in the housing market in Dublin, from 33 per cent in 1997 to 42 per cent in 1999, is consistent with policy objectives to raise housing density. Nevertheless, demand for houses, a great deal of which is the result of demographic factors, still exceeds the capacity of the construction sector and the provision of infrastructure. Some 50 000 new houses were completed in 2000 but it is still below what is believed to be the required level of 54 000 units to stabilise the market. With a tight labour market, further attempts to increase housing completions are likely to end up by merely raising costs, especially as the implementation of the National Development Plan gathers pace. The existing housing stock will thus have to be used more intensively, including through the strengthening of the rental housing market. Fiscal measures to limit the activity of non-owner occupiers, although they have been partially withdrawn, run the risk of retarding this development.

103. Important components of infrastructure such as water supply and sewage are probably not produced efficiently and households do not bear the full price of local services: there are no water charges and local household rates, while property holding taxes are still confined to the Strategic Planning Zones. Moreover, as noted in Chapter IV, households are not charged the full social costs of transport. It therefore appears likely that the present policy mix will continue the process of low density sprawl, and the consequent loss of green space, long commuting times, and associated congestion and environmental pressure. The move away from local micro planning is only very recent so that it is rather unclear at this stage how effective a more strategic approach will be in addressing the general issues of housing and spatial development. The government intends to specify eight or so areas/cities or "development gateways" under the Spatial Strategy but in a country as small as Ireland there is a danger that political pressure will result in a proliferation of such sites.

The changing demands on labour market policy and human capital formation

104. Labour market policy has evolved in line with the development of the economy and now stresses measures to increase labour supply, facilitate the rapid absorption of the unemployed, and improve skills and training[47]. Changes to the taxation and the social welfare system have been oriented towards increasing labour supply (Chapter II), while immigration policy with respect to non-EU nationals with certain high skill qualifications has been liberalised. Moreover, the National Development Plan provides for a marked increase of spending of some € 14 billion on employment and human resource development, including; € 4 billion on training and education for labour market entrants, € 4.6 billion to deal with the unemployed, particularly the long-term unemployed, € 2 billion on infrastructure and € 1.3 billion of social inclusion measures. The Programme for Prosperity and Fairness (PPF) also includes provisions about life-time learning, retraining, etc. and a number of bodies have been set up charged with overseeing implementation.

105. The rapid decline in unemployment and the marked change in its composition have altered the framework for labour market policy. In the fourth quarter of 2000, 68 800 people were unemployed (Labour Force Survey), corresponding to an unemployment rate of 3.9 per cent, and of these 24 200 were long-term unemployed (over 1 year) amounting to 1.4 per cent of the labour force. At the time of the previous *Survey*, the rate of long-term unemployment was 3.9 per cent (spring of 1998) although the incidence of long-term unemployment at 50 per cent remained above the OECD average but very near the EU average. Thus, in the last few years not only has the level of long-term unemployment declined in line with growth, but also by more than has total unemployment. At the same time, vacancies have increased to around 6 per cent covering most categories of jobs[48]. The reduction in the number of registered unemployed (Live Register) from 240 000 in November 1997 to 137 000 in November 2000 has served to

raise the ratio of placement officers to registered unemployed to international levels, thereby opening up new possibilities for policy.

106. In response to the evolving situation, a number of active labour market measures have either been halted or are in the process of changing. Wage subsidy programmes have now been dropped in favour of a greater emphasis on training programmes and more intensive counselling. The offers of support to young unemployed before they reach six months of unemployment commenced in September 1998 and have been gradually extended on a phased basis to adults during 1999 and 2000 with a reduction of the trigger point from twelve to nine months. Registered unemployed who cross the threshold are transferred to the FAS (the national employment service) for assistance at which time around two thirds often leave the system -- in part an indication of the tightness of the current labour market[49]. The remaining one third are turning out to be difficult cases so that training offers have become more customised to their specific needs.

107. A key active labour market programme has been the Community Employment Scheme which in November 1999 employed 33 259 in a range of community services. Follow-up studies have shown that the programme fails to increase the employability of its participants who are usually the most difficult cases in terms of education and social experience[50]: the most difficult cases were thus allocated to the least efficient programme with better cases being allocated to the most efficient ALMP programmes which involved close contact to the market. The dead weight costs of these latter programmes has thus been increased[51]. Reflecting the new circumstances in the labour market, the CES will be phased down to 28 000 by 2003 with 5 000 posts transferred to a new Social Economy Programme, which will be oriented to the provision of services, and by cutting 4 500 places. Moreover, under 25's will now be excluded from the programme and the length of time an individual may remain on such a post has been cut. The restructuring is part of a strategic shift in favour of more training places, particularly for the under 25 year olds, longer-term unemployed and lone parents. Nevertheless, the CES remains a large programme particularly at a time of buoyant labour demand. To increase the programme's efficiency will require a clear progression from social employment to training places and eventually market placements.

108. Labour market institutions are also evolving, and the local employment service has been combined with the FAS so as to establish a more integrated national employment service[52]. The local service will, however, continue to exist but will henceforth be contracted by the FAS to provide services: desired outcomes and target groups will be closely defined. The FAS itself is being restructured with an emphasis away from administration and employment experience programmes towards a greater concentration on guidance and placement functions. In view of the high vacancy rate, such a reorientation is appropriate.

109. The tight labour market meant that most employers had already raised rates to the minimum or above before the national minimum wage was introduced in April 2000. The wage has been set at Ir£ 4.40 per hour for an adult worker but less for inexperienced youth. The wage is to be increased in steps to Ir£ 5 pounds per hour from October 2002 and the government intends over time to exempt those people earning the minimum from the tax net. A tripartite group has been set up to monitor and assess the implementation of the minimum wage. It has commissioned a follow-up of those companies which were surveyed in late 1998 and 1999 when the likely impact of the minimum wage was being studied.

110. With respect to training and human capital formation, the pressure on resources has increased. For example, the number of apprentices has doubled in the space of five years. The apprentice system is now designed to provide broad-based training during the initial stages with the opportunity to develop specialist skills later, and is based on the achievement of standards rather than on time spent in the programme. This new modular approach is intended to allow for flexibility and cross-skilling. The coverage of the apprenticeship system in Ireland nevertheless remains very limited[53]. Expenditure under the National Development Plan (NDP) is due to rise sharply reflecting the government's view that there are

positive spill-over effects associated with the accumulation of human capital, which will underpin the sustainability of growth. The emphasis will not be solely on high skilled workers since the experience is that the requirement for such workers tends to co-exist with a demand for medium or low skill employees. The increased emphasis on training and education is not, however, without its problems and needs to be tightly focused to avoid excessive dead weight costs. Thus the ex-ante review of the NDP observed that third level skills measures such as post-graduate conversion courses are associated with high private returns and therefore high dead weight costs for the programme[54]. Excess demand is often put forward as a rationale for further increasing training measures. However, hasty interventions in the third level system need to be avoided.

111. At the end of 2000 the National Training Fund was established, financed by 0.7 per cent of employers' social insurance contributions. This is not a net addition to charges but a redirection and consolidation from those previously paid to the social security fund. Details of how the Fund will operate are still being worked out, but it seems likely that it will, *inter alia*, provide the means for a comprehensive review of the provision of in-company training. Training bodies like the FAS will have to bid for money from the Fund and not from the exchequer. The Fund will be used to help finance costs of upgrading skills at firms which have not been active in the past. The criteria for the training programmes still need to be worked out, but there should be a focus on certain skills visibly in short supply. A Training Networks Programme was established in June 1999 to provide an enterprise-led response to the training needs of companies by improving their capacity to identify shared training needs and addressing them through a network of interested parties. Applications are approved for funding to operate or develop training networks.

112. As part of a skills-based immigration policy, the government introduced a working visa for non-EU persons in certain occupational categories in March 2000[55]. The measure is aimed at addressing skills and labour shortages in the information technology sector, the nursing profession and in the building trades. The immigration of non-EU nationals has increased rapidly from 6 300 in 1999 to 10 650 in the first nine months of 2000[56]. The inflow of EU citizens has also accelerated, although as they do not need work permits it is difficult to determine the numbers involved with any precision. The number of asylum seekers has also increased markedly and, there is now the possibility of taking up work for those in the country before July 1999. Even though two thousand asylum seekers qualified for working in 1999, the take up has been very small (only 100).

Promoting competitive markets

113. Since the last *Survey* in 1999, competition policy and enforcement have been the subject of continued debate and the modernisation of the government, which started in 1994, has become more tightly focused on improving the efficiency of the regulatory process[57]. The objective is to make the regulatory process more sensitive to the need to create competition and lower barriers to entry rather that to simply be concerned about the abuse of market power. This reform process has been examined in depth this year in the OECD's *Regulatory Reform Review of Ireland*. At the same time, the authorities have made steady progress in changing the old network sectors characterised by state monopolies into ones driven by competitive markets, although this will be a long and complex process due in part to the smallness of the market.

Competition law

114. Although there are some differences in the powers of the competition authority and the methods of enforcement, the substance of Irish competition law is generally consistent with the laws in other OECD

countries and the Competition Act parallels EU competition policy. However, the Authority does not have the power to apply EU competition law directly[58], so at present the only way to obtain the remedies of EU competition policy through Irish institutions is by private lawsuit. The Authority's ability to deal with international matters is restricted by the prohibition to disclose information it obtains while exercising its official functions.

115. A four-year review of competition and mergers policy, undertaken by the Competition and Mergers Review Group (CMRG), was finalised in March 2000. One result was a new law announced in October (currently being drafted), which transfers responsibility for examining and deciding mergers and take-overs from the Ministry of Enterprise, Trade and Employment (DETE) to the Competition Authority. Moreover, these issues would be determined on the basis of competition criteria alone[59]. This will enhance transparency and bring the Irish legislation in line with best practices in many other OECD countries.

116. The Competition Authority is independent in decision making but it depends on the Minister of DETE for appointments and its budget. The Authority is not subject to DETE direction in its law enforcement actions, but as long as it operates under DETE's budget, for which the Minister is accountable to parliament, the Authority will not be fully independent. The *Regulatory Reform Review of Ireland* concluded that hiring authority and a separate budget are necessary for more effective decision-making independence.

117. Competition policies are formulated by the DETE, which is also responsible for monitoring the impact of other laws and regulations on competition policy. To provide the Authority opportunity to comment on policy proposals, the "Financial Autonomy Agreement" between the Authority and the Department calls for DETE to seek the views of the Authority on the competition implications of new legislation. Formal consultation channels with other departments need to be established. Indeed the CMRG's review of competition policy suggested that Ministers sponsoring legislation should be free to request the Authority's view directly and that the advice should be made public at the time the bill comes into force. This proposal would appear to be in line with the spirit of the regulatory reform programme.

118. The possibility to resort to courts and criminal sanctions shows that violations of the competition law are taken seriously, but it also introduces complexities and difficulties. There have been few litigated cases so it might take some time for judges to gain familiarity and experience in these new laws. The choice of court depends on the general rules of criminal law so cases may be heard in local Circuit Courts. An opportunity was missed in 1996 to assign all competition policy-related cases to the central criminal court and thus develop continuity and expertise. The CMRG has proposed a complex new procedure, a so-called "elective hearing" before the Authority where potential defendants could seek an outline of the case and to be advised about the fine to be sought. However, the elective hearing process would only be an alternative to criminal proceedings, not to civil suits. The *Regulatory Reform Review* concluded that at the present stage of development of Irish legislation, it would be more beneficial to try to make existing procedures work rather than introducing new ones. Since 1996, the Authority has been responsible for enforcement of competition policy, but the DETE still has parallel enforcement powers that it has never used. These enforcement powers of DETE should be repealed, so as to make the enforcement process more transparent.

119. The Authority lacks the legal power to implement a leniency programme to encourage parties to make first-hand disclosures which are necessary to prove secret agreements. One of the recommendations of the CMRG report includes "whistle-blower" protection, but only for private persons. Protection also needs to be extended to firms. Implementing these programmes would require co-operation and consultation with the Public Prosecutor.[60]

Regulatory reform

120. To promote competitive markets it is important not only to have an effective competition law focused on abuse of market power, but also to imbed the objective in the regulatory process. The Strategic Management Initiative (SMI), the ongoing reform programme in the Irish Civil and Public Service, puts special emphasis on promoting competition, entry and efficiency as well as protecting consumer interests. To this end, the authorities have introduced a quality regulation checklist against which all new legislative proposals must be measured. The competition policy criteria in the SMI checklist may, however, be too general and will need to be made more operational in the future. The *Regulatory Reform Review* noted that the new concept brings about tension with the old tradition of giving priority to producer interests, especially small businesses that has strong roots in Irish society. In order to balance representation, the consultative process needs to be widened and made more transparent. Departments have considerable discretionary power at present for carrying out the public consultation process in terms of the duration of the consultation and the selection of the interested parties that are consulted.

121. The need to give attention to the impact on competition and regulatory reform is particularly evident at local government levels. Anti-competitive decisions of local authorities are not considered to be violations of competition law if these bodies are not "undertakings" pursuing economic objectives. The Supreme Court has ruled that the phrase "for gain" is to be interpreted as "for a charge or payment". Local authorities have made anti-competitive decisions in the areas of land use, health care and licensing.

122. Quantitative entry barriers and other forms of protection remain in some sectors. Although there is no special provision for small business in the competition law, regulations (*i.e.* the Groceries Order) are used to protect small retailers (Box 7). The Competition Authority advocates repealing the Groceries Order. To enhance the protection of consumer interests, the Authority calls for eliminating anti-competitive behaviour by small firms including retailers, professionals and service providers that harm consumers to an even larger extent in a small country with a dispersed population. The CMRG proposed two *de minimis* exemptions (either that liability depend upon showing "substantial effects", or that the law establish a safe-harbour based on market share or turnover) in its interim report. Such exemptions would cover most vertical agreements involving small firms but would make it difficult to maintain a clear rule against horizontal cartels. It would also be hard to design safe-harbour tests that did not conceal competition violations in some sectors such as pubs. The *de minimis* proposal was dropped from its final recommendations, but the CMRG did propose that the Authority issue guidelines to give smaller businesses more confidence.

Box 7. **Groceries Order**

One of the most often-cited regulation that limits competition, the Groceries Order, appears to prohibit below-cost sales. But the rule is actually based on the invoice price ignoring off-invoice adjustments, allowances, discounts and rebates. It prohibits discrimination in terms and conditions of supply, but ignores actual effects and possible justifications based on different costs. The Order is preventing retailers from competing by lowering prices to consumers. The CMRG recommended repealing the Order. The CMRG did not object to new rules requiring retailers to honour suppliers' credit terms and banning discrimination, but to support consumer-welfare goals, these rules should be sensitive to actual effects in particular circumstances. After a review in October 2000, the Ministry of Enterprises, Trade and Employment decided to retain the Order.

The Groceries Order is a holdover from the pre-1991 era, when Ireland did not have a comprehensive competition law. The grocery sector has long been regulated by Restrictive Practices Orders. The first Order was issued in 1956 and was up-dated by new orders following new market practices. It is inconsistent with modern competition policy practices because it restricts competition and takes refusal of supply as a *per se* offence. Because of its anti-competitive nature, the Order should have been revoked in 1991 leaving all unfair practices to be taken care of by the Competition Act. However, due to the influence of wholesalers, who feared being bypassed by retailers, the Groceries Order survives.

123. Two sectors, taxis and pubs, reveal the difficulties of implementing deregulation which reduces the rents earned by protected incumbents. Liberalisation of entry to the taxi business was advocated in the previous *Survey*. In moving toward liberalisation, the government proposed issuing a number of new licenses, mostly to existing license holders which could have been sold. However, the High Court decided in October 2000 that limitation of taxi licences in the interests of existing licence-holders could not be contemplated. The government therefore brought in new regulations for the issuing of licences including a requirement to have a vehicle test certificate, a certificate of suitability and appropriate motor insurance and to pay a fee of Ir£ 5 000. The number of licences is no longer limited. As a conciliatory gesture to current licence holders who suffered a loss in the capital value of their licenses, the Minister for Finance has proposed a special tax-relief provision for license holders to write off their capital loss over a number of years[61]. Compensation might speed reform in this case by reducing industry resistance, but it may also increase the incentive for firms in other markets to lobby the State for similar treatment. This will be an important issue in the case of pubs (Box 8). If reform in the taxi market works efficiently, it will build public support for similar regulatory reform in areas such as public houses and pharmacies, where competition is similarly restricted.

Box 8. **Pubs**

The most well-known competition problem in Ireland involves one of its most characteristic institutions, the pub. The number of licenses in the country has been fixed since 1902. With only limited possibilities to move licenses, the situation has arisen of a large number of pubs in older rural areas which have lost population and a relatively small number of pubs in areas such as Dublin. Ostensibly intended to protect the small traditional pub, it has in fact led to large surface area pubs in Dublin which are the only ones that can afford to buy a license. Quantitative controls prevent entry to the sector and the government imposes price controls from time to time to solve competition problems instead of liberalising entry to the sector. The value of a pub license shows the economic significance of the limitation on entry. While a license costs around Ir£ 120 000 in rural areas, in Dublin it may sell for as much as Ir£ 650 000. To ease supply constraints in Dublin and in other cities, a law adopted in July 2000 permits regional transfer of pub licences and extends opening hours. Licences are often used as collateral, so it is not only the political pressure of licence owners, but also the protest of banks that prevents the government from completely liberalising entry to the sector. A commission has now been established to investigate the liquor licensing system more generally.

124. There still exist entry barriers to a wide range of services, particularly in the professions[62]. The lack of competition in the pharmacy sector stems from the strict limits on the number of university places as well as a cap on the number of outlets. The number of pharmacies is determined by "definite public health need", that is, at least 4 000 people to serve and no incumbent pharmacy within 250 meters (in rural areas 2 500 people and 5 kilometres). Besides these quantitative rules, local health boards also consider the effect of the new entrants on existing pharmacies. While the Ministry of Health is trying to safeguard interests of existing outlets, the Competition Authority and DETE both advocate reform.

Network regulation

125. In moving ahead with regulatory reform in the network sectors and in transport, a number of independent regulators have been established. There are independent regulators for telecommunications, electricity, and aviation (the Office of Director for Telecommunications Regulation, the Commission for Electricity Regulation and the Director for Aviation Regulation) and arrangements are in hand to establish them for gas and surface transport. In addition, a single regulator is to be set-up for financial services (see below). The concentration of a wide range of powers in the hands of independent regulatory bodies has raised the issue of accountability[63], transparency and the need to avoid the possibility of regulatory capture. Judicial or quasi-judicial oversight -- and purely political oversight -- appears inappropriate for supervising the kinds of flexible arrangements that are often required of a regulator so that other methods must be developed. In response to these concerns, the Department of Public Enterprise published policy proposals in March 2000 (*Governance and Accountability in the Regulatory Process: Policy Proposals*) on the governance and accountability aspects of the generic regulatory framework as it applies across all sectors within its remit. The report considered how the transparency of regulators should be enhanced and how accountability problems could be mitigated by clearly defining the relationship between regulators and Ministers, the Parliament, the courts and the general public. Specific actions derived from the conclusions include:

- The 1996 Act establishing the Office of Director for Telecommunications Regulation (ODTR) did not have a provision regarding its effective accountability to the Parliament, only financial accountability to the Minister. This omission will be corrected with the passage of a new law in the latter half of 2001 requiring the regulator to report to a relevant parliamentary committee on a regular basis in relation to its plans and overall performance. Moreover, the regulator will be changed to a three-person Committee which is intended to reduce the possibility of regulatory capture.

- The independent Commission for Electricity Regulation (CER), which was established later than the ODTR in 1999 submits regular strategy statements and work programmes to the Minister and is accountable to the parliament annually (it reports to a Joint Committee of the parliament). A new law, which is expected to come into force in 2001, proposes the integration of gas and electricity regulators, which would simplify the regulation of these two closely related sectors.

126. To avoid duplication or inconsistency, regulators need to develop formal ways of co-operation and indeed the last *Survey* did note inconsistencies between the Competition Authority and the telecommunications regulator. Because of constraints on disclosing information, legal changes are needed for effective co-operation among enforcers. Under present conditions, different regulating bodies may reach different conclusions that create regulatory uncertainties. The Competition and Mergers Review Group proposed that regulators give general priority to competition policy and that competition policy apply to all regulated sectors. The new draft communications law deals with closer co-operation between the two regulatory bodies to improve transparency. Specifically, where a regulatory issue falls within the competence of both bodies, one of them may defer from regulation allowing the other body to take action. It is also important, that the two bodies consult before taking any action in areas where both have competence and take into account the opinion of the other body. Finally, the two bodies should be allowed to exchange confidential information. These measures will also need to be implemented with respect to other regulators.

Electricity and gas

127. The Electricity Supply Board (ESB) generates almost all electricity in Ireland, and owns the transmission, distribution and generation assets and, until 2005, is the sole supplier to captive consumers. As the first step in a phased liberalisation of the electricity sector, since February 2000, 350-375 large users, using more than 4 million kWh annually (representing about 30 per cent of electricity demand) may choose their supplier. By 2002 this share is expected to reach 40 per cent and there is a commitment to fully liberalise the electricity supply market in 2005. Since 1995, gas consumers with annual usage above 25mcm/year and since August 2000, all power generators irrespective of size, have been able to choose their gas supplier. (This amounts to 6 to 8 large users and about 60 small-scale power generators accounting for about 75 per cent of demand). The old state electricity monopoly, the ESB, has been split into separate business units and it keeps separate company accounts for its generation, transmission, distribution, supply to captive consumers and supply to liberalised consumers businesses. The generation business of any company must be accounted separately from its other businesses under the terms of the generation licence. Operational control of electricity transmission was transferred to Eirgrid, but not the formal ownership of the grid and responsibility for maintenance. However, Eirgrid has few incentives to improve efficiency and limited means for ensuring that ESB is fulfilling its maintenance and development tasks in a non-discriminatory way.[64]

128. Regulatory uncertainty and the small size of the domestic market are barriers to new entry and to the development of competition. New generation plant would almost certainly rely on gas but there is excess demand for capacity. In the short term, the lack of gas transmission capacity restricts the number of new gas-fired power plants to two or three. The limited capacity was rationed by the regulator who, in complying with an Act to give priority to supply security over competition, granted the capacity to the incumbent and two new entrants. Not only must a new entrant obtain the gas allocation but they must also gain access to the grid, which also has capacity limits, absent further investment. However, the fundamental issue in Ireland is the small size of the market, and the minimum efficient scale of new generating units. The combined share of the two largest power stations is already 42 per cent of all electricity generation. Hence if new generators enter the market, their shares will be limited and they would still have to face a dominant, partially integrated player. Developing an all-island market is an alternative to overcome the size constraint only in the long term[65]. The number of competitors could be increased by having owners of distinct generator sets within a given site, for example, although a number of technical issues would need to be solved.

129. Despite accounting separation, the ESB still remains vertically integrated into both competitive activities (generation and supply) and monopolistic activities (transmission and distribution), even though operation of the grid has passed to another legal entity. This gives incentives to discriminate against non-integrated rivals and exercise market power. Moreover, the integrated company may lack incentives to expand the transmission network, something which is already happening in Ireland. An often-applied remedy for discrimination could be divestiture, that is separation of ownership of generation from the transmission grid. Complete vertical structural separation would resolve the competition problem better than regulation of behaviour and would provide the best assurance against the anti-competitive incentives and capabilities of integrated and dominant operators. Also, experience of other countries shows that new generating firms are much faster to enter the market where generation and transmission activities are separated. However, if the objective is to establish competition, the only way forward will be to enforce divestiture of some generating capacity of the dominant company and to open the way for trading with Northern Ireland[66].

130. In order to "kick start" an electricity market, the regulator has established "virtual independent power producers" (VIPPs) and has auctioned capacity to them for one year. VIPPs are financial instruments, and do not involve the change of ownership or operational control of any generating assets.

The product was designed with the aim to create a market operation in advance of substantial new independent generation being made available to the market so that the transition to the real market is facilitated once new generation comes on line. The instrument, however, does not create competition and there are no incentives to improve efficiency[67].

131. The natural gas sector is also highly concentrated and vertically integrated, with Bord Gáis (Irish Gas Bord) owning the transmission and distribution assets and being the monopoly supplier to captive consumers. The Irish Gas Bord is not subject to economic regulation, except for access to its pipelines. The limited capacity of transmission from Scotland to Ireland limits competition in the supply market. As in the case of the electricity market, distribution is a natural monopoly. Competition can be promoted by selling rights to transmission capacity and by awarding the permit to build a second transmission line from Britain to a new entrant. Integration of supply and transmission gives the Irish Gas Bord incentives to discriminate against non-integrated rivals. To counteract this, the Irish Gas Bord is to keep separate accounts for their supply and transmission and manage them as separate business units. However, accounting separation has proved, in other countries, to be the least effective way to reduce discrimination. Separation of supply from transmission is the only form that eliminates incentives to discriminate.

132. The Commission for Electricity Regulation (CER) is delegated the regulatory power on electricity prices to captive consumers by the Minister for Public Enterprise, and also regulates network access and entry into both electricity generation and supply to liberalised consumers. The Commission depends on the DPE in staff appointments but is independent in performing its functions. The CER's financial independence is enhanced by its ability to impose a levy on electricity undertakings. The government has approved the drafting of legislation to extend the power of the CER to include the regulation of electricity and gas. All aspects of economic regulation will need to be covered. A clearer regulatory framework with less uncertainty will create private interest in participating and facilitate the evolution of a competitive sector.

Telecommunications

133. The past five years of rapid liberalisation in the Irish telecommunications sector and the introduction of full competition in December 1998 have reshaped the market and made it among the most liberalised in the OECD. The government privatised the state monopoly in 1999, but this successful transfer of ownership did not immediately affect its market dominance. Eircom still has about 80 per cent market share in the fixed line market (based on revenue) and significant market power in leased line services and national interconnection[68]. New entrants have been making headway increasing their market share by some 2 per cent alone in the last quarter of 2000. Competition has already brought down prices for international charges to around half the OECD average for both business and residential calls, but in areas where competition is less developed – especially the mobile market – prices are higher.

134. In the mobile phone market competition is also beginning to emerge. Up to the end of 2000 there were only 2 operators (the third started service end February 2001). The largest, Eircell, is the market leader (60 per cent of the market) and also has significant market power in the national market for interconnection. Four UMTS licences will be awarded in coming months through a comparative selection process (so-called "beauty contest"). New forms of mobile service providers such as airtime resellers, indirect access providers, and mobile virtual network operators (MVNOs) are also expected to develop.

135. Recognising the need to improve regulation and the regulatory institutions, a new proposed communications regulation bill will be submitted to Parliament in the course of 2001 which provides for the extension of powers of the Director of Telecommunications Regulation and updates the regulatory framework. The new draft Act provides the regulator with more enforcement power. Penalties will increase

and the regulator is to be given the power to initiate civil proceedings to remedy breaches. Access to public highways, which has been a problem for new entrants, will be regulated in the proposed Communications Regulation Act so as to ensure fairness and consistency of access.

136. The ODTR is more independent compared to the corresponding regulator in the Electricity and gas sector (the CER). It maintains financial independence by imposing levies on telecommunications service providers (based on a percentage of turnover) and collecting licensing fees. The ODTR's main regulatory functions include tariff regulation (setting price caps), development and implementation of a licensing regime, supervision of the interconnection regime, dispute resolution, supervision of access to networks, management and licensing of frequency spectrum, management and administration of the national numbering resource, and monitoring and enforcing quality of service and performance targets. At the time of its establishment, in 1996, the ODTR did not have clearly defined objectives. Its task was described as facilitating the competitive development of the sector. However, recently greater emphasis has been given towards consumer interests. Besides this structural transparency issue, recruitment of staff in extremely tight labour market conditions is another challenge the ODTR is facing.

Transport

137. In September 2000 the Minister for Public Enterprise published a government consultation paper covering reform in the public transport sector. The consultation paper sets out a number of reform proposals including the introduction of competition for franchises covering the provision of public bus services in the Dublin area and the restructuring of CIE (Iarnród Éireann) into a number of separate operating companies. The consultation paper also concerns regulation of the bus market outside Dublin and in the Greater Dublin Area. It proposes a phased transition to a fully franchised bus market in the Dublin area. The first phase of this process involves increased sub-contracting of services by the State operator, Dublin Bus, and the issue of additional routes to private operators under the existing 1932 governing legislation.

138. The consultation paper proposes that the railway subsidiary of CIE be re-established as two independent companies, one of which would be responsible for the railway infrastructure and the other one for the operation of rail services. The Transport (Railway Infrastructure) Bill of 2000 established the Rail Procurement Agency (RPA), an independent commercial statutory body, to make provision for Public Private Partnership-related matters and to regulate the physical operating environment of light rail. The franchise contract for Dublin's first light rail lines will be awarded in autumn 2001 and will commence operation in 2003. The contract is for five years with an option to renew for a further five years. The RPA can contract for LUAS (Dublin light rail system) lines, and the agency itself may be an operator in certain circumstances. The Bill proposes to extend compulsory purchase powers for the development of a railway contained in the 1996 Transport (Dublin Light Rail) Act to the RPA.

Financial supervision

139. Financial markets including banking and insurance have expanded rapidly in recent years and with the strong expansion of cross-border activities in the International Financial Services Centre, Ireland is now the second largest hub in Europe for collective investment schemes. With the level of cross-ownership between financial institutions already high, the authorities have decided to establish a single regulatory authority for financial services. However, there has been considerable delay in deciding whether the body should be set up as a separate institution or should be attached to the Central Bank of Ireland. The issues included, *inter alia*, the accountability to parliament and the efficiency of actions by the CBI to preserve soundness of the banking sector. There was also pressure to resolve the impasse to achieve an

urgent strengthening of insurance supervision. As stressed by the IMF, the role that formation of the new unified supervisory agency could play in facilitating such a strengthening and in reducing the risk of regulatory arbitrage and contagion is important[69]. The government finally decided in February this year to establish an independent regulator formally accountable to the Minister of Finance and to the Parliament. The regulator (the Irish Financial Services Regulatory Authority) will be responsible for prudential regulation of both the banking and insurance sectors and for consumer protection. It will have its own board and an independent chairperson but will be located within a broader institution to be known as the Central Bank of Ireland and Financial Services Authority, which will be chaired by the governor of the central bank, which will be called the Irish Monetary Authority.

IV. MAKING GROWTH MORE ENVIRONMENTALLY SUSTAINABLE

Introduction

140. Although many of the environmental challenges faced by Ireland are common to other OECD countries and the pre-disposition to using regulatory policies rather than economic instruments broadly similar, there are also a number of special factors. The rapid growth of GDP is exceptional among OECD countries and has served to focus attention on the implications for the environment. Rapidly rising household income has also led to a significant change in consumption patterns. Reflecting its comparatively late start in the catch-up process, most environmental laws are less than ten years old and, despite considerable efforts, in part financed by the EU, a fully fledged modern environmental infrastructure is still being put in place. In addition, institutions are evolving and effective capacity building is taking time. While praising the high standard of environmental performance, these developments led the recent *Environmental Performance Review of Ireland* (OECD, 2000) to conclude that "… it is all the more necessary for Ireland to: i) further implement environmental policies and strengthen environmental infrastructure; ii) better integrate environmental concerns into economic decisions; and iii) reinforce international environmental co-operation". Moreover, to achieve improved environmental performance, "… Ireland will need to implement its environmental policies in a more cost effective way".

141. It is an appropriate time to review economic policies and options impinging on the environment. Although strategic decisions have been taken recently about how to achieve international commitments with respect to, for instance, greenhouse gas emissions, the design of policy instruments and the balance between regulatory and economic approaches remains for the moment open. This is perhaps fortunate since the structure of the economy and the policy framework are both evolving, presenting a window of opportunity to use economic policy to achieve environmental objectives in a more coherent and efficient manner. In meeting the challenges arising from rapid growth and modernisation, the government has been active in a number of policy areas. Administrative reform is designed to improve the regulatory and policy process through the greater use of, for example, regulatory impact assessment (see Chapter II) while the market mechanism in areas such as electricity and gas is being strengthened via improved regulation and the introduction of competition (Chapter III). The National Development Plan, which seeks to ease infrastructure shortages and address environmental concerns, is getting underway (Chapter II)[70]. Regulatory impact assessment should in principle improve the integration of economic and environmental concerns in both formulating and implementing policy. Competitive and properly regulated infrastructure sectors should also provide enhanced possibilities for using market instruments to achieve environmental objectives at least cost. However, it is not only costs which need to be considered. In the case of Ireland there are economic benefits from improved environmental performance. A high quality environment, including heritage buildings and associated cultural endowments, are key assets underpinning the rapidly growing tourist industry and attracting relatively scarce and mobile skills, entrepreneurial talent and capital. Moreover, there is also the pressure from Irish residents for a high quality local environment which is expressed most forcefully in the development of avoidance strategies concerning the local land fill and incineration proposals[71].

142. Within the context of the changing policy framework and the expanded role for markets, this chapter examines a number of areas where economic instruments have a greater role to play in addressing environmental objectives. The first section presents a brief overview of environmental issues in the context of rapid growth, while the following section describes the institutional setting and briefly reviews policy instruments which have been used up till now, including the National Development Plan. The third section reviews policy options to deal with international commitments with respect to greenhouse gas emissions and acidification. The following section discusses sector specific environmental issues concerning water quality and agriculture, and waste disposal. The final section draws together some conclusions.

Economic growth, air emissions and commitments

143. Although rapid growth has been associated with a partial decoupling of income and emissions, it will be difficult to meet international commitments in the years ahead. Over the period 1990-1998, emissions of greenhouse gases increased by 13 per cent. Thus Ireland has already used its allocation of a 13 per cent increase in GHG emissions, due to its status as a "cohesion country" within the EU's Kyoto envelope. Growth is expected to continue at a relatively rapid rate for some time to come with average annual growth projected to be around some 4½ per cent up to 2010[72]. As a result, the business-as-usual scenario indicates that they could exceed their target in the 2008-2012 reference period by some 37 to 41 per cent. The transport and energy sectors would account for over 44 per cent and 20 per cent of this increase, respectively, with the share of emissions produced by the transport sector rising rapidly. On the other hand, the share accounted for by agriculture and the residential sector is projected to fall (Table 17).

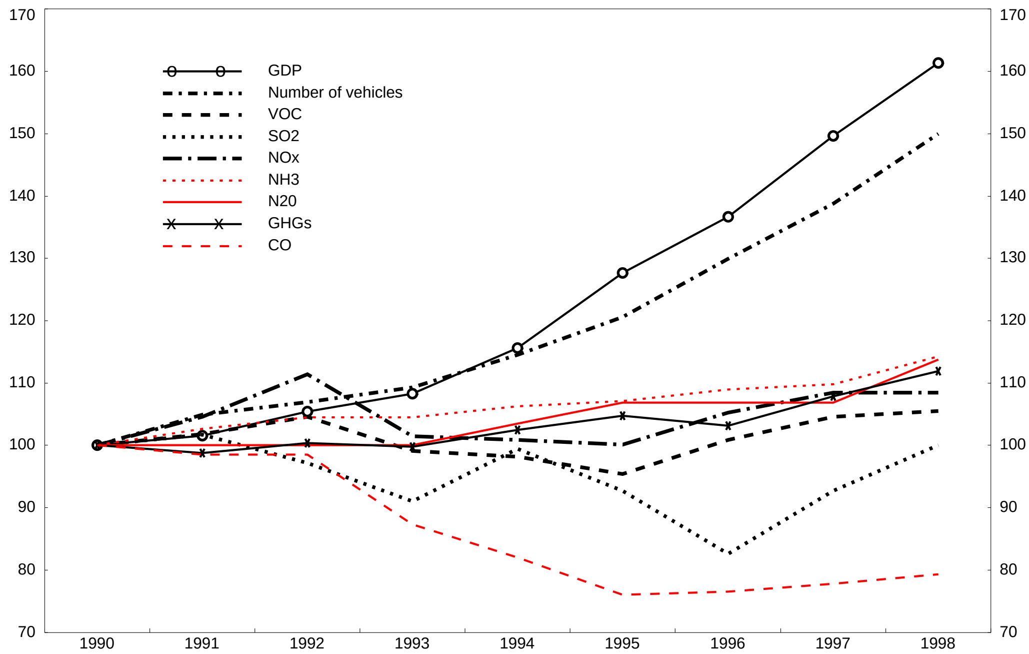
Table 17. **Breakdown of Greenhouse Gas Emissions by Sector, 1990 and 2010**

Sector	Proportion of Total Emissions 1990	Proportion of Total Emissions 2010
	Per cent	
Agriculture	34.6	25.6
Energy	21.6	25.0
Residential	13.1	9.0
Transport	9.5	18.9
Industrial	8.0	8.0
Process	5.4	6.6
Commercial/Institutional	4.5	5.4
Waste	3.3	1.5

Source: Consultation Group on Greenhouse Gas Emissions Trading (2000).

144. Although there was a decrease in the first half of the decade, emissions of SO_2, NO_x, VOCs and CO (see glossary) increased again during the late 1990s due to an increase in consumption of primary fuels as growth accelerated. According to Stapleton *et al.* (2000), the variation in NO_x (Figure 14) emissions over the decade is the result of a programme to retrofit some of the largest power stations with NO_x control technologies which led to some units being off-line for long periods. Given the rapid rate of growth in the economy, this performance could be said to be quite satisfactory. However, in relation to SO_2 emissions (60 per cent of which come from power stations), much of the offset has resulted from the one-off effects of the move to low-sulphur coal and gas-fired plants. While Ireland's emissions have only remained steady, emissions in other European countries are generally falling.

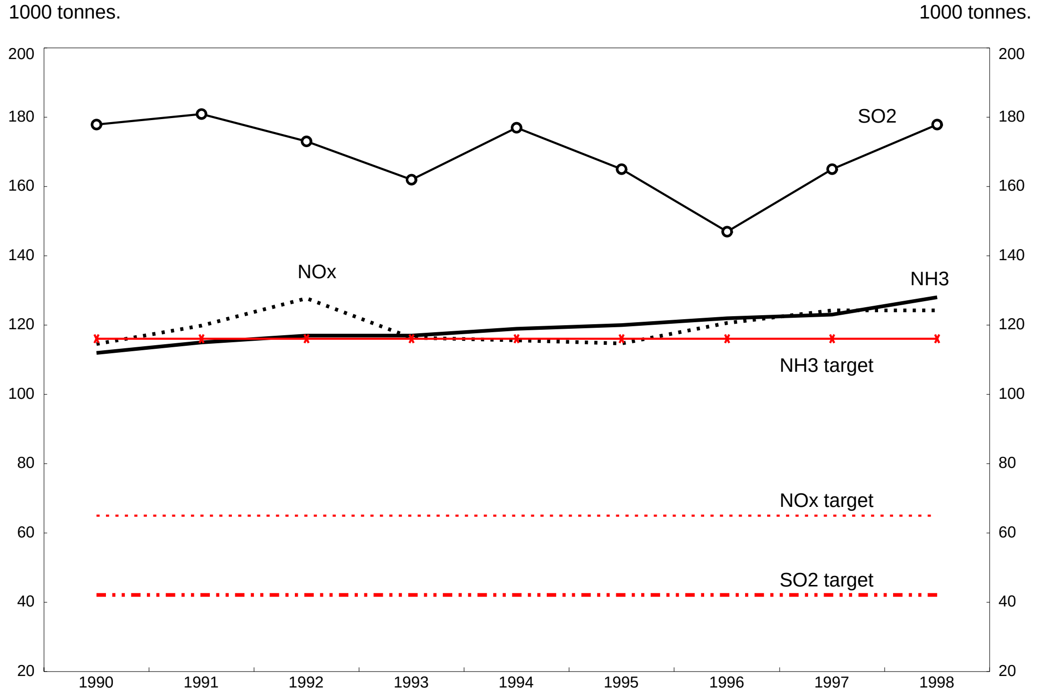
Figure 14. Development of GDP and selected emissions
1990=100



Source: Stapleton(2000).

145. Under the recently signed Gothenburg Protocol (1999) (and, most likely, the forthcoming EU Directive), Ireland is committed to reducing SO_2, NO_x, NH_3 and VOC emissions by 2010. This will require substantial reductions from current levels (Figure 15). Owing in part to unexpectedly rapid growth, Ireland has failed to meet the targets of 105 000 tonnes of NOx in 1994 (actual was 115 600 tonnes) set by the Sofia Protocol (1988) but is likely to meet the target of 155 000 tonnes of SO_2 in 2000 (actual in 1999 was 157 000 tonnes) set by the Oslo Protocol (1994). Some 40-50 per cent of emissions of NO_x and VOCs derive from the transport sector. Regulations regarding catalytic converters and other emission control technologies have only partly offset the increase in vehicle numbers.

Figure 15. Emissions and targets for 2010



Source: McGettigan and Duffy (2000).

146. There has been rapid growth in waste generation over the past five years although some of this growth is not "real" but rather based on better reporting. Nevertheless, Stapleton *et al*. (2000) notes that "Where historical data is considered to be reasonably reliable, waste quantities appear to be increasing more or less in line with economic growth." In regard to long-term sustainability, perhaps the most serious problem is the hazardous waste that is ‘unreported’. One estimate is that 296 thousand tonnes of hazardous waste are produced annually (which includes non-industrial waste), of which around 74 thousand tonnes or 25 per cent of the total is unreported, while 100 thousand tonnes, 34 per cent of the total, are exported. Some of the unreported waste is likely to impose large costs in the future both in terms of immediate environmental impact, and costs of clean-up. The government has proposed a hazardous waste management plan which lays emphasis on an ambitious prevention programme. It is hoped to adopt the plan this year.

147. The EU has set limits on the concentrations of various air-borne pollutants including SO_2, NO_X and particulate matter (PM). Measurement of particulate matter emissions began in Dublin in 1996 and, since then, emissions have remained relatively constant. The measurements show that, in a representative area (Wood Quay), 45 days have a concentration of PM_{10} greater than 50 ug/m^3 (which is the limit) with an annual mean of about 35 (Stapleton *et al*., 2000). Therefore, even if the expansion in vehicle numbers and increases in congestion do not have a significant impact on particulate matter concentrations in Dublin, and this is doubtful, the concentration levels are in excess of the limits in the EU Directive. The Directive also covers the health effects of concentrations of the relevant pollutants. Concentrations of SO_2 are well below

the limit, but NO_2 concentrations are close to the limit values for 2010 and the target will be difficult to achieve.

148. Ireland has agreed to reduce its ammonia emissions, which are a cause of acid rain, from 127 000 in 1999 to 116 000 tonnes by 2010. Preparations are also being made for an EU directive that would set national emission ceilings. Almost all of Ireland's ammonia emissions come from agriculture, mainly deriving from the application of nitrogenous fertiliser and animal waste: emissions have increased in line with trends in livestock numbers, with fertiliser use increasing from 112 000 tonnes in 1990 to 126 000 tonnes in 1998 (Stapleton *et al.*, 2000). Agriculture has not expanded in line with overall economic growth but the composition has shifted heavily toward livestock in line with the incentive structure of the CAP.

149. In sum, in view of favourable demographic developments and the probability that productivity growth will continue at a reasonably fast rate (Chapter I), the economy is set to expand at a relatively rapid pace for some time to come. On the basis of the business-as-usual scenario this will mean that it will be difficult to reach the greenhouse gas reduction commitments under Kyoto, and the reductions agreed for other emissions would also appear to be demanding. Other environmental problems such as water quality and eutrofication (see below) are less related to growth but are nevertheless regarded as important. A broad overview of environmental issues and policy is presented in Table 18. The resolution of a number of environmental issues does not, however, imply that growth needs to be in some manner reduced. On the contrary, although output per head is now close to the EU average there is still some way to go in terms of income per head (*i.e.* GNP per head). It is thus even more necessary for policies to be implemented which will be cost effective. To assess the issues which will arise it is important to keep in mind the institutional framework within which policies are formulated and the types of policies which are currently in use.

Table 18. **Key Environment-Development Issues, Performance and Policy Responses**

Environmental Issue	Performance	Existing Primary Policy Response
1. Meeting Kyoto greenhouse gas emissions target	Under business as usual, the 61 million tonne CO_2-equivalent target will be substantially exceeded	Global warming strategy document prepared, but no effective action yet. Discussion by Minister for Environment of mobilising taxes to this end; objection to EU 'Energy Products tax' proposals have been withdrawn
2. Meeting Acidification precursor targets as agreed under the CLRTAP and Gothenburg Protocol and meeting prospective standards for ambient concentrations of NOx and PM_{10s}	Stabilising of SO_2 emissions; nevertheless, under 'business as usual' projections, there will be substantial overshooting of targets agreed for SO_2 (by 136 thousand tonnes), NOx (by 60 thousand tonnes) and VOC (by 55 thousand tonnes). Level of PM_{10} and NOx in excess of Directive limits for 2005-2010 timeframe.	No action as yet on acidification precursors Investment in bypasses around most urban areas, and the development of mass transit infrastructure in Dublin (light rail, dedicated bus lanes, cycle lanes and pedestrianisation). Improvement in emissions per km travelled due to EU emission standards for new cars. Vehicle testing, introduced in 2000, will also help set minimum emission standards for old fleet.

Table 18. **Key Environment-Development Issues, Performance and Policy Responses (continued)**

Environmental Issue	Performance	Existing Primary Policy Response
3. Meeting water quality objectives in Irish and EU legislation	Downward trends in freshwater water quality. Challenge to comply with EU drinking water Directive, and Water Framework Directive as regards no deterioration in quality.	Pilot projects in river basin management; regulations specifying minimum standards in freshwater; grant schemes to support installation of nutrient storage on farms; integrated pollution control (IPC) licensing for most industry; EU supported investment in wastewater treatment capacity, driven by the Urban Wastewater Directive
4. Stabilising waste emissions (hazardous and non hazardous)	All categories – agricultural, manufacturing, mining and quarrying, hazardous, municipal, construction and demolition, drinking water sludges – increased over the 1995-'98 period	Some investment in modern landfill capacity; voluntary agreement re packaging waste beginning to have some effect. Charging industry, commercial based on weight beginning, but not applied to municipal. Expansion in number of recycling drop centres. EPA licensing has seen improvements in standard of existing and new landfills.
Sectoral Issues		
1. Transport	The growth in disposable income and population has led to a doubling of car numbers, and this in turn has resulted in serious congestion costs and increased emissions of NOx and PM_{10s}	Investment initiated in light rail (Dublin only), commuter rail, bus lanes, cycle lanes and pedestrianisation. No use of congestion charges. Virtually all on-street parking in Dublin city-centre is charged.
2. Energy	Final demand for energy continues to grow in line with GDP growth, and under 'business as usual' this is expected to continue across all consuming sectors, with growth especially pronounced in transport and households.	Good information programmes on energy conservation, some support for combined heat and power and renewables, higher house insulation standards mandated for all houses built post 1997, but otherwise few demand management efforts
3. Agriculture and Forestry	Key challenges are emissions of acid precursors (ammonia), eutrophication of freshwater, nitrification of groundwater, and biodiversity loss. Global warming also an issue.	Good information programme on eutrophication for farmers, some regulatory control in a few sensitive catchments, subsidies for animal waste storage, and for a range of environmental measures under the Rural Environmental Protection Scheme (REPS), which is a voluntary programme. Annual payments being made to farmers owning Special Areas of Conservation (SACs) under the Habitat protection scheme. No use of market based policies. Expansion of afforestation will give rise to landscape and habitat issues, but 'code of practise' and mandatory guidelines on various environmental dimensions are in train.
4. Tourism	Dramatic growth in visitor numbers leading to increase in access transport externalities, congestion, loss of character, and pressure for development of golf courses, hotels, and other tourist related facilities.	Control of development left to local authorities that suffer from diseconomies of scale in expertise and potential local pressures in making and enforcing decisions. A series of pilot schemes designed to demonstrate integration of environment and tourism have been initiated.
5. Industry	Rapid growth in industrial output has increased pollution potential, but nature of industry is relatively 'clean' and controlled.	The Integrated Pollution Control (IPC) licensing process now 'picks up' all new, and most existing industry with polluting potential. No use of market instruments.

Institutional structure and policy instruments

Institutional structure

150. A key force driving environmental policy is the EU in the form of assigned standards and quotas, which would not necessarily have been selected by the indigenous population if left to judge the optimal use of environmental resources. In a series of European Union directives and regulations, Ireland is obliged to meet legal obligations concerning a wide and growing range of issues, including emission standards for waste water; ambient air and water standards; standards for drinking water; quantified targets for recycling and re-use of packaging; requirements for provision of environmental performance information; and identification and protection of a network of Special Areas of Conservation (SACs) comprising habitats for flora and fauna that are of Europe-wide significance. Provisions in the Amsterdam Treaty allow the European Court of Justice to impose large fines on Member States which are judged to be in non-compliance, so that the potential costs are real. The European Union also has a key role to play via financing. Community Structural Funds have been subject to *ex-ante* audit which has served to tighten project objectives as well as to force at least a formal consideration of the environmental impact of projects.

151. The ministerial structure covering economic and environmental policy is broadly similar to that in other countries with the notable exception that one ministry covers environment, transport and local government (Box 9). This arrangement could be conducive to integrated policy, although public choice theory and experience point to a real danger of conflicts of interest which could be better resolved at a more open, inter-ministerial level, where political judgements would be transparent. In addition, there are also a number of government agencies and bodies with responsibilities for aspects of environmental performance. The *Environmental Protection Agency* is an independent organisation with responsibilities for licensing of industry (Integrated Pollution Control licensing since 1994, IPC), environmental monitoring (including production of state of the environment reports), research, and overview and support of the local authorities in the implementation of their responsibilities. Under IPC, a single licence is issued which covers air, water, waste emissions and noise. There are about 345 licences in operation at present and most pollution potential is covered by the licences. A new waste management act was introduced in 1996 which licences waste management facilities and disposal systems. None of these licences are tradeable. Non-governmental environmental organisations include *An Taisce*, the National Trust for Ireland. Under the planning regulations, this organisation receives planning applications likely to be of significant environmental importance. The National Sustainable Development Partnership (COMHAR) includes a wide range of both governmental and non-governmental representatives and is intended, *inter alia*, to help form a national consensus in this area. It has made inputs to policy integration such as the new planning law and the climate change strategy. The *Heritage Council* has responsibility for promoting conservation of the heritage endowment, the Environmental Information Service (*ENFO)* has the lead responsibility for promoting public awareness of environmental issues and performance, and the *Irish Energy Centre* has an information role in promoting energy conservation.

Box 9. **Key government institutions shaping economic and environmental policy**

The *Department of Finance* has lead responsibility for the preparation and execution of the National Development Plan, for fiscal policy, and for controlling expenditure. It leads an interdepartmental group that reviews the fiscal situation and the potential for the application of tax measures to advance environmental objectives.

The *Department of Environment and Local Government* has lead policy responsibility for: roads, housing, water and air quality, waste, and for the planning system. It allocates funding to local authorities for housing, local roads, water supply and wastewater treatment, and waste disposal. The Department led the preparation of the National Sustainability Strategy in 1997. It leads a 'Green Network of Government Departments' that comprises assistant Secretaries in departments with significant environmental impact. They aim to integrate environmental considerations into economic policy. Eco-auditing is regarded as a key element in the attainment of such integration.

The *Department of Arts, Heritage, Islands and the Gaeltacht* has the lead policy responsibility for conservation of the built and natural environment, including habitats, wildlife, National Parks and Monuments.

The key sectoral departments, Agriculture and Food, Enterprise, Trade and Employment (industry), Marine and Natural Resources (freshwater and marine fisheries, forestry), Public Enterprise (energy), Tourism Sport and Recreation, have units addressed to the environmental aspects of their activities.

For a detailed review of environmental policy responsibilities see the *Environmental Performance Review of Ireland*, OECD, 2000a.

152. Policy as regards housing, water supply, wastewater treatment, solid waste and land use is implemented by the *local authorities*, from whom permission must be sought for most industrial, residential and commercial development. Decisions by the local authorities are based on the provisions of the Development Plan for the area for which they have jurisdiction and on any policy guidance by the Minister for Environment and Local Government. Decisions can be appealed by the proposer or by any third party to a national appeals authority (An Bord Pleanála) whose decision is final. As noted in Chapter II, local authorities frequently lack adequate planning resources, and this has been instrumental in leading to a sub optimal scale of water and sewage facilities.

153. The formation and implementation of policy in general has been very diffuse with the Social Partnership exercising an important role (Chapter II). Indeed, they are represented on a number of committees dealing with environmental questions such as COMHAR. The current social partnership agreement specifies a wide range of objectives covering areas as diverse as health, wages, taxes, training and regional development but is rather unclear about how environmental objectives should be achieved, for instance via energy taxes.

Policy Instruments

Regulation and economic instruments

154. A striking feature of environmental policy up till now is the very limited range of policy instruments employed. There is a heavy dependence on regulations and exhortation to achieve objectives. Subsidies have been used in the agricultural sector, including the withdrawal of some of those which proved to be environmentally damaging. Taxes and charges are employed only with respect to energy use in transport, and then, with the notable exception of the excise duty differential favouring unleaded petrol, only as a by-product of revenue raising. Systematic information on environmental performance, in the sense of the "toxic release inventory" in the US, as a matter of routine, is not part of the policy process. There are several voluntary agreements in operation relating to packaging waste. Examples of the current use of policy instruments are presented in Table 19.

Investment: the National Development Plan 2000-2006

155. The National Development Plan identifies the key government programmes to be implemented over the seven-year period. With respect to projects with an environmental impact, the most important expenditures relate to roads and water treatment (Table 20). The proposed expenditure on public transport in Dublin arises out of the economic necessity to maintain mobility and to meet public frustrations regarding congestion, though it is likely to have positive environmental impacts. The investment in water and in waste water treatment is driven mainly by the need to improve water quality to meet EU requirements.

156. The likely environmental impact of the infrastructure investment plans were investigated by an independent unit (Community Support Framework Evaluation Unit) which concluded that public transport investments would have a generally positive environmental impact (CSF Evaluation Unit, 1999). However, they did note that "… an approach where users are faced with the full costs of service provision would be preferable from a sustainable development perspective"(CSF, Page 57). The *ex-ante* assessment went further and investigated the eco-audit set up by the Plan which involves the establishment of a formal procedure for identifying the environmental impacts of sectoral policies and programmes and for mitigating/eliminating their adverse impacts[73]. They concluded that the eco-audit endorsed some aspects of the approach to environmental problems which could only be characterised as second best in nature and therefore not cost effective. In conclusion, the study agreed with the suggestion by the government that individual Operational Plans be subject to eco-audits, while at the same time emphasising that a more critical approach could and should be taken at that stage. An assessment of these rather important eco-audits is currently not available. One key issue, which would have to be considered, is to what extent the road building programme will result in a large increase in the use of motor vehicles.

Table 19. **Policy Instruments: Examples of their Use in Environmental Policy**

Policy Instrument	Example
Information on environmental performance	State of the Environment report
Regulation (command and control). Limits on pollution are set, enforceable in a court of law	Integrated pollution license for most industry with polluting potential
Removal of environmentally damaging subsidies	'Capping' of ewe premia and headage payments for sheep, to reduce grazing pressure on upland commonages
Grants and cash subsidies to improve environmental performance	Cost-sharing grants to farmers to provide increased storage capacity for farmyard manure
Tax incentives to encourage environmentally useful behaviour	These have been provided to encourage the relocation of development activity into deprived inner cities and towns
Voluntary agreements to meet environmental objectives	Most of those involved in the packaging industry in Ireland have combined in a voluntary agreement ('REPAK') to meet recycling and re-use targets. Plastics packaging used in farming ('farm film') is also recycled via a voluntary agreement. Agreement to phase out phosphate-based detergents.
Taxes and charges on emissions to the environment	Some local authorities charge for emissions to wastewater plants based on magnitude of pollution loading.
Emissions trading, whereby a quota of emissions is fixed and allocated amongst polluters, who can then buy and sell them	None

157. A number of Operational Plans, particularly in the transport sector, are complete with projects now entering the tendering and implementation phase. Major projects have been subject to an environmental impact assessment, which covers the immediate impact on the environment such as crossing important wet lands. All major road projects are also subject to cost-benefit analysis and such an assessment should be extended to other projects. However, it appears that environmental costs and benefits have not been taken into account in a consistent manner, and this weakness will need to be addressed in the future. It is proposed to implement some projects via private/public partnership arrangements which raises the possibility that more efficient charging schemes for the use of infrastructure might be introduced (*e.g.* with respect to highways and major bridges). However, charging for private costs is one thing but charging to cover the full cost including the environmental externality is quite another.

Table 20. **Some Key Elements in the National Development Plan, 2000-2006**

Environmentally relevant element	Amount (€ millions)	Main features
National roads	7578	Bringing key national routes up to motorway standard.
Public transport – greater Dublin	2555	Provision of light rail, suburban rail, quality bus lanes and rolling stock
Regional public transport	1048	Improvements in safety, physical capacity and quality and reliability of national rail system.
Water and waste water	3168	Bring the wastewater emissions from the 155 urban agglomerations each with a population equivalent of at least 2000 into compliance with the Urban Wastewater Directive. Bring the quality of drinking water up to standards of the Drinking Water Directive, and invest in water conservation. Provide catchment protection, including monitoring of effectiveness of wastewater treatment capacity.
Coastal erosion	44	Provide environmentally sensitive protection in the case of particular cases of erosion, including research
Solid waste	825	Rationalise municipal waste landfills, leading to integrated network of some 20 state-of-the-art facilities. Develop waste recovery including development of composting.
Energy	185	Promotion of alternative energy, and energy efficiency
Agriculture – Rural Environmental Protection Scheme	1905 (includes annual payments)	Conservation, protection of habitats and water courses
Agriculture – waste management	187	Improved animal housing, and farm waste storage
Forestry	736 (includes annual premia)	20 000 hectares per annum to be planted; investment in roads and woodland improvement
Environmental research	25	Measuring impact of economic development, demonstrations of best practise, development of systems, models, instruments and techniques to assist policy and decision-making.
Total	18256	

Source: Government of Ireland (1999).

158. The National Development Plan provides funding for research. However, research in environmental economics and policy analysis that would inform choices with regard to either instrument selection or implementation appears to be lacking[74].

Policy options for achieving environmental objectives

159. It has been clear ever since Ireland signed the Kyoto Protocol that the country faces severe difficulties in meeting the set target (Figure 16). Despite this, there have been virtually no significant measures implemented to date. It is interesting to note that Ireland opposed the development of a European carbon tax despite the fact that such a flexible mechanism would reduce the cost of reducing emissions. The National Climate Change Strategy was adopted at the end of 2000 and also includes sequestrations the effect of which on environment is controversial (Box 10)[75]. As has become customary in national abatement plans, targets for reductions in each sector have been specified, although it is not evident that they have been based on judgements about the relative marginal costs of abatement in each sector (Table 21). This makes it all the more important that the policies to be adopted will be cross-sector in character. In the Strategy, there are, at least, some recognition that taxes are required in order to make a significant reduction from the business-as-usual-scenario as well as support for an EU-wide emissions trading system. While this acceptance of least-cost mechanisms is to be welcomed, investment in research on the appropriate structure and magnitude of a carbon/energy tax is lacking. This leaves the field open to the interest groups opposed to the tax with the authorities lacking research to rebut the criticism.

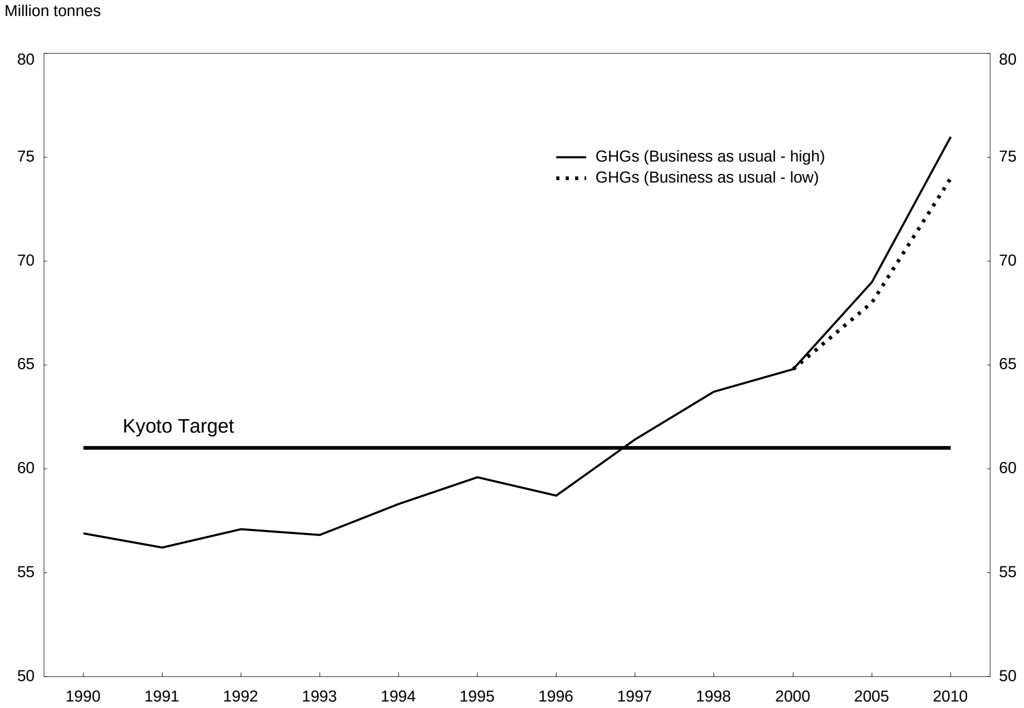
Table 21. **Targets of Draft Greenhouse Gas Abatement Strategy**

Reduction Source	Reduction in GHGs (mt)	% of proportion of overshoot
Energy	-6.35	44
Industry	-2.0	14
Agriculture	-2.26	16
Residential	-0.6	4
Transport	-2.67	19
Landfill and thermal treatment	-0.8	6
Business as usual overshoot	+14.423[1]	
Overshoot with Strategy 2010	-0.257	

1. Assuming 50% of current forestry target achieved.

Source: Department of the Environment and Local Government (2000a).

Figure 16. Business as usual greenhouse gas emissions and associated target for 2012



Source: McGettigan and Duffy(2000).

Box 10**. The use of carbon sinks in the national abatement strategy.**

An ambitious forestry programme (Department of Agriculture, Food and Forestry, 1996) to double the forest area was announced in 1996. This involves planting 20 000 to 25 000 hectares per annum up to 2030. Although the primary goal of this programme is to develop a sustainable wood supply and processing industry, under the provisions of the Kyoto protocol, CO_2 'sequestered' by forests established since 1990 is allowed as a deduction to the overall target. This sequestration is included in the figures above. However, the afforestation rate is running at about 50 per cent of the target. If this were to be continued, the 2010 'High' scenario in Figure 16 would apply under business as usual. If the full planting target is achieved, the 'Low' business as usual scenario would apply. However, the figures for sequestration involve a 'back of the envelope' procedure and there is some evidence that soil disturbance during forest establishment on some sites (particularly on peat soils) could result in net emissions of greenhouse gasses. A further issue in regard to the use of afforestation as a sink is the assumption in the figures that the majority of trees planted will be non-indigenous conifers. These trees grow rapidly in the Irish climate and therefore are ideal for sequestration. However, their effect on the environment is a controversial matter and Irish environmental NGOs have some success in holding up EU funding on the basis that more broad-leaves should be planted. If more broad-leaves are planted, the cumulative sequestration over the 2000-2012 period (the 'first commitment period' of the Kyoto Protocol) will be reduced.

Taxes and trading

160. A key element of the Strategy is the proposal to have a framework for greenhouse gas taxation in place from 2002, but initiatives have also been proposed to remove subsidies supporting inefficient use of energy. The revenue from the new tax is to be used to reduce direct taxes including labour taxes, as well as to support energy-efficiency measures, R&D and information and education programmes with partial tax-rebates for industries sensitive to external competition. The tax will be levied both upstream and downstream, the latter applying particularly in the case of electricity consumption. No initial rate has been set but it will be varied annually to improve its effectiveness. The Irish Energy Centre will advise on energy-efficient technologies, which will form the basis for negotiated agreements with the various sectors of industry. The first of these would be negotiated by 2002 and in place by 2005. Those industries/firms not in such an agreement would be subject to the energy tax. The potential for agreements will be explored during negotiations over tax rates. The tax will be reviewed in the context of the development of trading regimes for emissions.

161. The proposed tax regime appears to be underdeveloped at this stage and will need to be planned carefully. To be efficient, the tax will have to be based on the CO_2 equivalent content of fuels which could best be handled at the upstream level (*i.e.* primary energy sources such as burning peat for electricity generation). It is not evident why the tax would also have to apply to electricity consumption. A key weakness in the approach, however, is the proposal to negotiate tax breaks with firms which would seem to be inefficient and open the way to rent seeking activity. At a minimum, polluting enterprises should face the same marginal abatement costs whether they have signed an agreement or are subject to the tax. Such a scheme will require very careful specification if it is to be coherent and efficient and to compensate for the significant administrative costs involved[76].

162. Under the social partnership arrangements, the government will have to persuade industry (as represented by IBEC) and others to support the tax. IBEC favours voluntary agreements and tradable permits with only a small role for a greenhouse gas tax, which they argue would have little impact on emissions. Their concern is closely related to fears about the loss of competitiveness of some sectors, though most of such fears are misplaced[77]. The unions, stung by pay increases negotiated as part of the PPF being eroded by inflation, have called for reductions in excise duties, such as on petrol, in order to reduce inflation. It remains to be seen if, in the light of this, any agreement can be reached on taxation.

163. The taxation perspective with fixed emission targets is not necessarily the most suitable framework for Ireland with its (in part demographically-based) growth prospects. Indeed, a case could be made that Ireland should be able to raise its emissions quota by buying tradable permits. The Minster for the Environment and Local Government established a consultation group on greenhouse gas emissions trading to advise on options for trading both in Ireland and in the context of international agreements. The Group reported in July 2000 and concluded that emissions trading should be used to the maximum extent, that the Government should oppose a 'concrete ceiling' that would place a limit on the proportion of emission entitlements that can be traded domestically or internationally, and that Ireland should also participate in the Joint Implementation and Clean Development Mechanisms. The Group set out principles for a domestic emissions trading system and argued that the benefits would be substantial. CO_2 trading would be the most likely candidate for domestic action but there could be a number of problems unless international trading were also possible. Emissions of CO_2 are concentrated with no more than ten firms covering up to 50 per cent of national emissions. Consequently, there would be a high risk of the market being distorted and competition being hindered. Moreover, because the sectors involved are relatively concentrated, there is a risk that trading would not develop, as firms might be reluctant to sell emission permits to a rival. Nevertheless, they recommended that Ireland proceed with implementing some shadow schemes in order to gain experience.

164. Some of the initiatives for reducing greenhouse gases are complementary to efforts to reduce acidification precursors, such as the closure of Moneypoint power station by 2008 (see below). Interestingly, the Kyoto Protocol has received much greater attention than has Gothenburg. While there has not been a dramatic increase in the pollutants by Ireland covered by Gothenburg, large reductions are required. It would seem wise to develop an integrated strategy to address both issues together including a move to tradable permits. The expert group thought that a N_2O permit trading system would need a long time to mature but that it was feasible for other gases including methane. However in the case of the latter gas, the farming sector might have to act as a single entity within the trading system.

165. The Gothenburg Protocol negotiations employed the use of a computer programme called the RAINS Model to assist in identifying a cost-minimising strategy for abatement across Europe and thereby specified emissions ceilings for the countries concerned. On this basis, Ireland was initially allocated relatively strict emissions limits. This is because, heretofore, there have been very few initiatives to reduce acidification precursors so that Ireland is relatively far down the marginal abatement cost curves for the various pollutants. After negotiations Ireland obtained a relaxation of the SO_2 and NO_x ceilings against a tighter limit on ammonia emissions. The increase in the SO_2 ceiling is thought to have reduced compliance costs for the electricity generation sector considerably. Nevertheless, reductions of 76 per cent in SO_2 and 48 per cent in NO_x will be required by 2010 given that the Gothenburg ceilings are likely to be reflected in the forthcoming EU Directive. The VOC target of a 50 per cent reduction already reflects the EU Directive. Ireland will need to take policy action to live up to its commitments to Gothenburg. Failure to meet the forthcoming Directive will prove costly to the State.

Implications for the electricity sector

166. Despite the overall improvement in energy intensity, electricity output is expected to double by 2010 resulting in a substantial increase in emissions[78]. The electricity sector is already a major source of emissions: the largest power plants use oil and coal and account for 60 per cent of SO_2 emissions[79], 30 per cent of NO_x emissions and 22 per cent of all greenhouse gas emissions. Renewable energy, comprising mostly hydro-power, makes up just 2 per cent of Ireland's primary energy requirement since the river system is not suitable for this source of energy. The National Climate Change Strategy places a heavy load on the electricity sector expecting it to contribute 44 per cent of the required reduction in greenhouse gas emissions. In addition to the general policy intention to develop GHG taxation and an emissions trading system, the government's strategy comprises fuel switching and improvements in the efficiency of energy transformation, including additional regulatory measures.

167. The fuel substitution strategy involves switching to natural gas (saving 4.95mt of greenhouse gases per annum) and closing a major power plant, but how this substitution will be achieved is in great part unclear. Greenhouse gas taxation will presumably lower the relative price of natural gas, which is in any case now often the preferred energy source due to technological change. Natural gas penetration is growing with almost 80 per cent of the gas supply coming via the inter-connector between Ireland and the UK. The gas pipeline system is already over-stretched so it will be important that the pipeline operator (see Chapter III) and any new entrants have the incentive to continue to expand the network. With the introduction of competition in the electricity market (Chapter II), demand for capacity in the natural gas network exceeded the capacity available in the network. A law was passed in 2000 providing for a scheme to allocate a specific amount of capacity in the network for the purpose of fuelling new electricity generating capacity until a second interconnector with the UK becomes available. In addition, the coal fired plant at Moneypoint will be replaced by a Combined Cycle Gas Turbine plant by 2008, saving 3.4mt per annum.

168. The government has decided to close six older peat plants, which have particularly large emissions of CO_2, but to replace them by two, more thermally efficient, peat plants which will reduce net emissions by 2.05mt per annum. While this is an improvement, the decision does not go in the direction of encouraging the development of more environmentally friendly and economic generating capacity. While there will be no direct subsidies, the excess costs of production will be passed onto the costs of the entire electricity sector with little control over efficiency apart, that is, from new regulatory measures[80].

169. The target of the Green Paper on Sustainable Energy is for 500 MW to be produced from all "green" sources by 2005 reducing GHG emissions by a further 1mt per annum[81]. A Renewable Energy Strategy Group (2000) has just reported their recommendations in this regard. The costs of acquiring alternative green power will be passed on to electricity consumers, making it all the more important that targets for green power be met by tender rather than by fixed prices for output or by subsidies. However, if a GHG tax is introduced in an efficient manner related to the carbon content of primary fuels, it should not be necessary to support green electricity in this manner. More general issues might arise such as ensuring them access to the grid. There have been a number of initiatives to introduce wind power. Full planning permission has been granted to wind farms with a combined installed electricity generating capacity of 155 MW with a further 160 MW subject to planning permissions. There are potentially large negative environmental impacts of wind farms with regard to landscape impacts and noise, although these may be mitigated by moving some of these offshore.

170. Efficient generation is also to be achieved by a number of regulatory means. In addition to the usual issues of competition, the new sector regulator (the Commission for Electricity Regulation, see Chapter III) also has a duty to take into account the protection of the environment and encourage the efficient use of electricity. Other duties include encouraging research and development of methods using renewable, sustainable and alternative forms of energy and combined heat power installations. The remit also covers research into increasing efficiency of generation. Whether this will result in a dangerous over-extension of the regulators field of activity will remain an important question. At the same time, the Environmental Protection Agency will extend integrated pollution control licensing to all existing and new plants (above 50 MW) requiring that energy is used efficiently in the generation of electricity (a sector that it should be recalled is being liberalised so as to bring about competition and efficiency enhancement) and that all appropriate preventive measures are taken against pollution through application of best available techniques. It will be important -- but difficult -- to ensure that regulatory changes and tax measures will, at the end of the day, represent a coherent policy package.

Current policy priorities involving environmental issues

Water quality and agricultural policy

171. Apart from the pressing need to supply water and sewage infrastructure for new housing, the core issue today is the continuing secular decline in the length of unpolluted rivers, and continuing deterioration in lake quality due to eutrophication, *i.e.* enrichment of the river systems. This is a consequence of nutrients running off into freshwater systems, which stimulate the growth of algae. The percentage of unpolluted rivers, at 67 per cent, is very high in a European context, but the rate of deterioration is alarming -- a fall of more than 10 per cent in less than 10 years (Table 22). Nitrate concentrations have increased markedly in a number of rivers over the 1982-98 period. Sewage is the dominant cause of the heavily polluted stretches (48 per cent), but agriculture and industry are also major contributors (Table 23). The negative consequences of this deterioration for well-being have never been systematically evaluated. Apart from damage to fishing for residents as well as for a growing number of tourists, there are additional

costs of treating drinking water from surface sources and a negative impact on Ireland's image as clean and green.

Table 22. **Quality Status of Freshwater Rivers in Ireland**
per cent of total

River Quality	1987-90	1995-97
Unpolluted	77.3	66.9
Slightly polluted	12	18.2
Moderately polluted	9.7	14
Heavily polluted	0.9	0.9

Source: EPA, 1999.

Table 23. **Pollution in Irish Waterways by Severity and Source of Pollution**
1995-1997

	Slightly polluted		Moderately polluted		Heavily polluted	
Source	No.	% of total	No.	% of total	No.	% of total
Agriculture	274	47	276	46	16	25
Sewage	137	24	150	25	31	48
Industry	50	9	64	11	14	22
Other	119	21	111	18	4	6
Total	580	100	601	100	65	100

Source: EPA (1999, p. 10).

172. A number of actions have been taken, including a large volume of investment and a tightening of the regulatory framework. There has been substantial investment in municipal wastewater treatment plants that emit into fresh water and a number of local authorities are now charging for the use of wastewater treatment capacity based on the toxicity and costs imposed on the system. Some of the investment has been driven by the need to meet the objectives of the urban wastewater Directive and will reduce emissions from this source[82]. In addition, there has been substantial investment in farmyard-pollution reduction, specifically the grant scheme for the storage of farmyard manure, but also including investment under the Rural Environmental Protection Scheme (REPS)[83]. On the regulatory side, the Integrated Pollution Control (IPC) system operated by the EPA has been extended to the food and pharmaceutical industries. This should have reduced emissions from these sources. Regulations have been enacted setting minimum standards for various qualities of water and a number of pilot schemes have tested the utility and optimum mechanisms for implementing catchment-based planning and decision-making. River basin planning turns the attention on outputs, and "provides a forum for getting the key polluters and those most affected around a table to assess the situation and their contribution thereto, and a means of identifying the least-cost solutions to the water quality challenge being faced". The efficiency of such a process, however, depends on the relative strength of the parties involved and would be greater if the polluter pays principle were more effectively applied as recommended in the *OECD Environmental Performance Review of Ireland*. Given the extent of investment and other actions, it is surprising that the trend in quality is still downward. This raises questions concerning the effectiveness of such investment and other actions in achieving

improvement, but it is also true that much of the new treatment capacity remains to be installed and made operational.

173. Ireland is rather unique among OECD countries in that householders do not pay for supplies of municipal water directly. This is a product of public resistance to the annual water charges per household, on the basis that it is 'double taxation.' The charges imposed on householders before they were abolished were fixed charges, and so had no effect on household decisions regarding water use. The cost-recovery provisions in the EU Commission's Draft Water Framework Directive were opposed by the Irish government, because of the perceived popular resistance by householders. If meters were installed, and households were charged for water based on their use, this would greatly enhance the capacity for rational management of an expensive and increasingly scarce resource. However, on September 6, 2000, the European Parliament cleared a derogation from any obligation to introduce water charges in Ireland despite the best efforts of the European Commission. Inadequate possibilities for charging domestic consumers for water quality remains a key deficiency. Although non-domestic users will be charged the full economic cost of water usage by 2006, it may nevertheless prove difficult to maintain the effectiveness of the expensive wastewater treatment plant now in place. The additional energy, chemicals and labour costs are substantial. As direct revenues will not be sufficient to cover operating costs, some local authorities may be forced to operate the plant below optimum level, thereby damaging performance.

174. Agricultural activities are a significant cause of eutrophication and ground water contamination (Table 24). Most nitrate and phosphate found in natural waters comes from external organic and inorganic sources -- mainly from sewage and industrial waste discharges, and from diffuse sources such as forestry, agriculture and domestic septic tank systems. With regard to nitrates in groundwater, the response has been driven by the requirements of the EC Nitrates Directive (1991) which sets a maximum admissible concentration (MAC) of 50mg of nitrate per litre of water and a recommended limit of 25mg/l. The directive also obliges Member States to monitor ground and surface waters and to designate nitrate-sensitive zones (where nitrate concentrations exceed 50mg/l or are likely to do so). Member States must designate freshwater, estuaries, coastal and marine waters which are found to be eutrophic from nitrates or which are likely to be in the near future[84]. In response, the Department of the Environment and Local Government has conducted a survey which identified thirteen nitrate-sensitive zones, and one local authority has passed by-laws regulating agricultural activities in three nitrate sensitive areas as well as to leave buffer strips along water courses. These bylaws are being used also to control eutrophication problems, and meet water quality standards.

Table 24. **Freshwater Pollution Attributable to Agriculture**
1995-1997

Degree of pollution	% of cases attributed to agriculture
Slightly polluted	47
Moderately polluted	46
Heavily polluted	25

Source: EPA (1999, p. 10).

175. Given the limits imposed by the Common Agricultural Policy, information, command and control and subsidies are all employed to improve the environmental performance of farming in Ireland. But the data available all relate to inputs, rather than outputs, so it is not clear to what extent this effort is yielding internalisation of external costs and expanded output of external benefits (mainly biodiversity related). In regard to acidification, there is now a legally binding quota for ammonia emissions by the country, and

under 'business as usual' Ireland will exceed the quota. Since ammonia comes mainly from the farming sector, some policy intervention will be required. A combination of tax changes to encourage farmers to switch fertilisers -- including finally charging VAT rather than leaving most fertilisers zero-rated -- and requirements to switch from splash plate spreading of slurry look to be the most promising interventions. As regards eutrophication and nitrification, the poor performance of Ireland in this area is going to require a substantial improvement; the bylaws applying to a few catchments in Cork are likely to become much more pervasive, and this will impose costs on farmers and on other administrative processes. Taxing fertilisers is a second best option, a first best being to insist as do some Scandinavian countries on full nitrate accounts and to tax only the emissions of nitrates and not the input.

Waste disposal

176. The basic thrust of the national policy (set out in 1998) is to reduce national dependence on landfill which is reflected in the low recovery rate, and to aid local authorities make the transition to an integrated system, developed in a regional context (Table 25). As is usual in a great deal of environmental policy, specific targets have been set to reflect requirements under various EU directives, which often appear arbitrary[85]. It is difficult to envisage that the volume of waste going to land fill can be stabilised or reduced without the introduction of strong financial incentives for the key actors to move in this direction. There is no landfill tax to encourage diversion, although charges for deliveries to landfill are increasing and the government is investigating the issue. There are a few pilot projects testing the use of charging householders by weight. There are no fiscal incentives yet to encourage recycling and re-use. The Minister for the Environment and Local Government has proposed a tax on plastic bags, but no action has yet ensued. There is a voluntary agreement by the packaging interests -- producers and users -- to meet the EU recycling target for packaging, and to thereafter continue to increase the percentage of packing with re-used and recycled material. Unless these instruments are fully implemented the ambitious targets, which should remain only indicative, are unlikely to be met.

Table 25. **Waste arising in Ireland**
In millions of tonnes

Waste Category	1995	1998	Change 1995-98	Annual average change	Recovery 1998 (%)
Agricultural	31.00	64.58	33.58[1]	11.19	n.a.
Manufacturing	3.54	4.88	1.34	0.45	51.4
Energy Gas and Water Supply	0.35	0.45	0.1	0.03	16.0
Mining and Quarrying	2.2	3.51	1.29	0.43	0.4
Hazardous Waste	0.24	0.37	0.13	0.04	54.4
Municipal Waste	1.85	2.06	0.21	0.07	8.6
End-of-life vehicles/scrap metal	0.05	0.19	0.14	0.05	96.6
Construction and Demolition Waste	1.32	2.70	1.38	0.46	43.3
Urban wastewater sludges	0.85	0.51	-0.34	-0.11	5.9
Drinking water sludges	0.04	0.06	0.02	0.01	0.0
Dredge Spoils	0.78	0.73	-0.05	-0.02	
Total excl. agriculture	11.25	15.41	4.16	1.40	26.6
Total incl. agriculture	42.25	80.01	37.76	12.59	

1. The large increase between 1995 and 1998 is partly due to a change in the method of calculation so that they are not strictly comparable.

Source: EPA (2000, p. 57).

Transport

177. The National Climate Change Strategy aims to make substantial savings over the business-as-usual scenario in the transport sector via modal shift, increases in excise duty on fuels, and greater fuel efficiency of vehicles (assisted by the voluntary agreement between the EU and European, Japanese and Korean car manufacturers to reduce CO_2 emissions from new cars by an average of 25 per cent). In view of the rapid increase in vehicles and the proposed extension of the highway network even the business-as-usual scenario might be optimistic[86].

178. Recent policy measures with respect to modal shift have focused on increasing the supply of public transport mainly by increased investment such as a light rail system for Dublin, more buses and rail cars and Ir£ 500 million for an upgrading of the rail network. To promote utilisation of facilities, public transport is exempt from VAT and there is a tax rebate on fuel. This is a clear example of policy lacking coherence since emissions impose the same cost on the environment from whatever source. There are also proposals to raise the efficiency of this key sector including greater use of bus corridors. The implication of this measure for emissions per head carried by a given road is rather unclear so that it might be necessary to view the policy as an interim measure.

179. On the "demand" side, there are the usual taxes and excise duties (Ireland ranks fourth in the OECD for environmentally-related taxation as a percentage of GDP) which are aimed at reducing car ownership and usage while stimulating demand for public transport[87]. Commuting expenses are subject to tax and the use of company cars is treated as benefit in kind (30 per cent of the original market value of the car). But the tax structure is not yet consistent and other environmental considerations are not fully incorporated[88]. Registration tax and VAT on new cars amounts to around 50 per cent of the price but they do not take into account engine characteristics (apart from size) such as emissions and noise. With respect to car use which is the key factor as far as the environment is concerned, fuel prices remain lower than in many other OECD countries and below those in Northern Ireland. Moreover, excise duty on diesel was reduced in the 2001 budget to lower headline inflation and, in line with a number of EU countries, to compensate the road transport sector for higher fuel costs.[89]

180. In view of the evident ineffectiveness of the above measures to limit car use, a number of proposals have been put forward. A government commissioned report considered a road-pricing charge of Ir£ 3 per car entering Dublin city centre during peak hours and estimated that the system would pay for itself within one year. However, the report also noted the numerous difficulties in making road pricing operational. In addition, a group advising the Minister for Finance has recommended the introduction of a tax on workplace parking as a benefit in kind. No announcement has yet been made by the Minister about this recommendation, which is supported by the Director of Traffic of Dublin Corporation. It is notable that, despite deliberating for some time, the advisory group has not published any details about how such a tax scheme would operate and it seems that this is another area where research is lacking.

181. A report has been recently prepared for the Department of Public Enterprise on the environmental implications of Irish transport. The recommendations of the report are very strong but it remains to be seen whether they will be adopted and, if so, whether such contentious issues as charging for workplace parking and increasing tax on motorcycles can be overcome politically (Box 11). There are several points which need to be made about the report's conclusions. First, the recommendation not to raise fuel taxes is surprising. While the recent rise in oil prices has done little to reduce demand for petrol, suggesting that the short term price elasticity is very low, most research points to a much higher elasticity in the long term. The recent cut in fuel excises for some groups goes in the wrong direction and signals that, when set against other objectives, environmental considerations might not be that important after all. Second, the recommendation that the rebate on fuel for public transport should be eliminated goes in the right direction since the externalities associated with the emissions are basically the same from whatever source. The

suggestion to base explicit subsidies on passenger kilometres may not be a first best solution but certainly not bad as a second best. Removal of the rebate would, however, need to be co-ordinated with a more general increase of taxes on all fuels to reflect environmental policy objectives. Third, it seems as if road pricing is unlikely to be introduced any time soon, but second best approaches such as more comprehensive parking charges and taxes on parking as benefit in kind offer some potential. However, unless the level and quality of substitutes to commuting by car can be introduced, the suspicion is that such measures will merely be revenue raising without actually reducing congestion and other externalities, as suggested by motoring groups. This difficulty has a knock-on effect on environmental emissions where it is recognised that it is extremely difficult to achieve significant reductions. However, the bottom line is that, unless the supply-side measures are forthcoming, demand-side measures are likely to have little effect.

Box 11. **Recommendations of Report on Environmental Implications of Irish Transport**

– Registration tax and circulation tax should be differentiated more closely according to environmental damage. Focus should be on measures that encourage the production and purchase of more fuel-efficient vehicles rather than on fuel tax increases.

– Rebate of diesel for public transport should be replaced by explicit subsidies based on passenger kilometres.

– Workplace parking should be charged on a daily basis through the rating system rather than as benefit in kind.

– The feasibility of road pricing should be investigated as a medium to long-term measure.

– Judged by the polluter pays principle, heavy goods vehicles (HGVs) are underpaying. HGV tax should more closely related to external costs.

– Motorcycles should be more heavily taxed to reflect their contribution to accidents.

– Rebate on diesel for passenger rail should be replaced by a direct subsidy to Iarnrod Eireann (Irish Rail)

– The Irish Government should support the introduction of VAT and emission charges on air transport.

– Urban planning policies should complement the above.

– Traffic management measures should be reviewed and improved.

Source: Report prepared for the Department of Public Enterprise

Conclusions and Recommendations

182. Environmental policy in Ireland is driven mainly by international agreements on global warming (Kyoto Protocol) and acid precursors (Gothenburg Protocol), and by European Union legislation ranging from the quality of waste water to conservation of habitats of European significance. As regards global warming and acid precursors, the business-as-usual scenarios indicate substantial overshoots of the assigned amounts under these agreements. Current and prospective concentrations of micro particulates (PM_{10s}) are likely to be in excess of the EU legislative limits, while water quality will have great difficulty meeting current and prospective standards. This baseline scenario remains valid despite the very large investments in the National Development Plan 2000-2006 to address environmental issues, including water

and waste water (€ 3.168 billion), solid waste (€ 0.825 billion), farm waste (€ 0.185 billion), rural environmental protection, including habitat protection (€ 1.905 billion) and public transport (€ 2 555 billion). It is clear that the current policy mix, mainly regulation/command and control, direct investment (waste water and public transport) and subsidies (mainly to farmers), will not achieve compliance with international agreements and European Union requirements. Moreover, the actions will not internalise relevant costs in those areas where European Union legislation is not yet active but where there is a rising domestic concern (*e.g.* housing and congestion).

183. In response to these scenarios the government has agreed an ambitious plan, the National Climate Change Strategy, which aims to reduce greenhouse gas emissions by 20 per cent over the baseline with significant savings in the energy sector, transport and in agriculture. There is not as yet a strategy for dealing with acid precursors (Gothenburg Protocol) although some reductions would be expected as a side-effect of the Strategy. A key element is the introduction of a greenhouse gas taxation regime although further regulatory initiatives are also foreseen particularly in the area of energy. At the same time, the authorities have shown a great deal of interest in emissions trading, both internationally and domestically. However, the time is rapidly approaching when concrete decisions will have to be made about the exact path to be followed since some instruments are substitutes for others.

184. A key question is whether the targets themselves make much economic sense, especially in an economy that is characterised by different demographic developments than in many of its partner countries which will lead to higher rates of growth for some time to come. In a world of caps and international emissions trading, Ireland might be expected to become a purchaser of emission rights. Indeed, the authorities are quite rightly looking forward to international emissions trading to help achieve compliance with the Kyoto Protocol envelope. Ireland should actively pursue the introduction of emission trading, both internationally and in the EU, with no concrete ceilings. If this is the expectation, then Ireland would be best advised to start now in developing domestic trading systems in a number of areas including in unused limits specified by integrated pollution control licenses. Carbon dioxide emission trading might be difficult given the small size and concentration of the domestic market, but some schemes could be tried in order to gain experience. In this case a scheme could be based on the upstream principle (*i.e.* energy producers and importers). In order to overcome opposition and perhaps some legal issues, the initial allocation of permits might have to be grand-fathered for a period, at least in part, but there should at minimum be a commitment to move away from this system at a future date.

185. The Strategy gives a great deal of attention to greenhouse taxes but preliminary ideas are not consistent with the development of a least cost, environmentally efficient, tax regime. It is currently envisioned that companies will be able to establish agreements with the authorities about emissions, the efficiency of energy use etc which would then lead to the firm being exempt from the tax. Such a system would be unsatisfactory, expensive to administer and subject to rent seeking activity. In the absence of highly complex agreements, the equality of marginal costs across all polluting activities, the very reason for having a cross sector GHG tax, would be broken. The GHG tax will have to be based on CO_2 equivalents of all fuels, which will imply a large tax on peat. The decision to replace six old peat plants with two new ones undermines the credibility of any such future tax policy. To meet the agreed international limits, taxes might need to be rather high for a long period till the capital stock, technology and consumption patterns altered. The decision in the budget for 2001 to lower some energy excise taxes as a balance to higher energy costs has not sent an appropriate signal about how environmental policy will finally be organised.

186. Taxes and charges to signal environmental scarcity and to implement effectively the polluter pays principle should be used as environmental policy instruments in Ireland. A combination of charges on NO_x and SO_2 emissions, even when accompanied by carefully constructed rebates or tax credits to ensure revenue neutrality, would, in combination with other instruments, help Ireland achieve its obligations

under the Gothenburg Protocol. Charges to reflect the cost of the environmental externality need to be implemented in water and waste disposal including land fill. Even if the level of charges can only be determined approximately, market incentives would still be created which would improve the efficiency of waste disposal, either through recycling or incineration. With respect to specific environmental externalities associated with farming, taxation of fertiliser is desirable to cut ammonia emissions and, even though it is not a first best response, would also help reduce nitrification. A number of payments could be linked to the adoption of better environmental practices.

187. At the same time, households should bear the full costs of their location decisions and their demand for infrastructure. The Irish public has proved very resistant to paying charges imposed on households, on the basis that such imposts are 'double taxation'. Property tax (domestic rates) and water charges on domestic households have both been eliminated, and not all jurisdictions demand a charge for refuse collection. These three charges (property tax, water and refuse) were (or still are) all in the form of an annual fixed cost so that their impact on behaviour would have been negligible. The introduction of metered charges for domestic water, a land-fill charge, and charges on the basis of weight for domestic refuse, should all stimulate improved performance.

188. Some suggestions for policy intervention, drawing in part on the *Environmental Performance Review* (OECD, 2000a) are presented in relation to each issue in Box 12. This is intended not as an integrated package of measures, but an indicative list of possibilities. These initiatives, if acted upon, would introduce market forces in support of environmental conservation. However, the design and implementation of such interventions will be substantially enhanced if a research programme runs in parallel, which includes the following elements: collection and analysis of site-specific data in Ireland; pilot testing of specific policy interventions; collection, synthesis and application of best international practice. A particular focus should be on the estimation of the environmental responsiveness of proposed market-based interventions, economic efficiency and equity effects, and implementation mechanisms. If the market can be effectively mobilised in support of environmental quality, as has increasingly been done in many OECD countries, then economic growth and conservation of environmental endowments can be reconciled and made mutually supportive. Without the use of market-based instruments, this is unlikely to happen.

Box 12. **Key Environment-Development Issues and Recommended Market Interventions**

Environmental Issue	*Performance*	*Recommended Market Interventions*
1. Meeting Kyoto greenhouse gas emissions target	Under business as usual, The 61 million tonne CO -equivalent target will be substantially exceeded	Examine every existing energy-related tax and re-calibrate them to improve their environmental effectiveness Ireland ranks 4th in the OECD in terms of the proportion of GDP accounted for by environmentally related taxation. However, most existing taxes were not originally intended to be environmental taxes and could be more effective. Introduce emissions trading as quickly as feasible including volunteering for EU pilot schemes.
2. Meeting acidification precursor targets Meeting standards for NOx and PM_{10s}	Stabilising of SO_2 emissions; nevertheless, under 'business as usual' projections, there will be substantial overshooting of targets agreed for SO_2 (by 136 thousand tonnes), Nox (by 60 thousand tonnes) and VOC (by 55 thousand tonnes). Downward trend in ambient air quality in cities, especially regarding PM_{10} and NOx.	An acidification precursor abatement strategy is required that is integrated with the greenhouse gas abatement strategy. Introduce charges on NO_x and SO_2 emissions with appropriate rebates etc. to be used to address equity and competitiveness concerns. Taxation could be used to encourage farmers to switch from urea to CAN to reduce ammonia emissions. See transport also.

3. Meeting water quality objectives in Irish and EU legislation	Downward trends in freshwater water quality. Major non compliance with EU drinking water Directive, and prospective non compliance with Water Framework Directive as regards no deterioration.	Remove the VAT exemption from chemical fertilisers. In order to ensure that the €3 billion investment in water supply and wastewater treatment is used effectively, households should pay directly for water. Economic efficiency, environmental and political feasibility will be improved if metering is used with unit charges rising with increased use. Equity issues can be addressed easily.
4. Stabilising waste emissions (hazardous and non hazardous)	All categories – agricultural, manufacturing, mining and quarrying, hazardous, municipal, construction and demolition, drinking water sludges – increased over the 1995-'98 period	Introduce a land-fill tax and use the lessons deriving from the pilot schemes testing weight-based charges to implement such a scheme. Implement a Toxics-Release Inventory to stimulate reductions in the use and disposal of toxic substances.
Sectoral issues		
1. Transport	The growth in disposable income and population has led to a doubling of car numbers, and this in turn has resulted in serious congestion costs and increased emissions of NO_x and PM_{10s}	Supply-side is the key to increasing price elasticities. Press ahead with improvements in public transport and park-and-ride schemes. Traffic management of the entire Greater Dublin area should be the responsibility of one Director of Traffic. Re-structure annual vehicle tax and vehicle registration tax to better reflect the emissions, noise characteristics, and size of vehicles. Increase marginal costs relative to fixed costs of motoring. Reduce annual tax and use road pricing or second-best approaches such as parking pricing to increase marginal costs. Replace rebate on diesel for public transport with explicit subsidies based on passenger miles. Increase taxes on heavy goods vehicles. Refine on-street and multi-storey parking charges to reflect scarcity of road space with a zoned system
2. Energy	Final demand for energy continues to grow in line with GDP growth, and under 'business as usual' this is expected to continue across all consuming sectors, with growth especially pronounced in transport and households.	See recommendations with regard to greenhouse gases and acidification precursors and transport. Potential reduction of energy use in residential sector is much greater than outlined in the greenhouse gas abatement strategy (and there are also considerable health benefits). The principal initiatives recommended include a clear state-led information campaign combined with grants for low-income households for installing energy-efficiency measures.
3. Agriculture and Forestry	Key challenges are emissions of acid precursors (ammonia), eutrophication of freshwater, nitrification of groundwater, and biodiversity loss. Global warming also an issue.	Tradition of subsidy (victim pays principle) needs to be broken as it increases the number of producers and therefore the overall level of pollution. Including agriculture in greenhouse gas emissions trading will give an incentive for farmers to switch from pollution intensive activity (*e.g.* by switching to trees or using methane recovery systems). Taxation should be used to encourage farmers to switch from urea to CAN to reduce ammonia emissions. Restructure forestry grants to reflect CO_2 sequestration as well as other environmental benefits. Compensation for delivered positive externalities such as unique habitat protection should be continued (*e.g.* via REPS) but should be subjected to Benefit-Cost Analyses.
4. Industry	Rapid growth in industrial output, but nature of industry is relatively 'clean' and controlled.	Investigate potential for least-cost approaches and possible trading of elements of IPC quotas.

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NOTES

1. No regular statistics are available about vacancies but a survey conducted in 1998 found a vacancy rate of around 6 per cent spread across all skills. The regular survey of production constraints by IBEC indicated a rise in such constraints through 1999 and 2000 so that it is probably safe to conclude that vacancies have continued to be high. This judgement is also supported by a great deal of anecdotal evidence.

2. Indeed, one reason for the rapid fall in interest rates on mortgages has been the entry into the Irish market of a bank which does not have branches in Ireland.

3. Baygan G. and M. Freudenberg, "The internationalisation of venture capital activity in OECD countries: implications for measurement and policy", *STI Working Paper*, 2000/7, OECD, Paris.

4. Jim O'Leary (January, 2001) argues that the share of the United States as a destination of the Irish high-tech exports is just under 13 per cent when organic chemicals, whose location decision may be heavily influenced by tax consideration, are excluded from the total exports.

5. See "Revised OECD measures of structural unemployment", in *OECD Economic Outlook, No 68*, December, 2000.

6 . The Central Bank of Ireland (1999) has suggested that the gap between services inflation and goods inflation would be a better indicator for domestic inflation when specifying the Phillips curve relationship between inflation and the unemployment rate. It has shown that there exists a fairly stable relationship between the actual unemployment rate and the gap in inflation thus defined. The Secretariat has also experimented with such a measure but with rather poor results.

7. The low inflation is partly related to the fact that the price level of traded goods has already equalised. The comparative price level of Ireland, which is defined as the ratio of PPPs to the exchange rate, has already reached the average of EU 15 countries, though it still remains below the level of Germany and France. This suggests that room for catching-up with the developed EU countries in terms of price levels may be diminishing sharply, even though there still remain some margin.

8. Specifically, there is a dominance of UK retailers in Ireland which seem to have priced to market rather than pass on price rises to Irish consumers arising from the weakness of the euro relative to the pound sterling.

9. H-W. Sinn and M. Reuter, "The minimum inflation rate for euroland", *NBER Working Paper*, No. 8085, 2001.

10. See *OECD Economic Survey of Ireland*, 1999 for details of the Partnership 2000 agreement.

11. Regarding the prices of existing houses, the rate of inflation peaked in the third quarter of 1998 and, since then, has followed almost the same trend as the prices for new houses.

12. The estimation in Bacon (2000) is carried out by a simple linear regression by using level data. However, as house prices have tended to have a monotonically rising trend since the mid-1990s, it is likely that the series of data have some trends that may be stochastic or non-stochastic. If Bacon applied a linear

regression to level data without any appropriate remedies, their results should be viewed with some caution.

13. In Ireland, commercial debts are usually financed by debenture rather than by mortgage. If the credits to the construction and real estate sector are taken into account together, the level of real-estate-related loans amounts to 12.8 per cent of GDP in the third quarter of 2000.

14. For example see the discussion in J. Durkan, "The role of budgetary policy in social consensus", in C. Kearny *et al*. (eds), *Budget Perspectives*, ESRI, Dublin, 1999.

15 . The PPF is negotiated by trade unions, employer organisations, the government and social organisations including the association of the unemployed.

16. Industrial action over preceding years had already secured special treatment for some groups.

17. Fitzgerald, J. (2000).

18. Wages in the construction sector, where excess demand is most evident, have been rising at double digit rates.

19. For a compilation of comprehensive competitiveness indicators see *Annual Competitiveness Report*, National Competitiveness Council, Dublin, 2000.

20. Net receipts from the EU (including agricultural receipts) fell from over 3 per cent of GNP in 1998 to some 2¼ per cent of GNP in 1999. It is forecast to fall to around 1 per cent of GNP by 2006. Receipts from the EU structural funds in 2000 have been affected by timing factors thereby overstating the usual level of financing from this source. In 2000, Ireland received from the Regional Development Fund Ir£ 622 million (¾ per cent of GDP) and Ir£ 253 million from the Cohesion Fund. The country has now been split into two areas, which facilitates Ireland to continue to receive the structural funds.

21. *Ex ante Evaluation of the National Development Plan, 2000-2006*, Community Support Framework Evaluation Unit, Dublin, November 1999.

22. *International Trade and Investment Report*, 2000, FORFAS, Dublin 2000.

23. *Expert Group on Future Skill Needs*, FORFAS, 1999 and two follow-up reports.

24. During the year, the government received large revenues from the privatisation of the telecommunications operator and used part of the proceeds to discharge future pension liabilities of employees in both Telecom Eireann and An Post. While the revenues are counted beneath the budget line as a financing item, the prepayment needed to be classified as a capital transfer of some € 1.6 billion (2 per cent of GDP) -- *i.e.* as above the line -- giving the false impression that the budget situation had in fact deteriorated.

25. Full individualisation implies a situation where the band is independent of marital status i.e. where it is equalised for all individual tax payers.

26. Within the framework of European moves to reduce unfair tax practices, the government has an agreement with the EU Commission that the 10 per cent rate applying to manufacturing and internationally traded services will be unified with the standard rate by 2003.

27. The cost of child care is one of the fastest rising components of the CPI.

28. The last Economic Review noted that the ceiling was not a particularly tight constraint as it included interest outlays, which have been declining rapidly, and net social security outlays which are currently

negative. On a general government basis, annual growth in non- interest current spending averaged 10 per cent over the period 1997-2000.

29. *Budget 2001: Like Snuff at a Wake*, Davy Stockbrokers, Dublin, December 2000.

30. *Budget 2001*, Department of Finance, Dublin, 2000.

31. I. Kearney *et al.*, "Assessing the stance of Irish fiscal policy", in A. Barrett (ed) *Budget Perspectives*, ESRI, Dublin 2000.

32. For other points of difficulties D Cronnin and D, McCoy, "Measuring structural budget balances in a fast growing economy", in *Indicators of Structural Budget Balances*, Banca dÍtalia, 1999.

33. A number of other issues are now less relevant for Ireland, including the important role of government debt as a bench mark for financial markets. Even if Irish national debt is fully repaid, now that it is a member of the Euro area, debt of other countries is a virtually perfect substitute. This argument abstracts from the development of any risk premia between Euro area countries.

34. Such a position assumes of course that perfect Ricardian equivalence does not hold which posits that household savings would simply decline to offset public saving. There is little reason to suppose that Ricardian equivalence holds in Ireland even in a weak form. On the contrary, with a very young population becoming accustomed to rapidly rising living standards it is reasonable to suppose that the economy is in transition from one equilibrium path to another so that there is even less reason to expect equivalence to hold.

35. The ration of persons of working age to those aged 65+ will decline from 5 to 1 at present to 2 to 1 by 2056. Budget Strategy For Ageing Group Report, , Department of Finance, Dublin, See also D.Cronin and D. McCoy, "Fiscal sustainability when time is on your side", in *Fiscal Sustainability*, Banca d'Italia, Rome, December 2000.

36. Initial plans called for the operation of two funds, one of which would have been classed by Eurostat as outside the general government sector. Contributions would thus have made the general government fiscal position, which is used by the EU to judge compliance with the Stability and Growth Pact, worse. Proposals to establish this fund were abandoned in 2000.

37. Funds not being allocated according to individual accounts might also reduce any tendency for individuals to cut their own savings. On the other hand, this makes it more likely for contributions to be perceived as taxes, thereby negatively affecting work incentives.

38. Under the PCW 1994-1997, there was an agreed norm of 5½ per cent for local bargaining settlements in the public service. A number of groups, including nurses and the police, secured significantly higher settlements, generally following threatened or actual industrial action. As part of the PPF negotiations, an additional 3 per cent increase was paid to those who had received settlements at or around the norm. One of the three teachers' trade unions had continued to seek to establish a special case for a pay increase outside the PPF terms, taking industrial action at the end of 2000 and into 2001, but the government has resisted this claim..

39. To overcome the shortage the authorities have now started recruiting overseas.

40. For a review of reforms see *Regulatory Reform in Ireland*, OECD, 2001, Chapter II.

41. See, for example, E. Morgenroth, "Regionalisation and the functions of regional and local government", in A.Barrett et al, *Budget Perspectives*, ESRI, Dublin, 2000.

42. In many cases in rural areas such services are provided on a limited basis by local co-operatives.

43. A large proportion of the new starts are one-off houses in the rural countryside, with the architectural style often selected from a pattern book, with little or no original design input, and often with little reference to indigenous styles of building and landscape. The result is a tension between those who have an interest in conserving landscapes and maintaining this endowment for themselves and for visitors, and landowners -- for whom the sale of sites provides a handsome capital gain -- and those in need of relatively low cost housing, who need a site to provide themselves with affordable living space. There seems to be little consensus locally as regards what is acceptable and desirable in this regard, and so planners and policy makers find themselves fighting battles -- which they often lose -- with the 'one off' house. The wider issues of the costs of servicing these houses as regards infrastructure and social services, are also germane to this debate.

44. The dynamic growth of the Irish economy has resulted in immigration into Ireland; between 1994 and 1999, a net total of 236 000 persons arrived, with the highest annual figure, 47 500, taking place in the year to April 1999, and about half of it locating in the Dublin region (Williams and Shiels, 2000). Combined with the natural growth of household formation, the demand for housing has consequently increased. Production of housing has responded to this rising demand, with supply rising from 34 590 in 1996-'97 to 44 371 in 1998-99.

45 . Development levies are charged to the developer to cover the costs of infrastructure development.

46. In addition, the government has also sought to increase the supply of land and developed sites more directly through public schemes. The Serviced Land Initiative is expected to make available more than 115 000 sites by the end of 2001.

47. *Ireland's National Employment Action Plan 2000*. Department of Employment, Trade and Enterprise, Dublin.

48. *National Survey of Vacancies in the Private Non-agricultural Sector 1999/2000*, ESRI, 2000.

49. Of those who quit the live register, somewhat over a half are reported as leaving for "good" reasons such as finding a job. Employment Action Plan, Monthly Progress Report, No 26 November 2000, Department of Enterprise, Trade and Employment.

50. K. Denny et al, *Investing in people*, Policy Research Series, 38, November 2000, ESRI, Dublin.

51. P. O'Connell, "Spending Priorities in Labour Market Programmes for the Unemployed", T. Callan *et al*, *Budget Perspectives*, ESRI, Dublin 1998. It was also noted that the long-term unemployed who comprised around half the total unemployed, accounted for 95 per cent of participants on the CES programmes and only 11 per cent on mainstream training programmes of the FAS.

52. In addition, responsibility for supporting human resource development in indigenous manufacturing and domestic services has been transferred from the FAS to Enterprise Ireland, where it will operate in the context of the overall business development model.

53. The number of apprentices has risen from 10 770 in 1995 to 23 000 currently. The proportion of apprentices in the age group 15-24 in the labour force is, however, just 6½ per cent.

54. *Ex ante Evaluation of the National Development Plan, 2000-2006*, CSF Evaluation Unit, November, 1999.

55. At this time non-EU nationals comprised only some ¾ per cent of the labour force.

56. J. Sexton, *SOPEMI Report for Ireland*, OECD, December 2000.

57. The government adopted in July 1999 the policy, *Reducing Red Tape*, which requires that each department and office assess all new laws and regulations based on a “Quality Regulation Checklist” and assigns responsibility for implementing the programme at a senior management level.

58. The Broad Economic Policy Guidelines for 2000 issued by the EU included a recommendation relating to the Competition Authority, in particular to give it the power to enforce Articles 81 and 82 of the EC Treaty. Article 81 (1) of the Treaty prohibits agreements that fix prices, limit or control production, share markets, apply different conditions to the same type of transaction and which make the conclusion of contracts subject to obligations which have no connection to the original contract. However Article 81 (3) provides an exemption to this prohibition and at present it is the Commission that decides which agreements will qualify. A draft regulation will devolve this power to Member States and it will be the Irish Authority which will apply it.

59. Decisions to authorise or prohibit large mergers have been made by the Minister of the DETE, not the Competition Authority. The Mergers Acts' substantive standard includes a competition policy test, whether the transaction would be likely to prevent or restrict competition or restrain trade in any goods or services. There is also a general criterion, whether the transaction would be likely to operate against the "common good", which provides wide discretion for the Minister. The Mergers Act apply if each of the two (or more) firms involved has assets over Ir£ 10 million or annual turnover over Ir£ 20 million. It also applies to all newspaper and magazines mergers regardless of asset size or turnover. Smaller mergers falling below the Mergers Act's threshold can be reviewed as agreements under the Competition Act.

60. The need for co-operation arises because only the prosecutor can make a binding decision about leniency where enforcement is by criminal process.

61. Taxi drivers will be able to write-off the cost of a taxi licence over five years according to the details of the Finance Bill (2001) Preliminary List. But there will be restrictions where one person owns more than one licence. The List sets out the conditions for capital allowances for existing taxi licence owners. A full write-off over five years of the actual vouched cost of the licence backdated for three years to November 21st 1997 will be allowed. A licence owner who drives his own taxi will be able to write-off the full capital cost of the licence against trading income over a five-year period. A licence owner who drives a vehicle and rents it out on a part-time basis will be able to set off the licence cost against trading and rental income.

62. Examples include barristers, dentists and journalists.

63. Accountability concerns the obligation to explain, answer for, and bear the consequences of the manner in which one has discharged duties, fulfilled functions and utilised resources. Regulators can be rendered accountable by various means, through the Minister, the parliament, the Courts, other regulatory bodies and customers.

64 . *Regulatory Reform in Ireland*, OECD, Paris, 2001, p. 77.

65. Although the connection capacity is being upgraded, trade might be limited because of long-term contracts for generators in Northern Ireland at high prices.

66. Experience in other small markets is useful. Because of size constraints, the Northern pooling system in Scandinavia does not seem viable. In terms of size, the New Zealand scheme seems to be closer. New Zealand initially combined a cap with divestiture and ordered further divestiture by the dominant company because of insufficient competition. The other alternative of ownership change of these large generators would lead to the challenge of controlling a dominant private player, which is considered to be even more difficult than regulating a state-owned dominant entity.

67. According to original principles, the VIPP and real markets are separated and VIPP contract holders can not spill excess energy to the real market and have no access to Top Up (energy from the ESB in excess of

the VIPP contractor's contractual requirement). As of January 1st 2001, the Commission for Electricity Regulation (CER) implemented the scheme of VIPP mixing through the inter-connector under the original principles of no spill and no Top Up.

68. At present there are more than 80 telecommunications licence holders, of which 46 are operating, but these new entrants altogether only account for 19 per cent of the fixed line market.

69. *Joint Bank-Fund Financial Sector Assessment Programme (FSAP) for Ireland*, IMF, Washington, July 2000.

70. In addition, a National Spatial Strategy is under development and there are numerous other plans covering areas such as transport. See Chapter III for some detail.

71. However, the pressure tends to be relatively weak in relation to strategic national and regional issues such as congestion and settlement.

72. J. FitzGerald *et al*., *Medium Term Review 2000-2005*, ESRI, 1999.

73. In addition, a NDP/CSF Environment Co-ordinating Committee is being established including representation from the lead Departments for operational programmes, social partners, environmental NGO's, EPA and the EU Commission. Its remit is to examine and co-ordinate environmental policies in relation to issues across the programmes and initiatives under the NDP/CSF.

74. For a review of research and development issues more generally see the *Environmental Performance Review of Ireland*, OECD, 2000*a*.

75. Department of the Environment and Local Government (2000).

76. For a description and analysis of a similar scheme in operation in Denmark see OECD 2000*b* and more general comments in OECD 2001.

77 . In support of IBEC's case a report was commissioned: *The competitiveness and environmental impact of energy taxation on Irish industry*, Farrel Grant Sparks Consulting, Dublin, February 2000. The study focuses on large enterprises. A chapter in the OECD Economic Outlook (OECD, 2001) shows, however, that in most cases concerns about competitiveness are misdirected.

78. In the latter half of the 1990s, growth in energy demand has not kept pace with output as the overall energy intensity has fallen due to some combination of improved efficiency and the restructuring of Irish industry. However, electricity demand per worker more than doubled over the 1990s due to the increased use of electronic/electrical equipment.

79. Directive 88/609/EEC on large combustion plants sets emissions limits of 124 000 tonnes for SO_2 and 50 000 tonnes for NOx for Irish power plants of greater than 50 MW thermal capacity (Stapleton *et al.*, 2000). While the power plants are in compliance with this Directive, as discussed earlier, the Gothenburg Protocol sets new targets (across all sectors) of 42 000 tonnes of SO_2 and 65 000 tonnes of NOx which set new challenges for the power generation sector.

80. The Environmental Resources Management (1998) report produced for the Department of the Environment and Local Government showed that replacing Moneypoint (coal) and the oil and peat plants by Combined-Cycle Gas Turbine (CCGT) plants would reduce emissions of greenhouse gases by 5.6 million tonnes (about 40 per cent of the Kyoto overshoot) at negative cost. However, these costs do not include the political costs of closing certain stations.

81. A Green Paper on Sustainable Energy was published in 1999 which announced Ir£ 126m Exchequer funding for energy-related CO_2 abatement with a discussion of the issues vis-à-vis further refinement of policies and their implementation.

82. However, the imperatives of the Directive have concentrated the bulk of the new investment in coastal cities at marine outlets; it may be that there will be under-investment in wastewater treatment at inland freshwater sites, where problems are most acute.

83. The Rural Environmental Protection Scheme (REPS) provides annual income to farmers who participate and act positively to protect biodiversity, archaeological and natural features, including water courses. There are additional supplementary payments for participants whose land lies, wholly or partly, within areas designated for habitat conservation, and participation is obligatory in Special Areas of Conservation.

84 Annex II of the directive sets out a Code of Good Agricultural Practice, which the Department of the Environment and Local Government and the Department of Agriculture, Food and Forestry have published and distributed. Annex III sets out measures that must be taken by Member States.

85 . Largely reflecting EU directives, they include: diverting 50 per cent of overall household waste away from landfill; minimum reduction of 65 per cent in biodegradable waste going to landfill; development of waste recovery facilities, including the development of composting; recycling of 35 per cent of municipal waste; recycling of construction waste to reach 85 per cent over 15 years; rationalisation of landfills, with closure and reduction in overall numbers, leading to an integrated network of some 20 state of the art facilities incorporating energy recovery and high standards of environmental protection. Proposals for waste incineration (thermal plants) and the 20 landfill sites have been among the most controversial elements in these plans.

86 . The total number of vehicles has increased by more than half (Figure 5) and there has been a 34 per cent increase in the number of cars per thousand of the population between 1990 and 1997 (DTO, 2000). Such an expansion in numbers has considerable implications for vehicular emissions and congestion in urban areas, in particular, in Dublin as improvements in road networks, traffic management and public transport have not kept pace. Hence, the increase in peak-time journeys into the Dublin region of 64 per cent between 1991 and 1998 at the same time as the modal share accounted for by public transport has actually fallen by 8 per cent.

87. Some taxes however might actually encourage car use. The Office of the Director of Traffic in Dublin Corporation has introduced charges for on-street parking of 80p in the suburbs and low demand areas and Ir£ 1 in high demand areas in the city centre with a time limit of 3 hours. This has increased the turnover of on-street parking and increased the availability of spaces to shoppers and those on short visits at the expense of commuters. Dublin Corporation has proposed to introduce a schedule of charges ranging from 50p to Ir£ 1.50 in peak areas and to increase the time limit in most areas to 4 hours. All revenues are ring-fenced for traffic management measures.

88. However, the duty differential on types of petrol combined with EU regulations have seen the share of unleaded petrol rising steadily over the 1990s to over 85 per cent. Leaded petrol was prohibited from 1 January 2000.

89. The reduced rebate on diesel fuel will eventually be confined to only low-sulphur variants.

August 2003
IMF Country Report No. 03/242

Ireland: 2003 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Ireland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2003,** with the officials of Ireland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 9, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 25, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 30, 2003 discussion** of the staff report that concluded the Article IV consultation.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating tbe publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Ireland

Approved by Ajai Chopra and Martin Fetherston

July 9, 2003

- The Article IV consultation discussions were held in Dublin during May 6–15, 2003. The mission comprised Ms. Coorey (head), Mr. Soikkeli (both EU1), and Mr. Morales (MFD). Ms. Koeva (EUI) contributed at headquarters. The mission met with the Minister for Finance, the Governor of the Central Bank, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennett (Executive Director) attended the concluding meeting.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix I).

- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Ahern, which has been in power since June 1997, was re-elected in May 2002.

- At the conclusion of the last consultation in August 2002, Directors commended the authorities for Ireland's outstanding economic performance. They noted the downside risks to the global recovery and cautioned that euro appreciation and high wage inflation could adversely affect Ireland's competitiveness. Directors expressed concern about the sharp deterioration of the public finances and cautioned against continued rapid increases in public spending.

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Apendix Tables

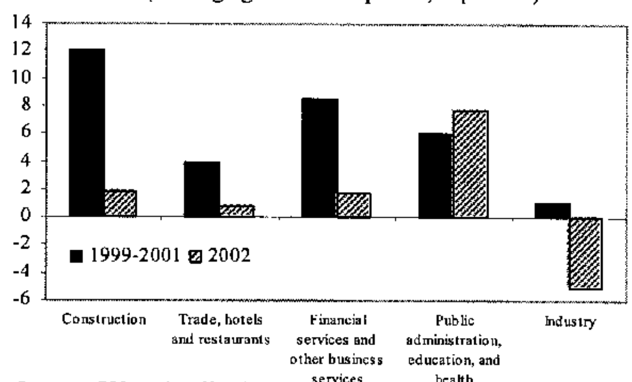
I. Background and Key Issues

1. **Ireland's economy has performed impressively over the past decade.** Income growth, measured by real GNP, averaged 6½ percent in 1991–2001, bringing per capita income above the euro area average (Table 1 and Figure 1). The unemployment rate plummeted from almost 16 percent to less than 4 percent and the employment ratio rose well above the euro area average. Substantial gains in competitiveness, particularly in the multinational-dominated manufacturing sector, kept the current account in surplus or close to balance. The fiscal position strengthened with the public debt ratio falling from almost 100 percent of GDP in the early 1990s to well below 40 percent in 2001 (Figure 2 and Appendix II).

2. **These enviable achievements have been due in significant measure to sound policies.** A high degree of openness to trade and foreign investment as well as EU and EMU membership, the latter of which caused a sharp decline in real interest rates, were significant factors. National wage agreements quelled industrial unrest and, in the initial stages, delivered wage moderation, allowing the burgeoning labor force to be absorbed into employment. Sensible public policies in the form of investment in education and skills, tax reforms that increased incentives to work and invest, and fiscal restraint were also important. A virtuous circle was created that took advantage of favorable circumstances—in particular, the global high-tech and financial services boom of the late 1990s.

3. **While openness has brought clear benefits to Ireland, it also exposes the economy to shifting global currents, as slowing activity since mid-2001 demonstrates.** GDP growth remained strong reaching almost 6½ percent in 2002 (outpacing that of other EU countries), but GNP growth—which normally better reflects domestic economic conditions[1]—decelerated sharply, from over 10½ percent in 2000 to just ½ percent in 2002 (Figures 3 and 4).

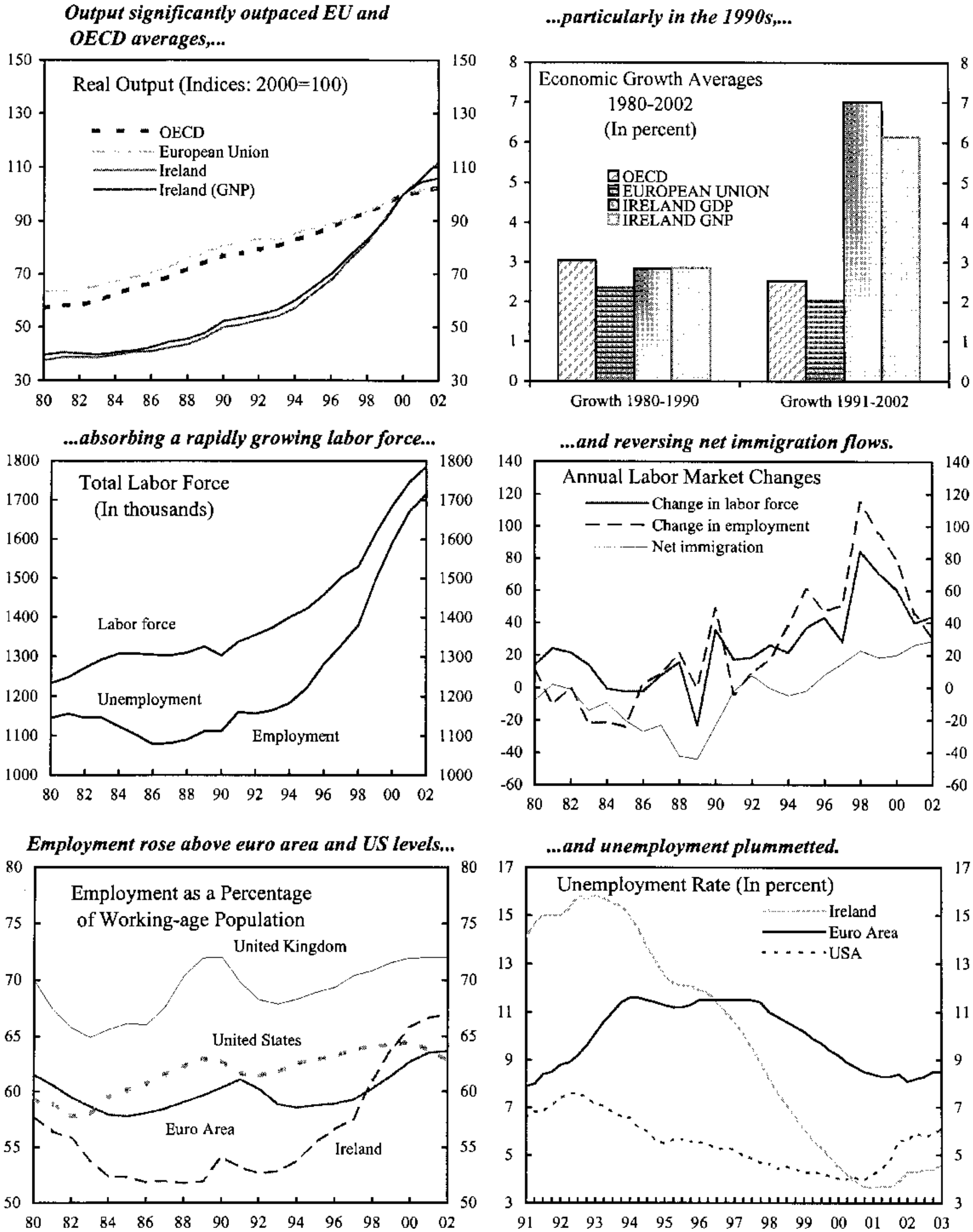
Employment Growth by Sector
(Average growth over period, in percent)



Sources: CSO; and staff estimates.

[1] The substantial contribution of multinationals to Irish output, and associated profits (possibly reflecting transfer pricing), create significant differences between measures of output and income. In 2002, GDP was boosted by unusually strong multinational profits—particularly in pharmaceuticals—which had limited implications for the rest of the economy (Table 2). On the other hand, GNP may exaggerate the slowdown in activity because the unusually sharp drop in profits of Irish firms abroad was partly driven by some firm-specific one-time factors. Officials noted that the growth in domestic demand—at about 2¾ percent—perhaps provided a better indication of the underlying pace of economic activity in 2002.

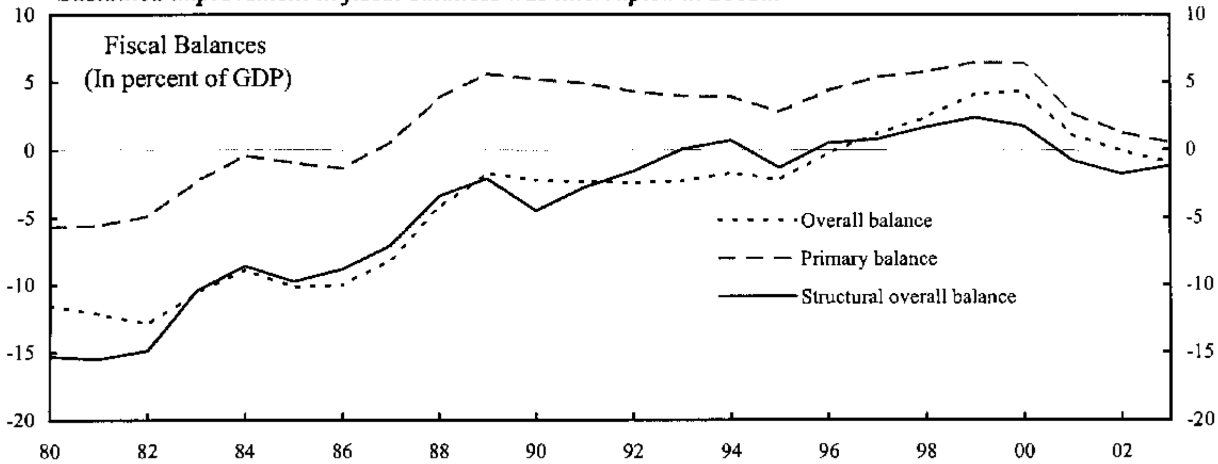
Figure 1. Ireland: Output Growth and Labor Market Trends



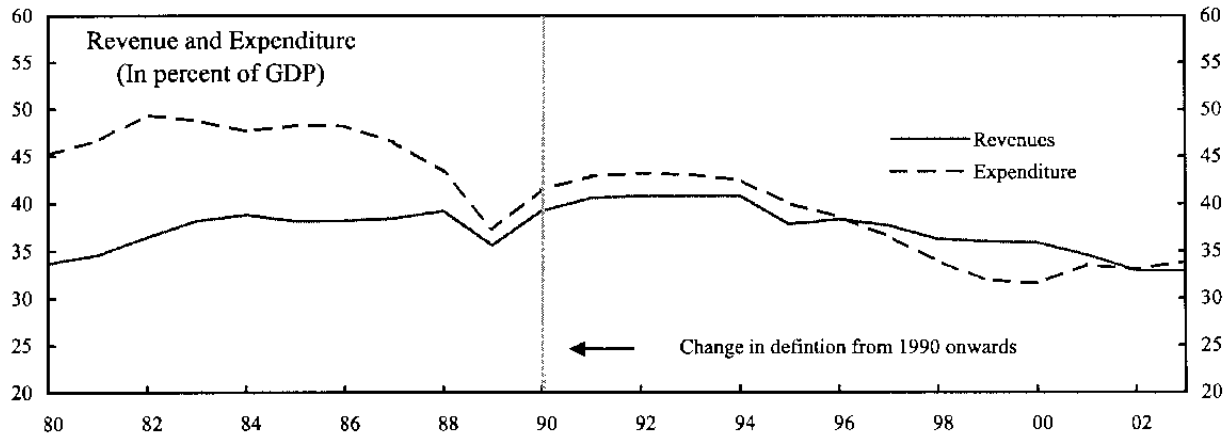
Sources: Central Statistics Office; OECD Main Economic Indicators; WEO; and IMF staff estimates.

Figure 2. Ireland: Fiscal Trends

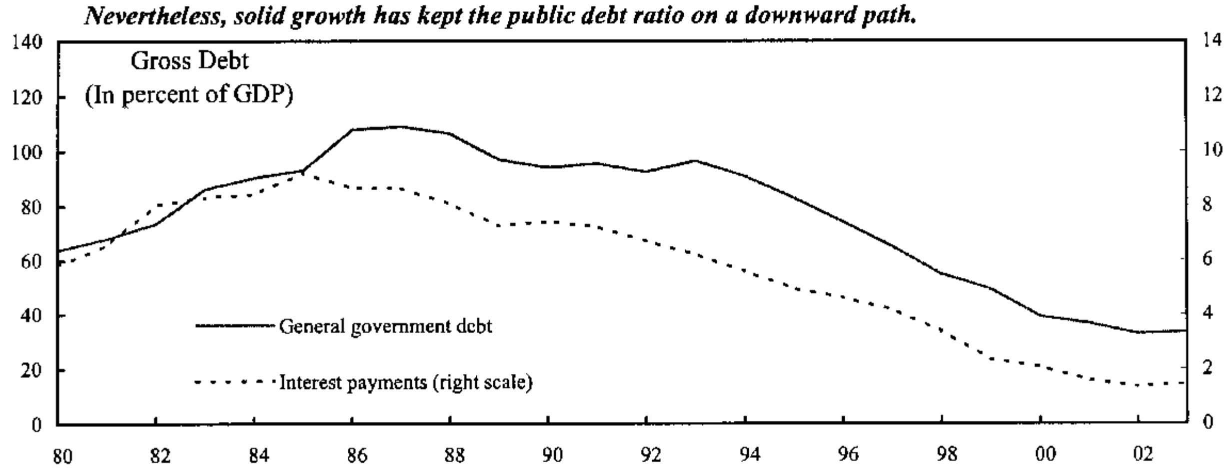
Sustained improvement in fiscal balances was interrupted in 2001...



...mostly due to a reversal in the spending ratio.



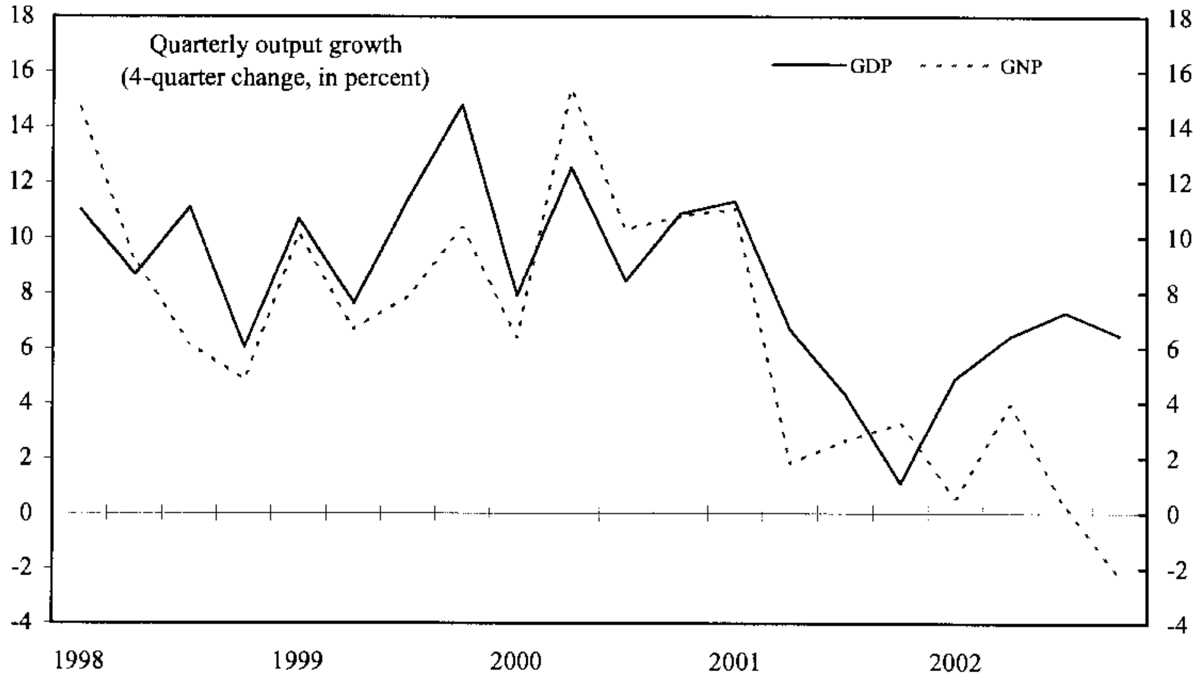
Nevertheless, solid growth has kept the public debt ratio on a downward path.



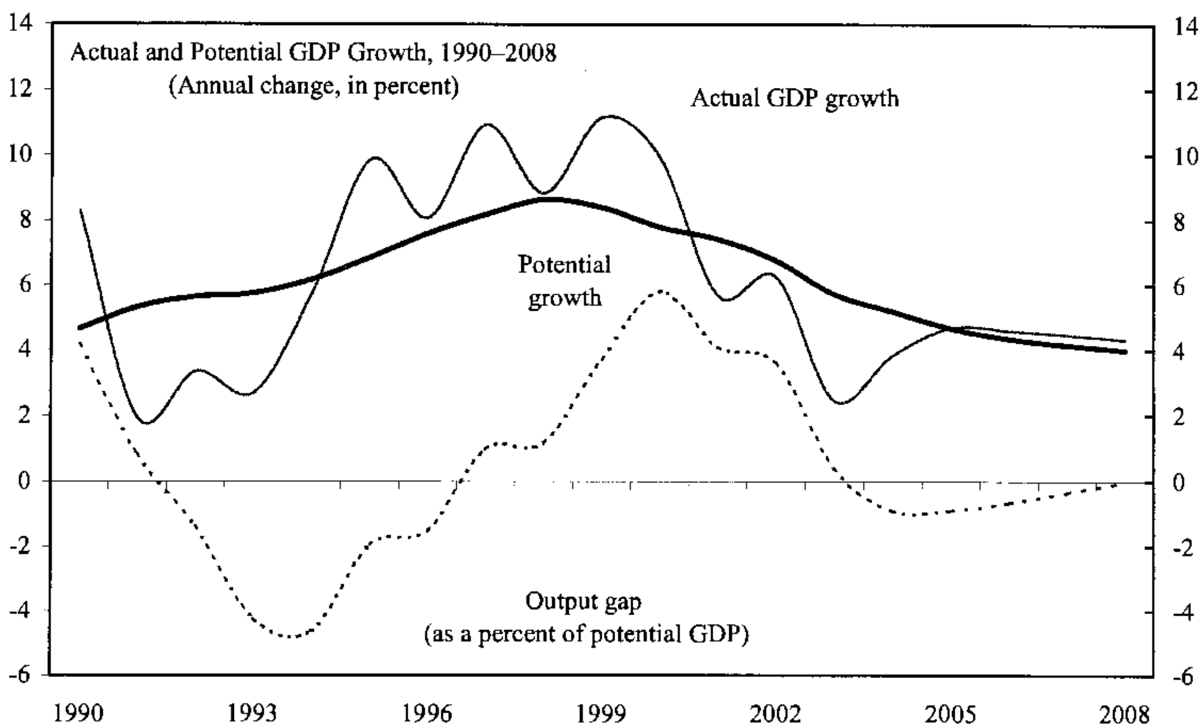
Sources: Central Statistics Office; Department of Finance; and staff estimates.

Figure 3. Ireland: Output Growth

GDP and GNP growth rates diverged considerably in 2002...

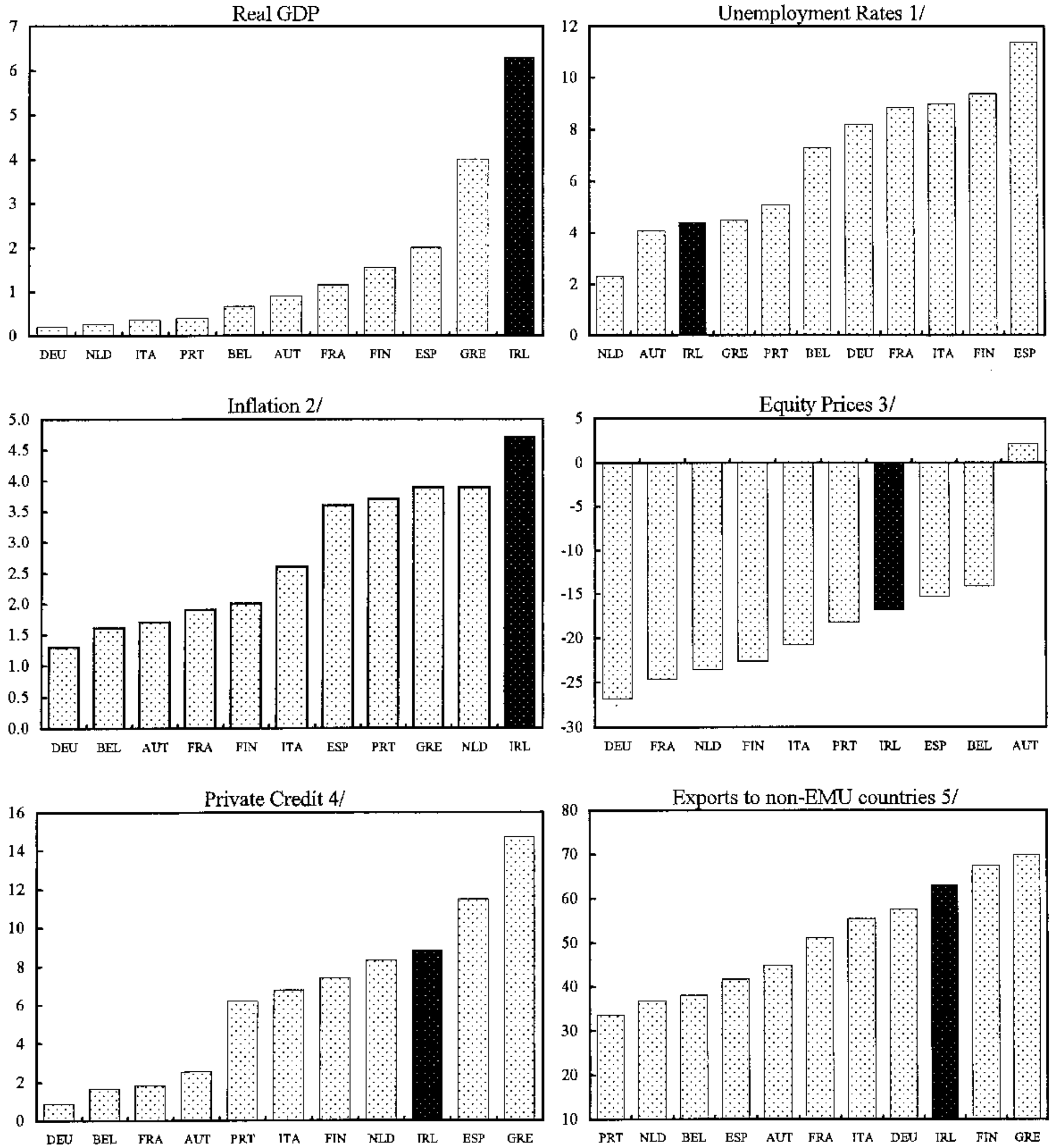


...while sluggish growth is expected to turn the output gap negative over the medium term.



Sources: Central Statistics Office; Economic and Social Research Institute; and staff estimates.

Figure 4. Ireland: Comparisons of Key Indicators with Other Euro Area Countries in 2002
(Annual growth rates, in percent, unless otherwise indicated)



Sources: WEO; IFS; Bloomberg; and staff estimates.

1/ ILO basis; levels, in percent.
2/ The EU Harmonized Index of Consumer Prices (HICP).
3/ Change from December 2001 to December 2002 (first working day of month).
4/ Bank lending to residents other than monetary authorities and banking institutions, year-on-year percent change, December 2002.
5/ As a share of total exports.

Personal consumption and export growth weakened from their previous rapid pace, while investment increased marginally, with strong residential investment offsetting a fall in business investment (Tables 1 and 3). However, unemployment increased only modestly as the rapid pace of public sector recruitment largely offset layoffs in manufacturing and business services, and wage growth moderated somewhat from the high rates seen in 2001 (Figure 5). Macroeconomic policies facilitated the soft landing: the ECB's monetary easing has kept short-term real interest rates negative since late 2001 (Figure 6), while fiscal policy was expansionary.

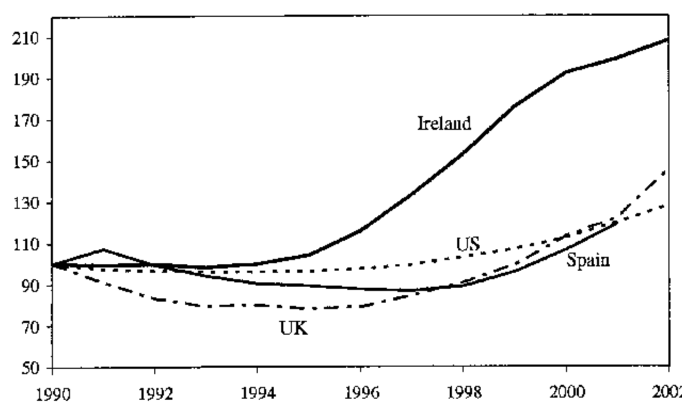
4. **Recent indicators suggest that activity has remained subdued so far in 2003.** The trend in manufacturing growth has been weak while both industrial confidence and orders have fallen back to, or below, the low levels of late 2001, after a modest improvement during 2002 (Figure 7). Moreover, consumer and service sector confidence deteriorated further and retail sales remained sluggish. However, unemployment remained stable at 4.6 percent (claimant count basis) in May 2003. Inflation eased to 3.9 percent in May, still well above the euro area average of 1.9 percent (Figure 8).

5. **Ireland has generally responded appropriately to policy challenges identified in previous Article IV consultations.** Fiscal policies were expansionary in 2000–02, contrary to Fund advice. However, starting in 2002, the authorities have reined in spending growth in order to stem the deterioration in the budget balance. In contrast to its predecessor, the national wage agreement signed in spring 2003 offered no fiscal concessions and provided a degree of wage moderation. Financial supervision is being strengthened along the lines recommended in the 2000 FSAP. Progress in improving public expenditure efficiency, controlling public sector wages, and increasing domestic competition has been more limited.

6. **Against this background, discussions focused on near-term vulnerabilities and challenges in sustaining strong medium-term economic performance.** The following questions were key:

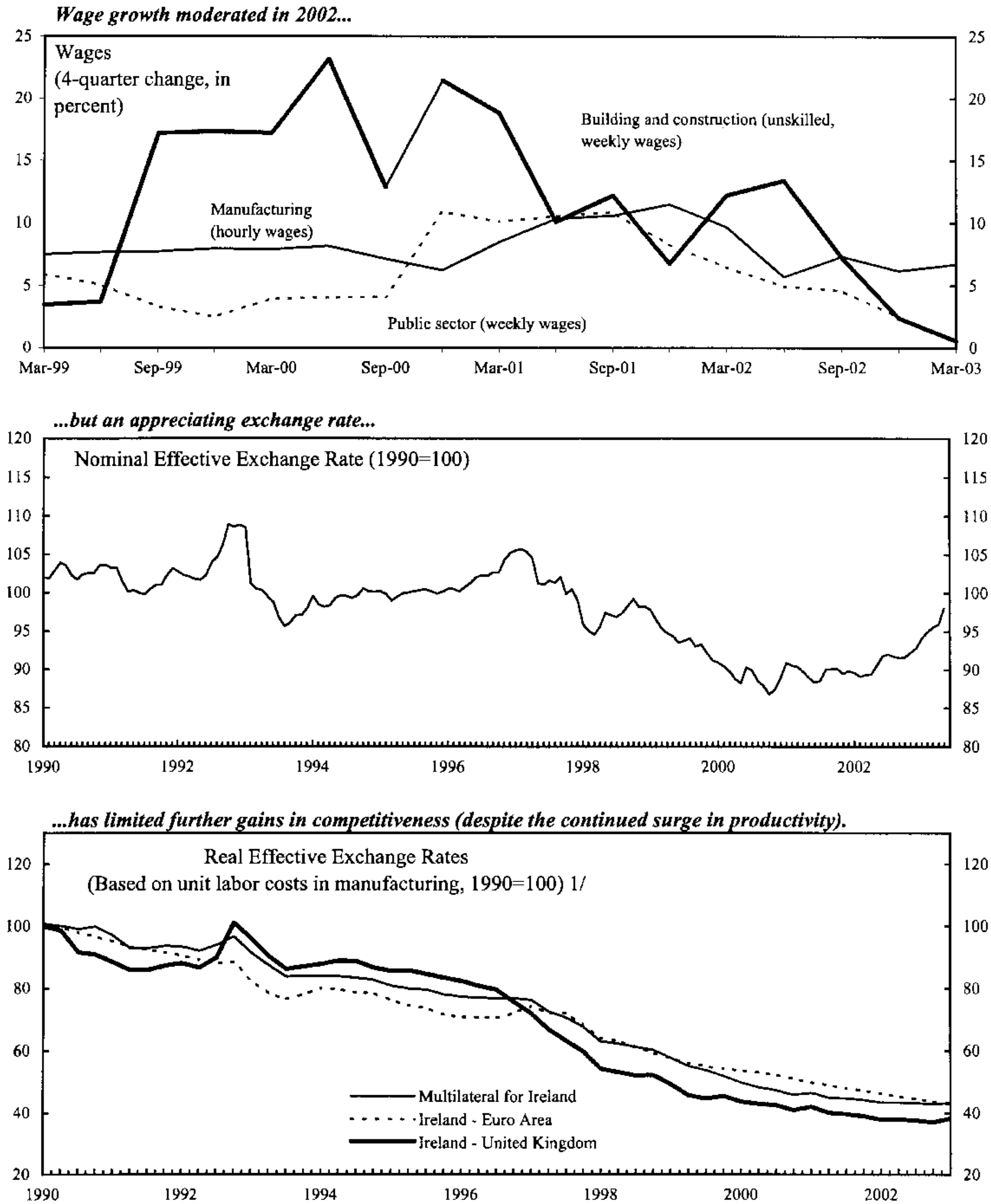
- With external demand slowing, strong credit growth and a prolonged house price boom have, to some extent, sustained domestic demand. **Can financial stability and strong macroeconomic performance be maintained if the global economy remains weak, the euro appreciates further, or house prices unwind—perhaps abruptly?**

Real House Prices (1990=100)



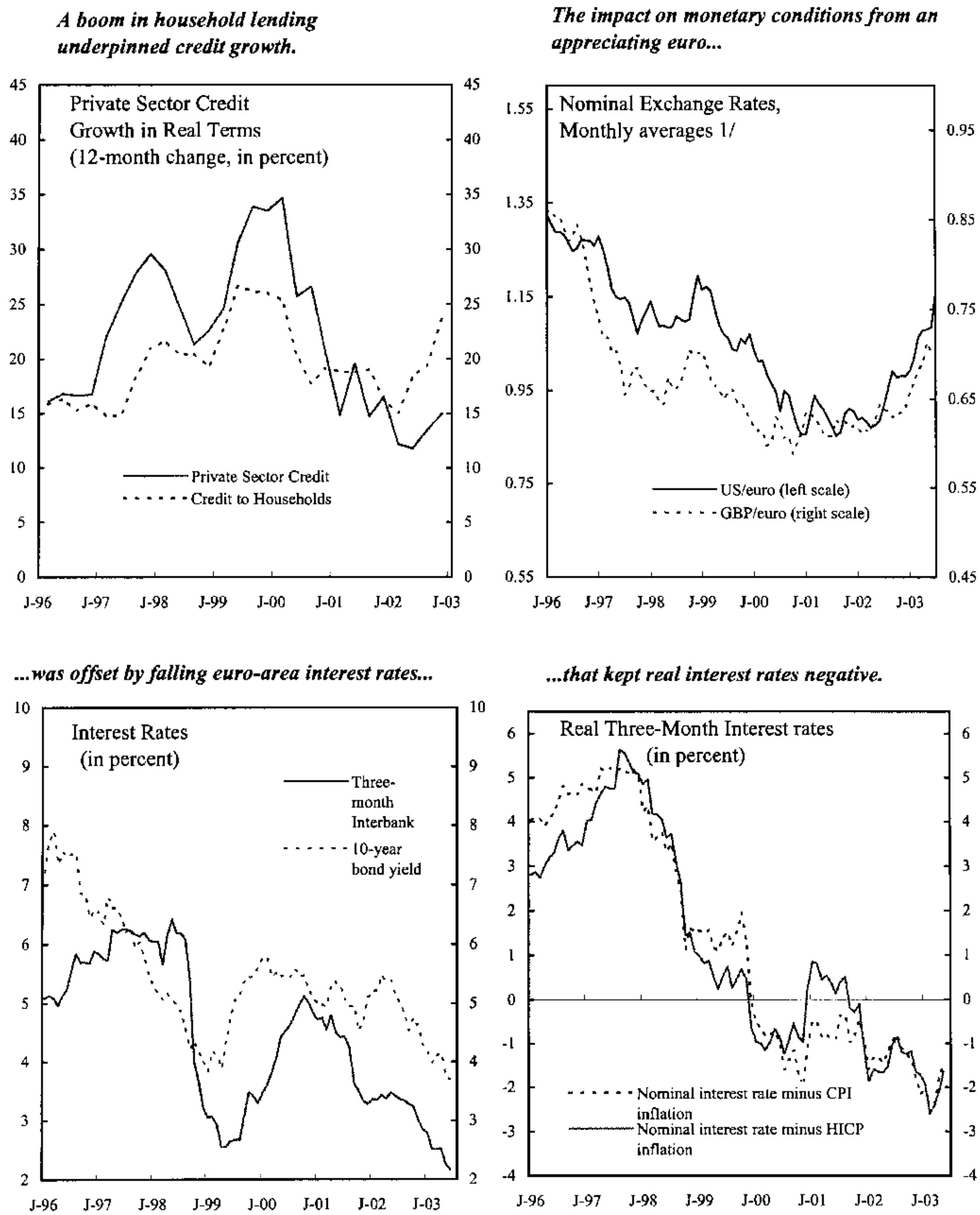
Source: Bank of International Settlements.

Figure 5. Nominal and Real Exchange Rates



Sources: Central Statistics Office; IFS; and OECD.
1/ With normalized productivity growth.

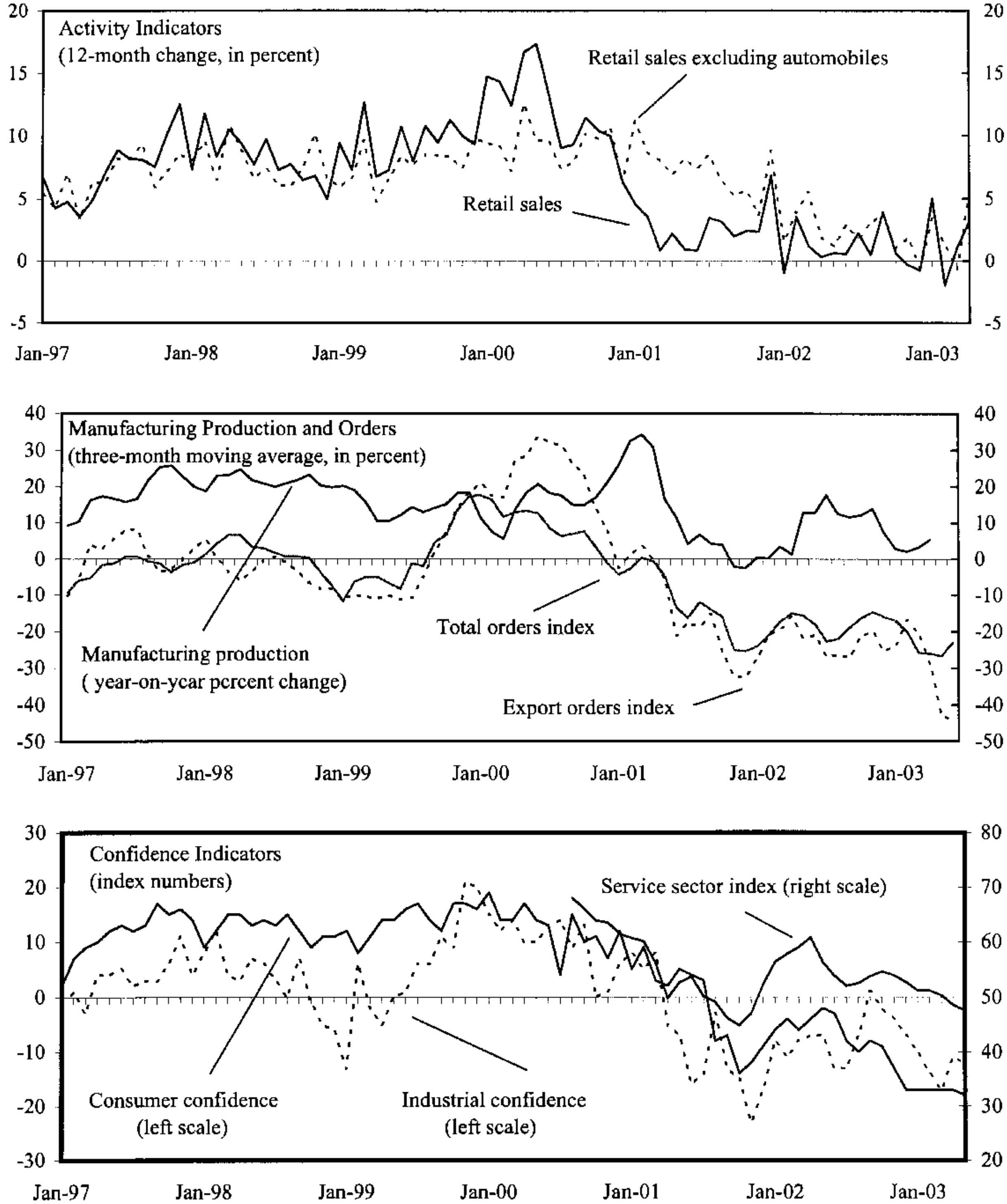
Figure 6. Ireland: Money, Credit, and Interest Rates



Sources: IMF; Central Bank of Ireland; Central Statistics Office; and staff calculations.
1/ Prior to 1999, synthetic euros used.

Figure 7. Ireland: High Frequency Indicators

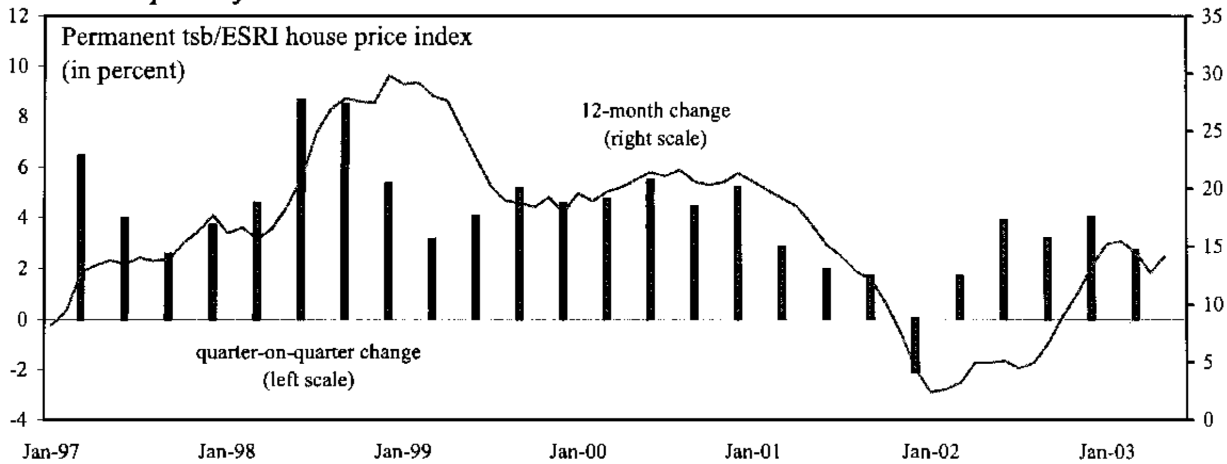
Retail sales, manufacturing production and orders, and confidence indices all suggest weak activity in early 2003.



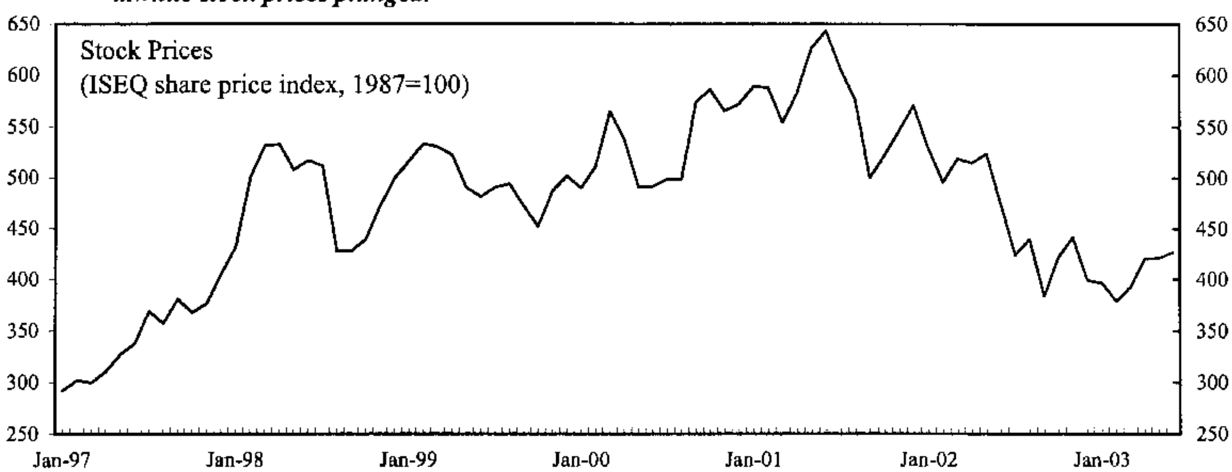
Sources: Central Statistical Office; NCB Stockbrokers; WEFA; and IMF staff estimates.

Figure 8. Asset and Consumer Prices

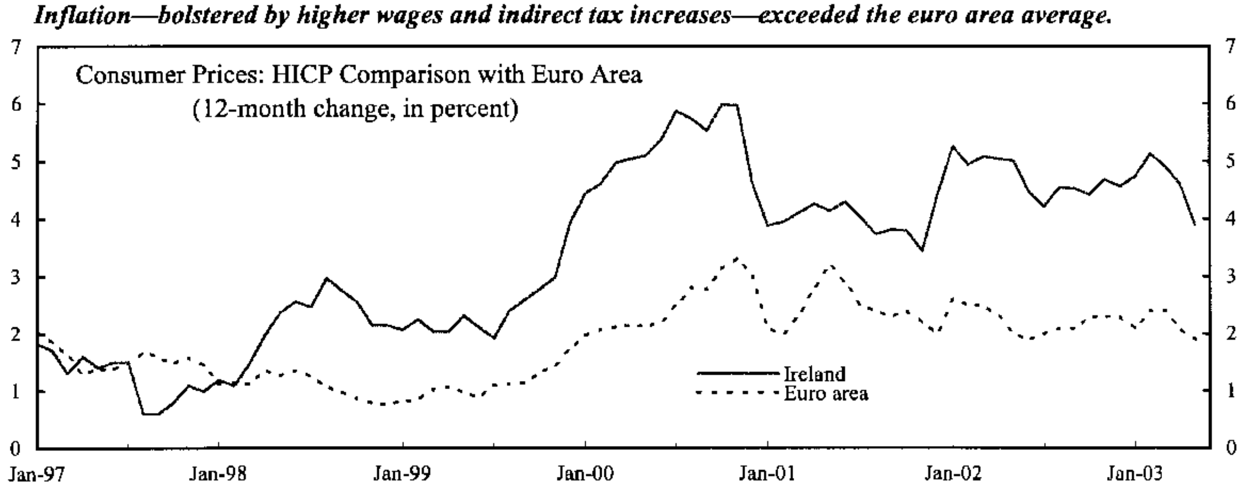
House price inflation rekindled in 2002...



...while stock prices plunged.



Inflation—bolstered by higher wages and indirect tax increases—exceeded the euro area average.



Sources: Central Statistics Office; IFS; and permanent tsb.

- Inflation has been persistently higher than the euro area average and, if wage bargaining focuses on maintaining real wages, this could lead to higher wage inflation than justified by productivity growth and recent euro appreciation. **Can competitiveness be maintained and wage pressures—particularly in the public sector—be contained?**

- A decade of rapid, export-led, income growth has led to high expectations about the future. **How can strong growth be sustained over the medium term, particularly, how can productivity growth in services (including the public sector), which now accounts for over half of value added, be improved?**

II. Report on the Discussions

A. Short-Term Economic Outlook and Risks

7. **There was general agreement that the expected economic recovery would be gradual given the weakness in the global economy.** Staff projects real GDP growth of 2½ percent in 2003—with GNP growing by 1¼ percent—both about a percentage point below the authorities' latest projections released in December 2002 (Table 3). This difference stems mainly from the authorities' expectations of a sharper rebound in global demand that they acknowledged would now need to be revised. Staff projects growth to pick up in 2004, with GNP picking up to about 3 percent (and GDP to 3¾ percent). Following a slowdown in 2003, private consumption growth would recover in 2004 as the external outlook improves. Exports would gather steam in late 2003, but given the ICT overhang, investment would decline before reviving next year as growth prospects improve. Monetary conditions would still remain supportive, as the effects of euro appreciation would be largely offset by the ECB's June rate cut (Figure 6).

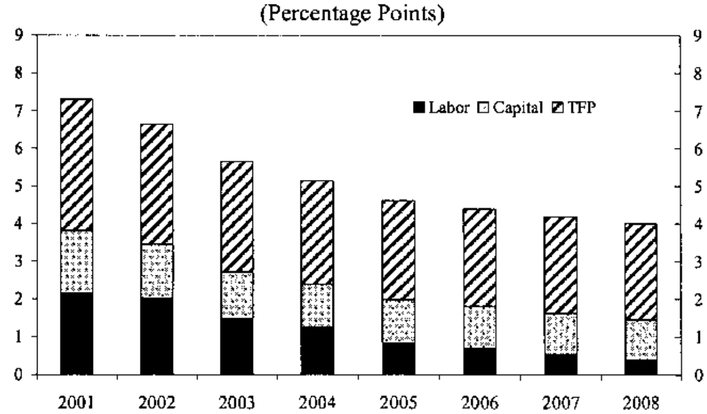
8. **The authorities and staff agreed there were significant downside risks to this outlook.** In particular:

- Global economic weakness may be prolonged further, thus delaying the expected rebound in Irish activity. Moreover, the euro could continue to strengthen, squeezing export margins, particularly in the employment-intensive indigenous sector, where productivity gains have been less pronounced.

- Unemployment may rise considerably if external demand does not recover and competitiveness deteriorates further, especially since employers may still be hoarding labor, given the previously very tight labor market. Furthermore, with the planned freeze in public employment, public sector hiring would not offset private sector layoffs.

- The spectacular increase in house prices and credit to households over the past several years inevitably raises the risk that prices may unwind, possibly abruptly, especially if unemployment were to rise further.

9. **The consensus was that, over the medium term, output would grow at a pace of about 4–5 percent per annum** (Figure 3). Given rapid structural changes, elastic labor supply, and very high rates of past TFP growth, potential output estimates for Ireland are subject to an unusually large degree of uncertainty. Staff—like many private forecasters—expect potential growth to slow to about rates of 4–5 percent due to lower growth of the labor force (reflecting the sharp decline in the birth rate in the early 1980s) and productivity (reflecting income convergence and lower FDI flows).[2] The authorities agreed with this view, but had higher potential growth projections (applying the EC's methodology) that gave rise to a sizeable negative output gap by 2005.

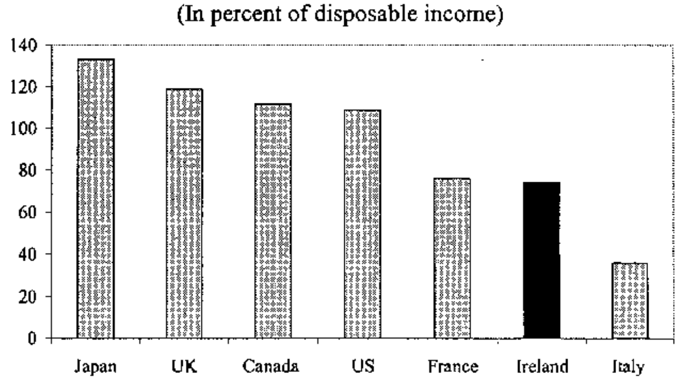


Sources: CSO; ESRI; and staff estimates.

B. Ensuring Financial Sector Stability

Risks from the housing market

10. **Ireland's house price and credit boom has been spectacular, but views differed on the possibility of a bubble.** Real house prices have increased by over 130 percent since 1993, while credit to households has grown in real terms at rates of 15–30 percent each year since 1996 (Figures 6 and 8). Many officials and analysts felt that house prices were not out of line with fundamentals. Moreover, the average household debt to income ratio, while rising rapidly, was still not high by international comparison, especially considering Ireland's relatively young population. With income growth and rents slowing and supply increasing, they expected house price inflation to moderate considerably, without a significant risk of a crash. But others



Sources: OECD, Central Bank of Ireland, and staff estimates.

[2] The general view was that FDI would slow from levels during the late-1990s' ICT boom, but would not be significantly affected by competition from EU accession countries given the shift to higher value-added activities.

cautioned that a bubble was likely since house prices had been outstripping rents and were inflated by speculative activity as investors had been shifting out of the stock market. Staff's analysis of the empirical evidence indicates that the possible existence of a house price bubble depends on whether the change in demand behavior observed in the late 1990s represents a permanent structural adjustment (e.g., to a different economic environment from joining EMU) or a temporary deviation. In the former case, fundamentals such as real income and real interest rates could largely explain house price growth. However, if behavior itself has been temporarily affected by boom conditions, there is a substantial risk that house prices may be significantly overvalued.[3]

11. **Discussions touched on whether the authorities' attempts to control house price developments might have contributed to price instability.** Various tax changes in recent years have sought to achieve a better balance between housing supply and demand, improve the position of first-time buyers, and facilitate the rental market. The stamp duty regime has been changed frequently. After measures to cool the housing market contributed to an unexpectedly sharp deceleration in house prices in 2001, the 2002 budget reintroduced measures that many analysts felt were fuelling the resurgence in house prices. Staff noted that frequent policy reversals could distort intertemporal decisions and induce market volatility. Moreover, care would need to be taken that measures do not postpone the adjustment of house prices, given the risk of an even sharper unwinding later on.

Financial system risks and reform

12. **The authorities were concerned about risks to banks from rapid house price and credit growth, but noted that high levels of capitalization and profits provided an adequate cushion to absorb the effects of potential shocks without systemic distress.** The Governor of the CBI had recently issued a warning letter to mortgage lenders on the need to maintain rigorous lending criteria despite intensifying competition. Supervisors were carrying out themed inspections on property loan portfolios of more exposed banks and planned to coordinate a stress testing exercise better tailored to pick up risks in loan portfolios and requiring disclosure of lenders' methodologies. Discussions also covered the health of the insurance sector, which officials noted remained well capitalized and less exposed to equities than U.K. and European counterparts. Staff agreed with the authorities' concerns about risks in mortgage lending, particularly from a possible rise in unemployment and from differential credit risks within mortgage loan portfolios.[4] Staff also noted that the concentration of large exposures to commercial property loans as well as insurance industry risks merited close attention.

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[3] See Annex I at the end of this report, "Can Fundamentals Explain the Growth of House Prices in Ireland?"

[4] See Annex II, "Financial Sector Risks in Ireland."

13. **Financial sector supervision has been unified under the Irish Financial Services Regulatory Authority (IFSRA) within the central bank.** The legislation establishing the new entity, which is also responsible for consumer protection, came into force on May 1, 2003. IFSRA's agenda placed priority on improving consolidated supervision of complex financial groups by implementing the related EU directive by 2004 and strengthening insurance supervision (falling under the central bank's purview for the first time), as recommended by the 2000 FSAP. The authorities intended to base insurance supervision reforms on best practice systems—adapted to local needs—and seek advice from the relevant countries on key issues, such as strengthening reserves and evaluating risks in asset/liability portfolios. They would also be recruiting the necessary expertise, strengthening reporting and disclosure requirements, and improving the on-site inspection program. The authorities observed that the new organizational structure allowed better information flow between supervisors and those monitoring systemic risks, as well as appropriate coordination among supervisory, monetary, and fiscal authorities, should a problem arise. Staff noted that these links should continue to be enhanced and encouraged further strengthening the analysis of forward-looking systemic risks, as recommended by the FSAP.

C. Maintaining Strong Macroeconomic Performance Following the 1990s' Boom

Inflation and competitiveness

14. **Inflation has continued to exceed the euro area average by a significant margin, with the differential averaging 2½ percent since the beginning of 2002** (Figure 8). Previous staff work has suggested that Balassa-Samuelson effects could account for an inflation differential above the euro area of about 1–1¼ percentage points over the medium term.[5] Further staff analysis suggests that specific, mostly temporary factors—particularly indirect taxes in 2002—could explain most of the remaining differential.[6] In the authorities' view, higher wage growth and anti-competitive practices led to the tax and administrative price increases underlying the higher inflation. Staff agreed on the need to control public sector wage increases, including in highly-unionized public enterprises. While anti-competitive practices could account for price level differences, continued service price inflation in the private sector most likely reflected strong productivity growth in the tradable sector and, in the short-run, possibly some excess demand pressures, with the resulting real appreciation and relative price adjustment being a largely equilibrating phenomenon. Staff felt that excess demand pressures were not large since the current account was close to balance, the deterioration of the real effective exchange rate (REER) was limited until end-2002 (see paragraph 15), and the output gap was shrinking rapidly. Indeed, there was broad consensus that inflation pressures would subside in 2003–04, reflecting slackening demand, euro appreciation, and slowing wage growth.

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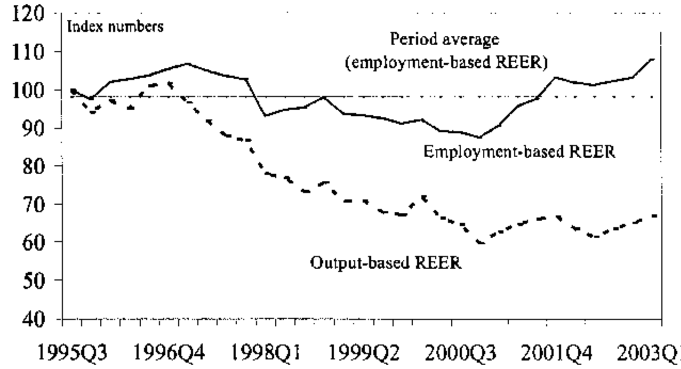
[5] See IMF Staff Country Report No. 99/108.

[6] See Annex III, "What Explains Ireland's Inflation Differential over the Euro Area?"

15. **The authorities were concerned that persistently higher wage and price inflation would worsen competitiveness as the euro strengthened and external demand weakened.**[7] Staff noted that the sharp deterioration in competitiveness in 2001 appeared to reflect mainly a catch-up in wages, since the unit-labor cost based REER—measured on an employment-weighted basis to remove output distortions due to multinational activity—had stabilized in 2002 at a level only somewhat above the average of the past several years.[8] Staff agreed that, from such a starting point, the rapid strengthening of the euro in 2003 was a risk—indeed, in the first quarter, the employment-weighted REER had already appreciated to a level some 10 percent above the period average. Wage growth would thus need to slow sharply to arrest a further deterioration in competitiveness, particularly in indigenous export sectors.

Real Effective Exchange Rates
(Based on unit labor costs in manufacturing)



Sources: CSO, INS, OECD, and staff estimates.

16. **The latest national wage agreement has provided for some degree of wage moderation, without significant fiscal concessions as in the past.** Staff noted, nevertheless, that the negotiated wage increases (some 7 percent over 18 months) might still prove a burden for some producers, given the less favorable external environment. The wage norm for the second phase of the agreement (to be negotiated in spring 2004) would need to reflect the deterioration in competitiveness and anticipate changing cyclical conditions. There should be sufficient de facto flexibility at the firm level to ensure that wages adjusted rapidly to minimize risks to employment and output. Most importantly, public sector wages, which were sheltered from market pressures, would need to be kept under firm control. The mission was assured that the agreement permitted flexibility if economic conditions hampered firms' ability to pay. Given the focus on real wages, social partners stressed that inflation would need to decelerate if wage demands were to moderate by next spring's negotiations.

17. **Many in the private sector regarded last July's pay recommendations of the Public Sector Benchmarking Body as overly generous, given sizeable public wage increases in recent years and because the exercise was carried out at the peak of a cycle.** Concerns were also raised about transparency since the report did not supply evidence of pay gaps vis-à-vis the private sector. (In fact, *all* groups were judged to qualify for a pay raise).

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[7] They noted, for instance, the European Commission's estimate that the Irish price level—measured by the GDP deflator in common currency terms—had increased from under 85 percent of the euro area average in 1995 to over 112 percent in 2002.

[8] The construction of this series is discussed in IMF Staff Country Report No. 02/171.

The pay increases—averaging 9 percent—will be phased in over three years at a cost of about 0.8 percent of 2002 GDP.[9] There could also be potential knock-on effects on inflation—to the extent that user fees and indirect taxes are raised to cover higher expenditure. However, 75 percent of the benchmarking awards and pay increases under the wage agreement are conditional on modernization and productivity improvements. Staff urged the authorities to strictly enforce this conditionality, including by insisting that improvements be substantive and publicly verifiable (see paragraph 26). In addition, the exercise should be a first step in developing a market-linked compensation system for public pay, with merit- and skill-based elements. The authorities noted that the recommendations were based on substantive evidence, the details of which could not be published due to their sensitivity. They stressed their intention to obtain demonstrable improvements in efficiency and acknowledged the need to reform public sector pay.

Short-term fiscal policy

18. **Following several years of procyclical, expansionary policy, the major challenge for fiscal policy is to adjust to the new economic reality in the aftermath of the late-1990s' boom.** Ireland's prolonged economic expansion had bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations but spending overshot (increasing by 12½ percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. With prospects for regaining very high output growth rates looking increasingly unlikely, the efficiency and control of public expenditure have become pressing concerns. From a short-term perspective, given the difficulties in precisely estimating Ireland's cyclical position and the well-known lags in adjusting fiscal policy, staff has advised aiming for a broadly neutral fiscal stance (that is, no change in the structural balance and allowing full operation of the automatic stabilizers)—other than to address serious overheating or recession, neither of which has been a significant threat recently.

19. **In 2002, fiscal policy turned out more expansionary than the broadly neutral stance that had been budgeted, mainly because of the overestimation of structural revenue**. The authorities explained that revenue—in particular personal and corporate taxes—underperformed mainly because of: (i) higher-than-expected take up of Special Savings Investment Accounts introduced last year; and (ii) weaker-than-expected corporate profits in 2001 that had a negative impact on 2002 corporate taxes, given collection lags. In contrast to 2001 and despite widespread expectations to the contrary, spending was held below budget due to a mid-year decision to claw back expenditure overruns and fortuitously low interest payments.

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[9] The phasing would be: (i) 25 percent from June 2003 (backdated to December 2001); (ii) 50 percent from January 2004; and (iii) 25 percent from June 2005.

General Government Budget and Outturn for 2002; Selected Components 1/
(Percent of budgeted GNP)

	Budget	Outturn	Cyclical error 2/	Non-cyclical deviation 3/
Total revenues	42.2	41.3	0.1	-0.9
o/w total taxes	29.7	29.1	0.0	-0.7
o/w income tax	9.1	8.8	0.0	-0.4
o/w corporate tax	5.2	4.6	0.0	-0.6
o/w indirect taxes	12.8	12.9	0.0	0.1
Total expenditures	41.8	41.4	-0.2	-0.1
o/w total current expenditures	35.2	34.8	-0.2	-0.1
o/w compensation of employees	10.0	10.3	0.0	0.3
o/w goods and services	7.8	7.2	0.0	-0.7
o/w interest rates	1.9	1.7	-0.2	0.0
o/w government investment	5.2	5.4	0.0	0.3
General government balance	0.4	-0.1	0.3	-0.8

Sources: Ministry of Finance and staff estimates.
1/ Based on OECD (GDP-based) tax elasticities applied on nominal GNP growth.
2/ Part of the deviation b/w budget and outturn that can be attributed to errors in forecasting nominal GNP growth, and interest payments.
3/ The remaining deviation between budget and outturn after adjusting for forecasting errors.

While supporting expenditure control, staff noted that such stop-and-go measures were unlikely to result in sustainable spending restraint.

20. **The authorities were aiming for a somewhat contractionary fiscal stance this year, reversing the expansionary trend of recent years and marking progress towards their objective of structural balance over the medium term.** The 2003 budget implies a fiscal tightening of about ½ percent of GDP (Table 4).[10] The structural revenue-GDP ratio would be sustained by various measures, including increases in VAT and excise duties, while expenditure growth is projected to slow—although to a still-rapid pace—helped by a sharp cutback in public investment. Output was still estimated to be somewhat above potential, so that a mild contraction would not be procyclical. The authorities felt that revenue would perform close to budget and noted that spending would be held to budgeted levels.[11] Staff welcomed the emphasis on expenditure control, particularly since outturns so far

Fiscal Stance (General Government): 2001–03 1/
(In percent of potential GDP, unless otherwise noted)

	2001 Act.	2002 Budg.	2002 Act.	2003 Budg.
Structural Balances:				
Revenue	34.5	34.9	32.7	32.7
Expenditure	35.3	35.7	34.5	34.0
Overall balance	-0.8	-0.8	-1.8	-1.4
Fiscal impulse 2/ ("-" indicates expansion)	-2.5	0.0	-1.0	0.4
Memorandum item:				
Nominal overall balance	1.1	0.4	-0.1	-0.8

Sources: Ministry of Finance, and staff estimates.
1/ Based on Staff's methodology and estimates of potential output (see Table 4).
2/ Change in the structural balance over the actual outcome of the previous year.

[10] The fiscal stance is similar when measured on the basis of GNP, rather than GDP, growth.

[11] In early-July, however, the Minister of Finance announced that revenue was expected to fall short of budget by up to €500 million (0.4 percent of GDP), while expenditure was on track.

this year suggested that revenue could continue to underperform.[12] However, restraint on current spending—especially the wage bill and transfers—would be preferable to curtailing capital spending (and tax increases), given the need to improve Ireland's lagging infrastructure, particularly at a time when construction inflation was moderating. The authorities assured the mission that steps were being taken to protect capital spending. For 2004, staff advised that fiscal policy should, at a minimum, be neutral, barring any major unanticipated shocks to the economy.

Central Government Revenue and Expenditure Growth in 2003
(Annual changes in percent)

	First half of 2003		2003
	Outturn	Projected	Budgeted
Tax Receipts	9.2	12.8	8.6
Of which:			
Income	-7.1	-1.8	2.7
Corporate	47.5	55.0	5.5
VAT	10.6	11.1	10.6
Excise	0.9	12.8	12.1
Discretionary Spending	6.1	14.8	6.8

Source: Department of Finance

D. Sustaining Growth Over the Medium Term

Improving the medium-term public finances

21. **The authorities emphasized their commitment to the SGP, including achieving a zero structural balance over the medium term.** The projected structural balances in the 2003 Stability Programme were in line with commitments under the SGP and would maintain sufficient margin against the risk of breaching the 3 percent of GDP deficit limit. Given this year's structural deficit of 1¼–1½ percent of GDP, staff estimated that a modest adjustment would be required over the next few years to reach this target.

22. **Would current policies be sufficient for balancing the structural budget?** The authorities noted that the projected sharp slowdown in spending, as well as several revenue-enhancing measures introduced in the 2003 budget would halt the deterioration in the nominal government finances over the next few years. At the same time, the Stability

Contribution to Real General Government Expenditure Growth 1/
(Annual change in percent)

	2001	2002	2003	2004	2005
Total expenditure	12.6	6.7	4.6	2.8	3.6
Current transfers	5.4	2.9	2.8	2.1	1.6
Compensation of employees	3.0	2.4	1.4	1.0	0.8
Spending on goods, services, and depreciation	3.5	1.9	1.0	0.6	0.4
Interest payments	-1.3	-0.3	0.3	-0.7	0.7
Capital spending 2/	2.0	-0.1	-0.9	-0.2	0.2

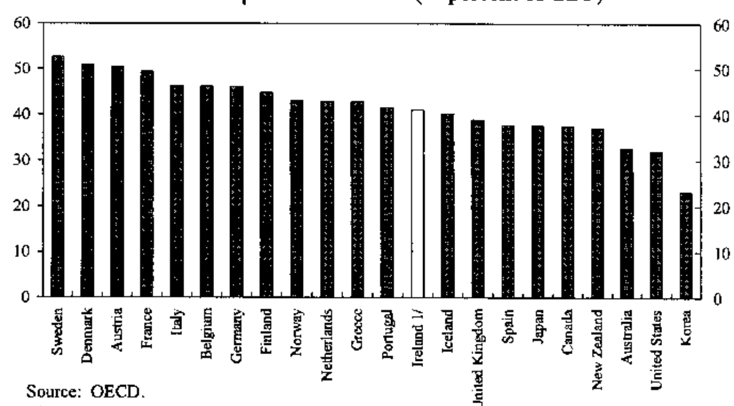
Sources: Department of Finance and staff estimates.
1/ Current expenditures deflated by HICP and capital expenditures by capital-goods deflator.
2/ Includes fixed investment and capital transfers.

[12] ESRI, a well-known think tank, argued that shortfalls in income taxes reflected the fact that the revenue impact of past tax cuts and changing demographics was not well understood. The shortfall in excise taxes could reflect substitution effects following recent increases in duty rates.

Programme envisaged that strong potential growth (projected at about 6 percent in 2004–05) would eliminate the structural deficit by 2005. However, staff projected that without further measures, the structural deficit would remain close to its 2003 level over the medium term (Table 5). Therefore, additional—albeit moderate—tightening efforts would be needed as soon as the economic recovery was firmly established. Staff cautioned against relying entirely on favorable economic conditions to eliminate the structural deficit: (i) potential output growth might well be weaker than estimated; (ii) the structural revenue ratio could decline further,[13] while the cost of spending commitments might turn out higher than anticipated; and (iii) repeated upward revisions to the deficit outlook might eventually weaken fiscal credibility. The authorities did not take issue with staff's analysis, but indicated that medium-term revenue projections had been made on a cautious basis, minimizing the potential need for downward revisions.

23. **Staff argued that further tax increases should be avoided as a means to improve the fiscal balances.** There did not appear to be a *prima facie* case for increasing the overall tax burden, given that the size of government was not small in comparison with other OECD countries. Moreover, the significant improvements to the tax structure over the past several years, which had enhanced incentives to work and invest, should be preserved. However, if revenue had to be raised, limiting tax expenditures and broadening the scope of user fees (with targeted transfers to the poor) would be more efficient than increasing tax rates. Officials were open to these suggestions, noting that all options would be kept under consideration in future budgets.

Total Expenditure in 2002 (In percent of GDP)



Source: OECD.
1/ The ratio for Ireland is in relation to GNP, which better reflects the size of the domestic economy given large multinational profits.

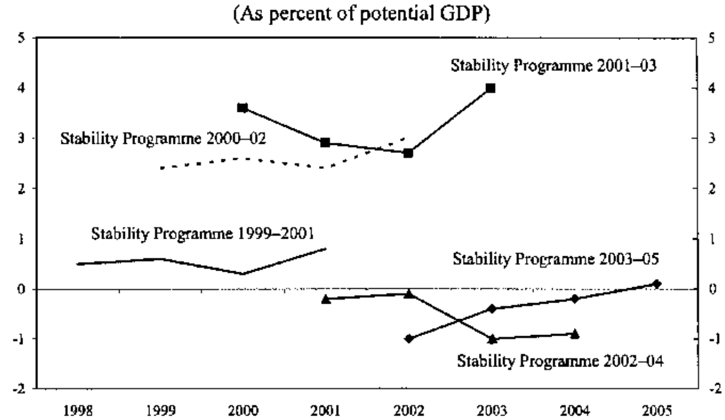
24. **The authorities agreed that the most obvious alternative would be to restrain public spending, especially current expenditure, by increasing its efficiency.** In staff's view, popular dissatisfaction with the quality of public services in health, education, and infrastructure, despite double-digit spending growth rates in recent years, indicated significant expenditure inefficiencies. Staff suggested that both current and capital budgets be comprehensively reviewed on a zero base to assess the most efficient means of delivering services and that all projects be rigorously screened for value for money. Moreover, administrative structures in certain sectors—most notably healthcare—needed to be

[13] For instance a deceleration in housing turnover would adversely affect indirect taxes and stamp duties. More generally, tax revenue could decline if the house price boom unwound quickly.

fundamentally reformed to foster accountability and rationalize service provision, and public expenditure management strengthened across all levels of general government. Increased competition and greater private sector involvement in public service provision could also improve efficiency. The authorities noted ongoing efforts to improve expenditure management, including expenditure reviews to assess spending efficiency and a framework to strengthen management information systems. They indicated their intention to reform healthcare, but cautioned that such reform was extremely complex and likely to be gradual. Subsequent to the discussions, on June 18, the authorities announced a significant healthcare reform program that would consolidate the administrative structure, devolve the budgetary process, and reform the hospital sector.

25. **The authorities were also improving budget planning through a greater medium-term orientation.** They indicated that steps were being taken to introduce multi-year departmental spending envelopes for capital expenditure and measures to improve flexibility and incentives, such as allowing departments to use savings—achieved through efficiency gains or spending cuts—to finance other high priority programs. Staff noted that a formal medium-term fiscal framework—at the general government level—would place these improvements in a broader context and usefully supplement the Stability Programme, which did not provide sufficient policy predictability in its current form (e.g., as demonstrated by the large swings in projected Programme fiscal balances). Such a framework could include: (i) an overall fiscal constraint—consistent with the SGP—requiring structural balance over the medium-term; (ii) transparent rolling five-year budget projections that set out revenue and expenditure plans demonstrating how this overall constraint would be met; and (iii) a medium-term expenditure framework, for instance, extending the capital spending envelopes to cover all non-cyclical primary departmental spending, in a binding manner, with safeguards to protect capital expenditure from overall budget squeezes. As experience from other countries suggested, it would be critical to foster ownership of such a framework by committing both the parliament and the government to the agreed ceilings and to facilitate public scrutiny through clear communication and a high degree of transparency. The authorities did not dispute the usefulness of a formal framework, but progress towards establishing such a framework has so far been slow.

Cyclically-adjusted General Government Budget Balances
(As percent of potential GDP)



Source: Department of Finance.

26. **Staff encouraged greater fiscal transparency both as a part of a medium-term framework and as a means of fostering public sector efficiency.** Advance publication and regular ex-post valuation of each department's service delivery commitments would enhance accountability and incentives. It would also permit public scrutiny of modernization and

productivity improvements actually delivered under the benchmarking exercise. The authorities noted that they published departmental expenditure reviews and had begun to publish monthly departmental spending profiles to facilitate monitoring. Staff welcomed these practices and encouraged the authorities to undertake a fiscal ROSC to identify areas where transparency could be further enhanced.

Strengthening productivity through increased competition

27. **Enhancing competition and reducing regulatory restrictions are key for sustaining strong productivity and income growth over the medium term, as well as for lowering the cost of living.** The Competition Authority and the legal framework governing competition have been strengthened, particularly with respect to investigative powers and the approval of mergers. The Authority noted that regulatory reform should be oriented to fostering competition in order to break Ireland's traditional focus on producer interests. With regard to specific sectors, competition within network utilities needed to be increased, for example, by separating electricity generation from its transmission. The Authority was shifting its focus to scrutinizing restrictive practices in services—particularly transport, pubs, pharmacies, legal, medical and other services—and an ongoing assessment of anti-competitive practices in various professions had already identified issues to be addressed. Staff encouraged these efforts, as well as overcoming union resistance and exposing public enterprises and public services—including transport and health—to private competition. In addition, scope remained for further enhancing competition law to provide for civil sanctions.

E. Other Issues

28. **Ireland's statistics are being improved to meet international requirements** (Appendix III). Staff welcomed the newly-introduced data on the International Investment Position and stressed the need to improve fiscal reporting at the general government level and to publish a national earnings index as well as sectoral balance sheets. The authorities noted difficulties in obtaining timely data from local governments. They were compiling an earnings index and complete balance sheet data, but this would take 2–3 years to complete.

29. Ireland has signed the OECD **anti-bribery** convention, and the Parliament approved the motion to ratify the convention—along with relevant EU and Council of Europe Conventions on corruption—in December 2002. The authorities expect to complete ratification this year. Ireland is also a member of the FATF and party to the principal international treaties and conventions on **money laundering**. It has signed the International Convention for the Suppression of **Terrorist Financing** and the relevant legislation has been prepared for the Parliament, although no date for its consideration has been set yet.

30. **The authorities indicated strong opposition to proposals to reform CAP**—put forward in the Commission's Medium Term Review—maintaining that these changes were not in accordance with EU policy objectives and strategically not well-timed given that the

likely shape of the WTO round was not yet known.[14] Nevertheless, Ireland subsequently supported the proposals for CAP reform agreed in Luxembourg on June 26. Ireland is also centrally involved in the EU's "Everything but Arms" initiative that provides least developed countries duty- and quota-free access for most goods.

31. **The authorities remain committed to reaching the U.N. target of 0.7 percent of GNP for official development assistance (ODA) by 2007**. Accordingly, ODA is budgeted at 0.4 percent of GNP in 2003.

III. Staff Appraisal

32. **After a decade of spectacular growth, the Irish economy has achieved a soft landing, thanks to a long record of sound policies that have left the economy comparatively robust and flexible**. Openness, years of wage moderation, investment in human capital, as well as the considerable fillip from the decline in interest rates from EMU membership, have sustained growth, allowing Ireland to "catch up" with the rest of the euro area. At the same time, a strong fiscal position and flexible private labor market have enhanced the economy's capacity to weather external shocks. Supportive fiscal and monetary policies have also softened the impact of the ongoing global slowdown.

33. **There are, nonetheless, appreciable risks to the outlook.** Activity is expected to pick up with the recovery in world demand towards the end of this year and thereafter to accelerate towards its potential growth rate. But the global recovery could be more anemic than expected and the euro may continue to appreciate rapidly, adversely affecting competitiveness. Unemployment, no longer held down by public sector recruitment, could rise, posing risks to the housing market and—most likely to a manageable extent—to the financial sector.

34. **After a long credit boom, there is a substantial risk that house prices could be overvalued**. Equilibrium asset price levels cannot be reliably estimated and the prolonged nature of the house price boom itself may have temporarily affected investors' behavior, driving house prices well above equilibrium values consistent with disposable income growth, real interest rates, and demographics. Frequent policy reversals, as seen in the past, should be avoided as they could induce market volatility. Care should also be taken that measures do not postpone the adjustment of house prices, lest this lead to a sharper unwinding further down the road.

35. **Continued supervisory vigilance will be needed to ensure the stability of the financial system, given risks from slower growth, higher unemployment, and a potentially abrupt unwinding of house prices**. While high levels of capitalization and profitability have fortified banks' capacity to absorb the effects of potential macroeconomic

[14] In 2002, Ireland received €1.9 billion in transfers to agriculture from the EU budget.

shocks without systemic distress, some issues merit close attention. These include differential credit risk within mortgage loan portfolios; the vulnerability of debt service payments to sharp increases in unemployment; the concentration of large exposure to commercial property loans among a few institutions; and the health of the insurance industry. The unification of supervision under IFSRA within the central bank has strengthened the supervisory regime. Plans to improve insurance supervision are welcome and priorities should include obtaining an accurate picture of risks in insurance portfolios and monitoring potential vulnerabilities from links between bank and insurance activities, especially through consolidated supervision of complex financial groups. The central bank's analysis of forward-looking systemic risks should continue to be strengthened as should the information flow between supervisors and those charged with monitoring and responding to systemic risks.

36. **With the late 1990s' boom past and risks to competitiveness intensifying, particularly from rapid euro appreciation, wage growth must continue to moderate**. The persistent inflation differential above the euro area average is largely explainable, and likely to narrow during this year and next as one-time factors wear off, domestic demand and wage pressures slacken, and the effects of euro appreciation pass through. Nevertheless, with weak external demand and sharp appreciation of the euro in 2003, wage growth will have to slow significantly to stem the deterioration in competitiveness and consequent risks to employment and output. While the new national wage agreement is commendable for its wage moderation and avoidance of fiscal concessions, the wage norm for the second phase will need to reflect these changing cyclical conditions. In particular, wage earners may need to accept declines in real wages (i.e., wages deflated by HICP), especially in the public sector and publicly-owned enterprises, which are less exposed to immediate market pressures. In addition, public sector productivity improvements delivered under the very generous benchmarking recommendations must be substantive and publicly verifiable. The exercise should be a first step in developing a market-linked compensation system for public pay, with merit- and skill-based elements.

37. **The somewhat contractionary fiscal stance envisaged for 2003 is appropriate and makes adequate progress towards the medium-term fiscal target**. Spending should be held to budgeted levels since cyclically-adjusted revenue might continue to underperform. Spending restraint should be focused on the wage bill and transfers, with capital spending protected given pressing infrastructure needs. For 2004, fiscal policy should, at a minimum, be neutral, barring any major economic shocks.

38. **A medium-term fiscal target of overall structural balance is appropriate.** To ensure this target is met, further moderate contractionary measures will be needed as soon as the economy recovers and the downside risks to the short-term outlook recede. The assumption that potential growth will continue to be strong should not be relied on to eliminate the structural deficit, given uncertain fiscal prospects and the need to maintain policy credibility.

39. **There is not a strong case for further tax increases.** Most importantly, the considerable improvements to the tax structure in recent years should be preserved. Moreover, increases in indirect taxes would raise inflation, adding upward pressure to private sector wages. If a compelling need arose, limiting tax expenditures and broadening the scope of user fees (with targeted transfers to the poor) would be less distorting than increasing tax rates.

40. **Restraining public spending, especially current expenditure, by increasing efficiency would be a better way to reach the medium-term fiscal target**. Public expenditure management should be strengthened across all levels of general government and fundamental reforms made in key areas. The recently-announced healthcare reforms are welcome in this context. Increased competition and greater private sector involvement in public service provision should also be considered.

41. **A formal medium-term fiscal framework—at the level of general government—and greater fiscal transparency would foster efficiency in public spending and improve policy predictability**. Such a framework could include an overall fiscal constraint consistent with the SGP and five-year budget projections based on a medium-term expenditure framework. The planned multi-year departmental capital spending envelopes is a welcome first step and should be extended to cover, in a binding manner, all non-cyclical primary expenditure, with adequate protection of capital expenditure. Public scrutiny of spending would be facilitated through more extensive publication of service commitments and ex-post evaluations. A fiscal ROSC would be a useful means to identify ways to further improve fiscal transparency.

42. **Enhancing competition is key for sustaining medium-term productivity and income growth**. Strengthening the Competition Authority's powers and the legal framework governing competition is welcome and further efforts could be made to provide for civil sanctions. Regulatory reform should be reoriented from protecting producer interests to serving consumer interests. Greater political commitment is needed to improve competition within network utilities and transport. The Authority's scrutiny of restrictive practices in services is timely and issues that are identified should be addressed without delay.

43. **Scope remains for improving the provision of statistics**. Ensuring the timeliness of general government accounts and developing a national earnings index and sectoral balance sheets should be priorities.

44. **The authorities should adopt a more supportive stance within the EU in favor of trade liberalization,** particularly on CAP, which has a particularly adverse impact on developing countries. This would complement the welcome progress and commitment towards achieving the U.N.'s ODA target by 2007.

45. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Can Fundamentals Explain the Growth of House Prices in Ireland?[1]

What do we learn from the empirical analysis?

1. The potential for fundamentals—strong demand and insufficient supply—to justify the sustained rise in house prices in Ireland is easy to recognize *qualitatively*. On the supply side, Ireland's housing stock remains low compared with other countries, despite its comparatively high growth rate in recent years. In 2002, dwellings per thousand persons was 340 in Ireland, well below continental European levels of 400–450. On the demand side, real disposable income has risen by over 70 percent since 1993, real mortgage rates have fallen from over 7 percent in the early 1990s to below zero in 2002, while growth in the number of households has picked up in the 1990s—reflecting a surge in net migration and a rise in the proportion of the population in household-forming age groups.

2. However, it is difficult to assess *quantitatively* the degree to which these strong fundamentals explain Ireland's housing boom.

- First, two standard measures of asset price valuation, the price-to-rent ratio (P/E)—equivalent to a price earnings ratio—and the price-to-income ratio (P/I), do not provide a clear answer (Figure 1.1). In recent years, while the P/E ratio has reached a record-high level, the P/I ratio has exceeded its long-run average only by about 15 percent.

- Second, staff analysis—based on a simple error-correction model of house prices, incorporating the impact of real disposable income, real mortgage rates, and household formation during 1976–2002 (see below)—suggests that the actual house price in 2002 was 16½ percent higher than its long-run equilibrium,[2] but only 3 percent higher than the fitted value that allows for short-run dynamics (Figure 1.2).

- However, the estimated responsiveness of house prices to fundamentals could be biased, given that many observations could be coming from a bubble period. For example, if the model is estimated for 1976–97 and the derived coefficient estimates used to forecast prices in 2002, the implied deviation of tbe actual house price from its long-run equilibrium is over 50 percent!

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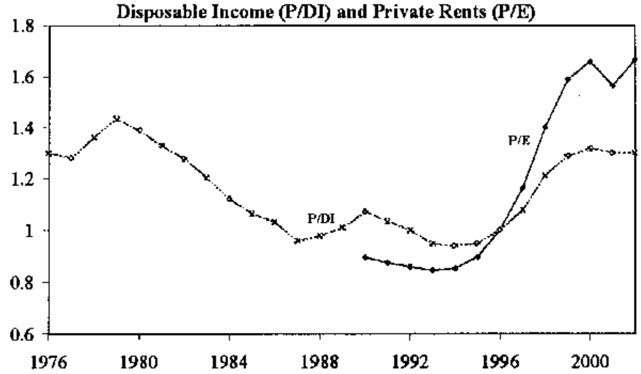
[1] Prepared by Petya Koeva.

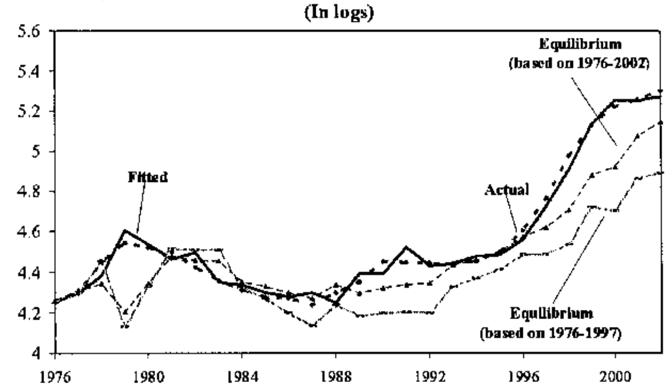
[2] This deviation of actual prices from their long-run equilibrium may be underestimated if one assumes that some of the rise in fundamentals in the late 1990s is temporary and should not be taken into account in the computation of long-run equilibrium house prices.

Figure 1.1 Ratios of House Prices to Disposable Income (P/DI) and Private Rents (P/E)



Sources: ESRI, CSO, and staff estimates.

Figure 1.2 Actual, Fitted, and Equilibrium Real House Prices (In logs)



Source: Staff estimates.

3. In conclusion, no one can know the equilibrium price of an asset with any degree of certainty. In the case of Irish house prices, the empirical evidence suggests, that as long as the change in demand behavior that seemed to have occurred in the late 1990s is permanent, the sustained rise is quite consistent with the strong fundamentals. (Some of these fundamentals, particularly real interest rates could reverse, but not necessarily abruptly). For instance, it is possible that as it became clear in the mid-1990s that Ireland would join EMU and real interest rates would decline permanently, there was a structural shift in the demand for housing. Similar arguments could be made with regard to the extensive structural changes that have taken place in the economy, including increased financial sector competition and the reduced future tax burden associated with the strengthening of the fiscal position. On the other hand, it is possible that the housing boom itself spurred changes in market psychology and led to a temporary change in demand behavior. If so, the underlying behavioral relationships would be better represented by the coefficients of the regression covering the pre-boom period. In this case, house prices would be considerably above their long-run equilibrium values, indicating a bubble.

Empirical methodology[3]

4. House prices can be estimated from a system of two structural (supply and demand) equations. However, these equations are difficult to estimate consistently given simultaneity problems. Hence, the empirical approach used in the analysis focused on estimating a reduced-form equation of log real house prices (*p)* as a function of log disposable income (*di)*, real mortgage rates (*mr*), and the share of households aged 25–35 (*dem*). After testing that all variables were nonstationarity (that is I(1)), an error-correction VAR model produced the following house-price equation:

[3] The estimation was conducted using data on house prices, disposable income, and mortgage interest rates from the Economic and Social Research Institute (ESRI). Household formation and construction cost data were available from the Central Statistics Office (CSO).

$$\Delta p_t = 0.76\Delta p_{t-1} - 0.001\Delta mr_{t-1} + 0.83\Delta di_{t-1} + 0.14\Delta dem_{t-1} - 0.31\left(p_{t-1} + 0.02mr_{t-1} - 0.92di_{t-1} - 5.40\Delta dem_{t-1} + 0.76\right)$$
$$(3.43) \quad (-0.30) \quad (2.30) \quad (0.03) \quad (-2.75) \quad (6.76) \quad (-17.77) \quad (-2.12) \quad (1.12)$$

5. An alternative specification that included real construction costs in addition to the above explanatory variables showed a smaller deviation of real house prices from their long-run equilibrium. In other words, when the upward shift in the supply curve reflecting increases in construction costs were taken into account, the degree of house price overvaluation appeared smaller than under the preferred specification, reported above. However, these estimates were somewhat unstable partly reflecting the loss in degrees of freedom in this relatively small sample. This specification had the added disadvantage that the house price equation could not be estimated for the restricted sample, excluding the late 1990s, because of problems with the degrees of freedom.

Financial Sector Risks in Ireland[1]

The financial sector faces numerous risks related to loan quality, competition pressures, the macroeconomic environment, and the insurance industry.

A. Banks' Risks

Credit risks

- Credit growth has remained very high for some years, with heavy exposure to the mortgage and real estate markets. While growth in non-mortgage credit to the private sector slowed to 10 percent in 2002, mortgage loans rose by 23 percent and other real estate lending by 28 percent. At end-2002, mortgage loans accounted for over 42½ percent, and commercial real estate for an additional 22 percent, of total loans (excluding financial intermediation). (See Table 2.1).

- Credit risks within the mortgage portfolio have also risen. The hoom in house prices has led to an increase in borrowers' leverage, resulting in rising mortgage equity withdrawal and loans to small investors to acquire rental properties. (The latter was boosted by measures introduced in the 2002 budget as well). A recent survey indicated that about 60 percent of landlords in Ireland have entered the property market in the last 3 years.

- In commercial real estate, borrowers' cash flow likely declined in 2002 as office rents fell by 6 percent and office values declined by 8 percent, while vacancy rates rose to 14 percent. No defaults have occurred so far and market participants were of the view that profitability, while lower than anticipated, was sufficient to service debt at current interest rates. Nonetheless, the largest banks appear to have become more cautious in lending to this sector and exposures appear to he concentrated around a few institutions.

Risk management and competition issues

- Banks have shifted their loan policy from loan-to-value (LTV) criteria to capacity-to-repay considerations based on the borrowers' disposable income, resulting in a non-negligible share of loans showing LTV ratios above 90 percent. Most banks, however, insure the segment of mortgage loans exceeding LTV ratios above 70-80 percent at origination through indemnity guarantees.[2]

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[1] Prepared by Armando Morales.

[2] Some banks indicated that the social welfare system also provides for mortgage repayment protection to lower-income borrowers. In fact, mortgage borrowers eligible for social welfare assistance (i.e., those who satisfy means test criteria) can also apply for assistance towards the interest portion of their mortgage repayments.

- The increase in competition has eroded margins. The spread between clearing banks' prime rate and demand deposit rates fell to 340 basis points in 2002 from 470 in 2000. As returns from non-interest earning activities slipped, the contribution of non-interest income to total income declined to 35 percent in 2001 from 42 percent in 2000. Banks appear to have shifted toward mortgage lending partly because this market—despite rising competition—still allowed for larger margins than other activities. However, competition is intensifying in the mortgage market as well.

B. Insurance Industry Risks

- Links between banking and insurance could pose a risk as some banks contract indemnity guarantees and provide mortgage and home insurance to borrowers with insurance companies belonging to the same group. Market participants noted that this risk was usually reinsured abroad. However, for indemnity guarantees as for most credit derivatives, the legal vulnerability of such reinsurance is difficult to ascertain in the absence of a trigger event.

- Market risk exposure of the insurance sector has been mitigated by the use of unit-linked schemes (estimated at 90 percent of policies), which entail adjustable premia and/or coverage. Nonetheless, the operating profit of the main life insurance companies fell by 4–29 percent in 2002, reflecting low yields and declining equity prices. Also, problems in the international market for parent companies may have consequences domestically.

- Until insurance supervision reforms have been implemented and the risks in insurance companies' asset/liability portfolios better understood, there are potential, as yet unidentified, risks in this sector.

C. Macroeconomic Vulnerabilities and Risk Mitigators

Financial institutions are vulnerable to sharp increases in unemployment and/or interest rates and to decreases in house prices.

- An increase in unemployment is a key macroeconomic vulnerability to banks. It would initially lower the demand for mortgage loans, requiring banks to shift to other, less profitable, activities. Market participants felt, however, that an increase in unemployment severe enough to affect default rates significantly was unlikely.

- A sharp increase in interest rates—beyond two percentage points—is another vulnerability, given the widespread preference for floating rates among borrowers (93 percent of new mortgage loans in 2002). Again, market participants viewed such a rise as unlikely, given economic conditions in the euro area. Moreover, mortgage debt service remains low, on average, at 25.4 percent of disposable income in 2002.

- A fall in house prices was perceived as less of a vulnerability in and of itself. The general view was that, given the strong preference for home ownership, borrowers were unlikely to renege on debt obligations in the face of negative equity. However, risks remain, since about one-third of mortgage loans were approved in the last two years (at higher loan-to-value ratios) and exposures to small investors in the rental property market—who may behave differently from owner-occupiers—have increased (see above). Moreover, even if only a small portion of borrowers renege on obligations, execution of the corresponding collateral could create a dangerous dynamic if Ireland's small housing market were not able to absorb the additional supply without a further sharp reduction in house prices (particularly in a deepening downturn).

These risks and vulnerabilities are mitigated by several factors:

- Domestic banks have comfortable levels of capitalization and profitability. In 2002, the average risk-weighted capital-asset ratios increased to 12.5 percent (Table 2.1), while the two main banks showed rates of return on equity of 25–29 percent. The average rates of return on assets were 0.9 percent in 2001, above that of comparable financial systems, except those in the United Kingdom and the United States.

- Asset quality remains high, with non-performing loans at 1.7 percent of total loans; and loan-loss provisions accounted for more than 100 percent of nonperforming loans (Table 2.1).

- Small mortgage-lending institutions—identified in the 2000 FSAP as being more vulnerable to adverse macroeconomic shocks—have, for the most part, been absorbed by better-capitalized domestic and foreign commercial banks.

- Supervision is being strengthened under the newly formed IFSRA, particularly with regard to the insurance/reinsurance industry and the consolidated supervision of complex financial groups. The central bank's monitoring and analysis of systemic risks is also being continually enhanced, as recommended by the 2000 FSAP.

Table 2.1. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003 Latest estimate	Date
External Indicators						
Exports (annual percent change, value in U.S. dollars)	12.4	10.6	8.0	11.8	22.7	
Imports (annual percent change, value in U.S. dollars)	9.2	12.8	6.6	5.2	21.0	
Terms of trade (goods, annual percent change)	-2.5	-3.1	0.7	4.1	0.8	
Current account balance 1/	0.4	0.1	-0.3	-0.1	-0.7	
Capital and financial account balance, 1/	-1.5	10.0	1.6	1.8	...	
Of which:						
Inward portfolio investment	70.9	81.5	91.0	56.2	...	
Inward foreign direct investment	19.3	27.9	15.3	15.6	...	
Other investment liabilities (net)	-1.1	-8.8	9.2	15.5	...	
Total external debt 2/	2.8	2.0	1.8	0.6	...	
Of which:						
External debt to exports ratio	3.2	2.1	1.8	0.6	...	
External interest payments to exports (in percent)	0.2	0.2	0.1	0.1	...	
US dollar per euro (period average)	1.07	0.92	0.90	0.95	1.15	July 3
UK £ per euro (period average)	0.66	0.61	0.62	0.63	0.69	July 3
Financial Markets Indicators						
General government debt	49.3	39.3	36.8	33.0	33.6	
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	3.7	June
Real government bond yield (10-year, period average, based on national CPI)	3.2	-0.2	0.1	0.4	...	
Annual change in stock market index (in percent, end of period)	3.0	6.9	8.2	-19.4	-9.8	June
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.1	June
Interest rate spread (basis points)	375.0	472.0	380.0	340.0		
Personal lending interest rate	10.5	11.8	10.6	10.4		
Variable Mortgage interest rate	4.2	6.0	4.6	4.2		
Financial Sector Risk Indicators						
Annual credit growth rates (to private sector)	33.5	21.3	15.1	15.0		
Annual deposit growth rates	8.1	16.6	13.9	9.0		
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	...	
(excluding financial intermediation and government)						
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	...	
Other housing finance	0.9	1.0	0.9	0.8	...	
Other personal lending	13.0	12.2	12.5	10.3	...	
Annual Mortgage Credit Growth Rates	24.0	24.3	17.8	23.1		
Commercial property lending as a percent of total loans						
(excluding financial intermediation)	18.2	20.5	21.6	22.1	...	
Foreign-currency denominated assets (in percent of total assets)	36.5	37.4	36.3	31.2	...	
Foreign-currency denominated liabilities (in percent of total liabilities)	32.9	34.1	33.1	29.4	...	
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	...	
Non-performing loans (in percent of total loans) 4/	1.8	1.9	1.9	1.7	...	
Total provisions for loan losses (in percent of total loans)	2.0	2.0	2.3	1.9		
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.4	9.7	11.2	12.5	...	
Banks return on assets 5/	1.3	1.2	0.9	1.5		
Banks return on equity 5/	23.0	22.0	16.0	27.0		
Liquid assets of all banks to total assets (liquid asset ratio)	32	32	30	30	...	
Liquid assets of all banks to short-term liabilities (in percent)	39	44	62	58	...	
Deposits to M3 ratio 6/	1.03	1.03	1.02	1.02	...	
Loan-to-deposit ratiovis-à-vis Irish residents 7/	1.29	1.36	1.44	1.49	...	
vis-à-vis total 7/	1.48	1.55	1.61	1.53	...	
Concentration ratios in the banking sector						
No. of banks accounting for 25% of total assets	3	3	3	3	...	
No. of banks accounting for 75% of total assets	23	23	21	19	...	
Share of state-owned banks in total assets	3	2	1	0		
Share of foreign-owned banks in total assets	37	39	42	51		

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and staff estimates.

1/ Owing to methodological changes, a break in the series occurred between 1997 and 1998.

2/ Represents a non-Irish pound debt in 1995-98, and a non-euro debt of the government sector in 1999.

3/ Credit equivalent values.

4/ Owing to differences in classification, international comparisons of non-performing loans are indicative only.

5/ For 2002, data corresponds to Allied Irish Bank and Bank of Ireland only.

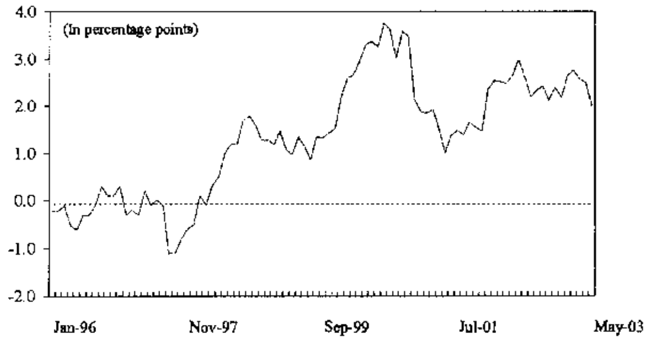
6/ Non-government deposits vis-à-vis Irish and non-residents to M3 ratio.

7/ Non-government loans/non-government deposits ratio.

What Explains Ireland's Inflation Differential Over the Euro Area?[1]

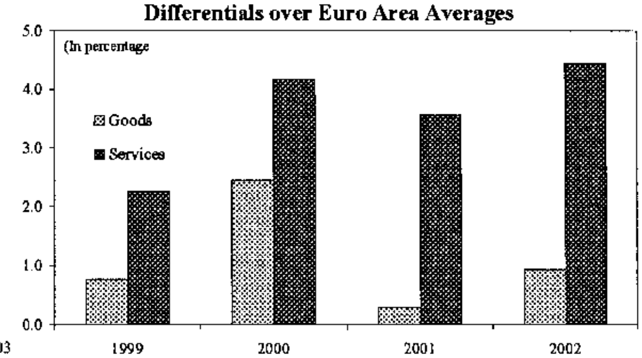
1. **Since the late 1990s, Ireland's consumer price inflation—measured by the Harmonized Consumer Price Index (HIPC)—has been among the highest in the euro area** (Figure 3.1). The inflation differential between Ireland and the euro area turned positive starting in mid-1998 (just before EMU membership in 1999) and fluctuated between 1.3–3.1 percentage points from January 1999 to May 2003, with a peak in late 2000. This note takes a closer look at some of the factors that could account for this differential.

Figure 3.1 Ireland: HICP Inflation Differential over the Euro Area Average



Source: Eurostat.

Figure 3.2. Ireland: Goods and Services Inflation Differentials over Euro Area Averages



Source: Eurostat.

2. **Ireland's stronger service price inflation has been a key driver of its higher inflation rate** (Figure 3.2). Given the robust productivity growth in the tradable sector, Balassa-Samuelson effects could be responsible for part of the higher wage inflation in nontradable (mainly service) sectors in Ireland compared with the euro area average (see below). However, these effects prevail over long periods of time and, in the short-run, other factors could also be important in boosting wage growth. In practice, it is difficult to disentangle Balassa-Samuelson effects from the impact on wages of disparate macroeconomic shocks that have boosted domestic demand at a time of tight labor market conditions. Such shocks could include: (i) the initial boost to demand from the sharp fall in real interest rates as a result of joining EMU; (ii) the impact on consumption from the wealth effects of the house price boom (itself partly driven by the fall in interest rates); (iii) an FDI-led surge in investment as a response to EMU membership and the ICT boom of the late 1990s; and (iv) expansionary fiscal policy in 2000–02.

3. Some factors can be identified as having contributed to Ireland's inflation differential over the euro area average during 1999–2002 (Table 3.1):

[1] Prepared by Petya Koeva.

- **Depreciation of the nominal effective exchange rate (NEER).** Owing to a large share of trade with the United States and the United Kingdom, Ireland's NEER reflects closely movements of the euro against sterling and the U.S. dollar. Since Ireland's NEER weakened by more 8 percent in the period 1998–2000, exceeding the NEER depreciations in all other EMU members, Ireland's high inflation could have reflected—via a pass-through to domestic prices—a larger exchange rate shock. Staff calculations, based on work by Honohan and Lane (2003), suggest that this more pronounced depreciation can account for a significant part of Ireland's inflation differential in 1999–2001.

Table 3.1 Contributing Factors to the Overall Inflation Differential

	1999	2000	2001	2002
Contributing factors				
NEER	1.3	0.6	0.7	-0.2
Housing market	0.0	0.2	0.2	0.0
Indirect taxes 1/	0.3	1.1	-0.3	1.2
Administrative and government-affected prices, of which:	0.0	0.1	0.1	0.3
Education	0.0	0.1	0.1	0.2
Health	0.0	0.0	0.1	0.1
Productivity	1- 1¼	1- 1¼	1- 1¼	1- 1¼
Effect of contributing factors 2/	2.6	3.0	1.7	2.3
Overall inflation differential	1.3	3.1	1.6	2.5

Sources: Eurostat, CSO, INS, and staff estimates.

1/ Assuming a neglibible effect of indirect taxes on inflation in the eurozone.

2/ Assuming a productivity effect of 1 percentage point.

- **Housing market boom.** The boom in the housing market—partly due to a decline in real interest rates after joining the EMU in 1999—could have also contributed to the inflation differential. While the overall effect of the surge in house prices on consumer inflation is difficult to estimate (due to potentially important wealth effects), the HICP component *Actual rents* can capture the direct impact of the housing boom on consumer inflation to the extent that house prices move together with rents. Staff estimates indicate that cross-country variation in rents explains some of Ireland's inflation differential in 2000 and 2001.

- **Indirect taxes.** Using the CSO constant tax price index, indirect tax measures—mainly changes in VAT rates and excise duties—appear to have pushed up inflation in 2000 and 2002. Estimates of the impact of indirect taxes on inflation for the euro area as a whole are not readily available, but staff work suggests these effects were relatively small in 1999–2002. Therefore, assuming a negligible role for indirect taxes in euro area inflation, the hikes in indirect taxes in Ireland in 2000 and 2002 can be seen to contribute significantly to the inflation differential in these years. By the same token, indirect taxes contributed to narrowing the inflation differential in 2001.

- **Administered and government-influenced prices**. The inflation differential can also be attributed to different price movements between Ireland and the euro area in sectors dominated by government—such as health, education, and transport—to the extent that these prices are influenced by non-market factors, including public sector wage and price policies. Using detailed HICP data, staff estimates the magnitude of this effect to be about ¼ percentage point in 2002.

- **Productivity differential**. Ireland has had notably higher productivity growth in tradables than most countries in the euro area. Previous staff analysis (IMF Staff Country Report No. 99/108)—which adjusts for the distorting effects of multinational activity on measured productivity in tradable goods—indicates that Balassa-Samuelson effects could account for an inflation differential of 1–1¼ percentage points over the rest of the euro area. As discussed above, in the short run, it is difficult to disentangle these effects from demand-led factors, but over this period Balassa-Samuelson effects are likely to have been an underlying factor.

4. **In conclusion, Ireland's inflation differential over euro area can be largely explained.** When one accounts for specific factors, such as nominal effective depreciation and indirect tax changes, the remaining differential is of a magnitude consistent with a conservative estimate of a Balassa-Samuelson effect—even if, in the short-run, this cannot be distinguished precisely from the impact of demand-led factors.

Table 1. Ireland: Selected Economic Indicators

(Annual change unless otherwise stated)

	1999	2000	2001	2002	2003 Proj./Latest		2004 Proj.
National accounts (constant prices) 1/							
GNP	8.8	10.7	4.6	0.6	1.3		3.1
GDP	11.1	10.0	5.7	6.3	2.5		3.8
Domestic demand	8.3	8.5	4.1	2.7	1.1		2.3
Private consumption	9.3	9.0	5.1	2.6	2.2		3.1
Public consumption	6.6	7.5	10.8	8.3	1.5		1.7
Gross fixed investment	14.4	6.7	-0.5	0.4	-1.5		0.5
Net exports (contribution to GDP growth)	4.3	2.4	1.6	5.0	1.0		2.0
Exports of goods and services	15.2	20.6	6.7	3.8	2.5		4.4
Imports of goods and services	12.0	21.2	6.1	-1.0	2.0		3.1
Prices, wages and employment							
Harmonized Index of Consumer Prices (annual average)	2.5	5.3	4.0	4.7	4.1		2.6
Average hourly earnings , manufacturing	5.6	6.2	10.3	7.2	...		...
Output, manufacturing 2/	15.0	15.7	10.2	8.4	...		...
Unit wage costs (manufacturing) 2/	-9.0	-4.7	-2.6	-8.9	...		...
GNP/Employment	2.4	5.7	1.6	-0.8	0.5		2.0
Employment	6.3	4.7	2.9	1.4	0.8		1.1
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.3		5.6
Money and credit (end-period)							
M3E 3/	...	14.7	17.2	9.3	8.8	6/	...
Private sector credit 4/	21.3	21.3	15.9	15.0	16.0	6/	...
Financial and asset markets (end of period)							
Three-month treasury bill	3.3	4.8	3.3	2.9	2.2	7/	...
10-year government bond	5.6	5.1	5.1	4.3	3.7	7/	...
ISEQ share prices	3.0	6.9	8.2	-19.4	-9.8	7/	...
House prices (permanent tsb index/ESRI)	17.9	21.3	4.4	13.3	14.2	6/	...
Public finance (In percent of GDP)							
General Government Balance 5/	4.1	4.3	1.1	-0.1	-0.9		-1.4
Primary balance 5/	6.5	6.4	2.7	1.3	0.5		-0.2
General government debt	49.3	39.3	36.8	33.0	33.6		34.5
External trade and balance of payments							
Balance of goods and services (Percent of GDP)	13.8	13.6	14.7	18.4	18.9		19.7
Current account (Percent of GDP)	0.4	0.1	-0.3	-0.1	-0.7		-0.4
Official reserves(In billions of SDRs, end of period.)	3.9	4.2	4.5	4.0	2.8	6/	...
Effective exchange rates (1995=100, annual average)							
Nominal	94.0	88.3	89.2	90.7	95.9	8/	...
Real (CPI based)	93.9	90.9	94.3	98.7	106.6	8/	...
Memorandum items for 2002							
Area		70.3 thousand square kilometers					
Population (in million)		3.9					
Natural rate of increase (percent change)		1.5					
GDP per capita (in SDRs)		24,189					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).

2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.

3/ M3E was discontinued in December 1998. The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.

4/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.

5/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2004.

6/ As of May 2003.

7/ As of June 2003.

8/ As of April 2003.

Table 2. Ireland: Summary of Balance of Payments

	1999	2000	2001	2002	2003	2004	2005	2006
				(In millions of euro)				
Current account balance	333	53	-345	-184	-1,013	-595	-267	122
Trade balance	22,802	28,133	34,258	38,279	39,393	42,478	46,212	50,383
Exports of goods	64,406	80,922	88,551	90,397	92,027	97,234	105,017	113,962
Imports of goods	-41,604	-52,789	-54,294	-52,118	-52,634	-54,756	-58,805	-63,579
Services	-10,428	-14,098	-17,380	-14,387	-13,520	-13,572	-14,286	-15,305
Credit	14,608	19,967	23,817	28,731	30,501	32,475	35,378	38,392
Debit	-25,037	-34,065	-41,197	-43,119	-44,021	-46,047	-49,664	-53,697
of which Royalties								
Credit	392	492	241	284	...	...	...	...
Debit	-6,902	-9,051	-9,989	-10,841	...	...	...	...
Balance on goods and services	12,373	14,035	16,877	23,891	25,873	28,906	31,926	35,078
Net factor incomes	-13,218	-14,976	-17,677	-24,957	-27,176	-29,732	-32,378	-35,105
Credit	23,002	30,089	29,956	27,899	...	...	...	...
Debit	-36,220	-45,065	-47,633	-52,855	...	...	...	...
Balance on goods, services and income	-844	-941	-800	-1063	-1303	-826	-452	-26
Current transfers (net)	1,177	994	455	879	290	232	185	148
Capital and financial account	-1,379	10,327	1,871	2,274	...	...	...	...
Capital account balance	560	1182	654	564	...	...	...	...
Financial account	-1,939	9,145	1,217	1,710	...	...	...	...
Direct investment	11,631	23,682	10,972	17,348	...	...	...	...
Portfolio investment	-14,342	-5,358	-19,893	-36,135	...	...	...	...
Other investment	-974	-9,037	10,579	20,153	...	...	...	...
Reserve assets	1,746	-142	-441	343	...	...	...	...
Net errors and omissions	1,046	-10,380	-1,526	-2,089	...	...	...	...
				(In percent of GDP)				
Memorandum itmes								
Current account balance	0.4	0.1	-0.3	-0.1	-0.7	-0.4	-0.2	0.1
Trade balance	25.4	27.3	29.9	29.5	28.7	28.9	29.2	29.8
Services	-11.6	-13.7	-15.2	-11.1	-9.9	-9.2	-9.0	-9.0
Net factor incomes	-14.7	-14.6	-15.4	-19.2	-19.8	-20.2	-20.5	-20.7
Balance on goods, services and income	-0.9	-0.9	-0.7	-0.8	-0.9	-0.6	-0.3	0.0
Transfers	1.3	1.0	0.4	0.7	0.2	0.2	0.1	0.1

Sources: The Central Statistics Office; and staff estimates.

Table 3. Contribution to GDP Growth
(In percent) 1/

	1999	2000	2001	2002	2003 Proj.	2004 Proj.
Domestic demand	7.3	7.4	3.5	2.3	0.9	1.8
Private consumption	4.8	4.6	2.6	1.3	1.1	1.5
Public consumption	0.9	0.9	1.3	1.1	0.2	0.2
Fixed investment	3.1	1.5	-0.1	0.1	-0.3	0.1
Business	1.8	0.2	-1.1	-0.3	0.1	0.0
Residential investment	0.6	0.5	0.3	0.4	0.0	0.0
Public	0.7	0.8	0.7	0.0	-0.4	0.1
Change in stocks	-1.5	0.3	-0.4	-0.2	-0.1	0.0
Net exports	4.3	2.4	1.6	5.0	1.0	2.0
Exports	14.2	20.0	7.1	4.0	2.7	4.6
Imports	-9.9	-17.6	-5.6	0.9	-1.7	-2.6
Statistical discrepancy	-0.5	0.2	0.6	-1.0	0.6	0.0
GDP (annual percent change)	11.1	10.0	5.7	6.3	2.5	3.8
GNP (annual percent change)	8.8	10.7	4.6	0.6	1.3	3.1
Memorandum:						
Current account (as a percent of GDP)	0.4	0.1	-0.3	-0.1	-0.7	-0.4

Source: Staff estimates.

1/ Rounding may affect totals.

Table 4. Ireland: General Government Finances
(In percent of GDP)

	1999	2000	2001	2002	Proj. 2003	Official 2003 1/
Current surplus:	6.2	7.3	4.6	3.3	2.1	2.2
Current revenue, of which	33.8	33.8	32.5	31.1	31.1	31.3
Tax revenue (excluding taxes on capital)	26.2	26.0	24.4	23.2	23.2	23.5
Social security receipts	4.1	4.3	4.4	4.2	4.2	4.2
Miscellaneous	3.5	3.5	3.7	3.7	3.7	3.7
Current expenditure, of which	27.6	26.5	27.8	27.8	29.0	29.1
Interest payments	2.4	2.1	1.6	1.4	1.4	1.5
Goods and services	5.1	5.1	5.7	5.7	5.8	5.8
Compensation of employees	8.1	7.8	8.1	8.2	8.5	8.5
Transfers	11.4	10.8	11.6	11.6	12.3	12.3
Depreciation	0.7	0.7	0.8	0.8	1.0	1.0
Current expenditure, excluding interest and transfers	13.9	13.6	14.6	14.8	15.3	15.3
Capital deficit 2/	2.1	3.0	3.5	3.4	3.0	3.0
Capital receipts (including taxes on capital)	2.2	2.1	2.1	1.9	1.9	1.9
Gross capital formation	3.2	3.9	4.6	4.3	3.8	3.8
Capital transfers 2/	1.1	1.2	1.1	1.0	1.0	1.0
General government balance 2/	4.1	4.3	1.1	-0.1	-0.9	-0.8
Primary balance	6.5	6.4	2.7	1.3	0.5	0.8
Memorandum items:						
Structural (as a percent of potential GDP):						
Revenue 3/	35.9	35.7	34.5	32.7	32.8	32.7
Expenditure, of which	33.6	34.0	35.3	34.5	34.0	34.0
unemployment benefits	1.6	1.4	1.1	1.0	0.8	...
Government balance	2.4	1.7	-0.8	-1.8	-1.2	-1.4
Primary balance	4.7	3.8	0.8	-0.4	0.3	0.1
General government gross debt (as percent of GDP)	49.3	39.3	36.8	33.0	33.6	33.3
Growth in nominal GDP	15.7	14.6	11.2	13.3	5.8	7.2

Sources: Department of Finance and staff estimates.

1/ The official projections are based on Budget 2003 and revised estimates from March 2003 but are presented as a percent of staff's estimate of GDP. Structural numbers are based on the staff's methodology and estimates of structural unemployment, unemployment benefits and potential output, but on the authorities' estimates of revenues, expenditures and actual GDP growth.
2/ Excluding a capital transfer related to the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999 to maintain comparability. If the transfer were included, capital transfers and the overall balance would have been 3.0 and 2.3 percent of GDP in 1999, respectively.
3/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008
Total revenue	34.6	33.0	32.9	32.1	31.5	31.6	31.4	31.4
of which:								
Taxes and social security contributions	29.7	28.2	28.3	28.0	27.6	27.7	27.6	27.7
Other	4.9	4.8	4.6	4.1	3.9	3.9	3.8	3.8
Total expenditure	33.5	33.0	33.9	33.4	33.0	32.8	32.6	32.3
of which:								
Primary expenditure	31.9	31.7	32.4	32.3	31.7	31.3	31.0	30.7
of which:								
Gross fixed investment	4.6	4.3	3.8	3.9	3.8	3.7	3.7	3.7
Interest payments	1.6	1.4	1.4	1.2	1.3	1.5	1.6	1.7
Budget balance	1.1	-0.1	-0.9	-1.4	-1.5	-1.2	-1.1	-0.9
Memorandum:								
Nominal GDP growth in percent	11.2	13.3	5.8	7.0	7.6	7.2	6.9	6.6
Gross debt	36.8	33.0	33.6	34.5	35.3	36.0	36.6	37.0
Structural budget balance 2/	-0.8	-1.8	-1.2	-1.0	-1.2	-0.9	-1.0	-0.9
Output gap	4.1	3.6	0.4	-0.9	-0.9	-0.6	-0.3	0.0
	Stability Programme December 2002 Update							
Total revenue	35.8	35.0	34.4	33.5	32.9	...	...	...
Total expenditure	34.2	35.3	35.1	34.7	34.1	...	...	...
of which:								
Collective consumption	5.5	5.8	6.0	5.9	5.7	...	...	...
Individual consumption	9.2	9.6	9.8	9.7	9.5			
Social transfers in kind	1.3	1.4	1.4	1.4	1.3	...	...	...
Social transfers other than in kind	8.6	9.1	9.1	9.2	9.3			
Gross fixed investment	4.3	4.4	4.1	4.1	4.0	...	...	...
Interest payments	1.6	1.5	1.6	1.5	1.5	...	...	...
Subsidies	1.1	0.9	0.8	0.8	0.7	...	...	...
Other	2.6	2.5	2.3	2.1	2.0	...	...	...
General government balance	1.6	-0.3	-0.7	-1.2	-1.2	...	...	...
of which due to contingency	...	...	...	-0.4	-0.8	...	...	...
Memorandum:								
Nominal GDP growth in percent	11.2	9.7	7.2	7.4	7.7	...	...	...
Gross debt	36.7	34.1	34.0	34.5	34.9	...	...	...
Structural budget balance 2/	0.1	-1.0	-0.4	-0.2	0.1	...	...	...
Output gap	4.4	2.0	-0.9	-2.9	-3.7	...	...	...

Sources: Staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2004–05, but are adjusted for the difference between the government's and staff's growth assumptions. From 2006 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2003 are based on the latest available official information, whereas projections for 2004–05 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.

2/ As a percent of potential GDP. The balance for 2002 excludes UMTS receipts of 0.2 percent of GDP.

Ireland: Fund Relations
(As of April 30, 2003)

I. **Membership Status**: Joined 8/08/57; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	838.40	100.00
Fund holdings of currency	492.53	58.75
Reserve position in Fund	345.87	41.25
Financial Transaction Plan transfers (net)	20.00	

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	87.26	100.00
Holdings	49.87	57.14

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	0.49	0.66	0.66	0.66	0.66
Total	0.49	0.66	0.66	0.66	0.66

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland and the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564.

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 7–16, 2002. The staff report (SM/02/209) was considered by the Executive Board on July 31, 2002 (SUR/02/89). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Sustainability Exercise

Fiscal Sustainability

The sustainability of Ireland's fiscal position was assessed, analyzing the evolution of gross public sector debt under several alternative scenarios that deviate from staff's baseline projections (Table A1). In the baseline, gross public sector debt would increase somewhat from 33 percent of GDP in 2002 to 37 percent of GDP in 2008. However, this corresponds mainly to increases in assets, such as those accumulated in government pension and social security funds.[1] In fact, if these assets were excluded (on a net basis), public debt-to-GDP ratio would decline further to about 30.5 percent of GDP in 2008.[2] The primary balance remains close to balance throughout, while GDP growth exceeds the average real interest rate, leading to a favorable medium-term fiscal outlook.

The alternative scenarios all show a sustainable fiscal position.

- Given the low initial debt, real interest rate and growth shocks would not have severe effects on the public debt ratio (scenarios 2 and 3).
- A real deprecation scenario has no appreciable effect given the very low level of non-euro denominated public debt.
- A lower primary balance has no appreciable impact given the very large primary surpluses in past years.
- The only scenario that has an appreciable impact on debt levels is a 10 percent of GDP increase in the debt stock in 2003, which raises the 2008 debt-ratio by some 13 percentage points to just under 46 percent of GDP, still well below the prevailing EU average.

External Sustainability

With a net external position (excluding direct investment) showing substantial claims on the rest of the world (around 100 percent of GDP), external debt sustainability does not seem to be an issue (Table A2). The net external position, including direct investment, is in broad balance given the very strong continued FDI inflows into Ireland. The fact that Ireland is a net creditor with regard to portfolio and other investment suggests little vulnerability to interest rate shocks or to a sudden reversal in short-term capital flows. The large gross assets and liabilities in portfolio and other investments reflects the activities of the International Financial Service Center, which the 2000 FSAP noted does not appear to pose a systemic risk to the domestic financial system.

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[1] These items are included in the category "other identified debt-creating flows."

[2] This would correspond to including contribution from categories "primary deficit" and "automatic debt dynamics" to debt dynamics, while excluding the impact of "other identified debt-creating flows."

Table A1. Ireland: Public Sector Debt Sustainability Framework, 2000–08
(In percent of GDP, unless otherwise indicated)

	Actual		Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections									
Public sector debt 1/	39.3	36.8	**33.0**	**33.6**	**34.5**	**35.3**	**36.0**	**36.6**	**37.0**
Change in public sector debt	-9.9	-2.6	-3.8	0.6	0.9	0.9	0.6	0.6	0.4
Identified debt-creating flows (4+7+12)	-7.9	-2.1	-4.2	0.6	0.9	0.9	0.6	0.6	0.4
Primary deficit	-6.4	-2.7	-1.3	-0.5	0.2	0.2	-0.3	-0.4	-0.8
Revenue and grants	35.9	34.6	33.0	32.9	32.1	31.5	31.6	31.4	31.4
Primary (noninterest) expenditure	29.5	31.9	31.7	32.4	32.3	31.7	31.3	31.0	30.7
Automatic debt dynamics 2/	-4.0	-2.3	-3.2	-0.4	-1.0	-1.1	-0.9	-0.8	-0.7
Contribution from interest rate/growth differential 3/	-4.2	-2.4	-2.9	-0.4	-1.0	-1.1	-0.9	-0.8	-0.7
Of which contribution from real interest rate	0.1	-0.4	-0.9	0.4	0.2	0.4	0.6	0.7	0.8
Of which contribution from real GDP growth	-4.3	-2.0	-2.0	-0.8	-1.2	-1.5	-1.5	-1.5	-1.5
Contribution from exchange rate depreciation 4/	0.2	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Denominator = $1+g+\pi+g\pi$	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Other identified debt-creating flows 5/	2.5	2.9	0.3	1.5	1.7	1.8	1.8	1.8	1.8
Residual, including asset changes (2-3)	-2.1	-0.5	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	109.6	106.3	100.0	102.0	107.5	112.0	113.8	116.3	117.7
Key Macroeconomic and Fiscal Assumptions									
Real GDP growth (in percent)	10.0	5.7	6.3	2.5	3.8	4.7	4.6	4.5	4.3
Average nominal interest rate on public debt (in percent) 6/	4.8	4.5	4.2	4.7	3.7	4.1	4.4	4.6	4.7
Average nominal interest rate on forex debt (in percent) 6/	7.0	6.1	4.2	5.2	4.7	5.1	5.4	5.6	5.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	-0.8	0.0	1.4	0.6	1.3	1.9	2.3	2.5
Exchange rate (LC per US dollar)	1.07	1.13	0.95	0.88	0.88	0.89	0.90	0.91	0.91
Nominal depreciation of local currency (LC per dollar)	8.0	5.6	-16.0	-7.4	-0.1	1.0	0.9	0.9	0.5
Exchange rate (US dollar per LC)	0.93	0.88	1.05	1.13	1.13	1.12	1.11	1.10	1.10
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.4	-5.3	19.0	8.0	0.1	-1.0	-0.9	-0.9	-0.5
Inflation rate (GDP deflator, in percent)	4.3	5.3	6.6	3.3	3.0	2.8	2.4	2.3	2.2
Growth of real primary spending (deflated by GDP deflator, in percent)	9.8	14.2	5.5	4.9	3.3	2.9	3.3	3.3	3.2
II. Stress Tests for Public Debt Ratio									
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007			**33.0**	**28.0**	**23.4**	**19.2**	**15.1**	**11.2**	**7.5**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004			**33.0**	**35.0**	**37.5**	**38.2**	**38.8**	**39.4**	**39.7**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004			**33.0**	**33.9**	**35.6**	**36.5**	**37.1**	**37.8**	**38.2**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004			**33.0**	**32.2**	**31.0**	**32.0**	**32.7**	**33.4**	**33.8**
5. Combination of 2-4 using one standard deviation shocks			**33.0**	**30.9**	**29.1**	**30.9**	**32.4**	**33.9**	**35.2**
6. One time 30 percent real depreciation in 2003 7/			**33.0**	**33.6**	**34.5**	**35.3**	**36.0**	**36.6**	**37.0**
7. 10 percent of GDP increase in other debt-creating flows in 2003			**33.0**	**43.6**	**44.2**	**44.7**	**45.1**	**45.5**	**45.8**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	-4.6	1.3	-0.3
Real GDP growth (in percent)	7.6	3.1	4.4
Nominal interest rate (in percent) 6/	6.0	1.0	4.3
Real interest rate (in percent)	1.8	2.0	1.3
Inflation rate (GDP deflator, in percent)	3.9	1.5	3.4
Revenue to GDP ratio	37.9	2.3	32.1

Sources: CSO, Central Bank of Ireland, Department of Finance, and staff estimates.
1/ General government gross debt. Although no official figures for the net debt position of general government are available, its level is considerably lower given the accumulated assets, such as capital in the National Pension Reserve Fund (estimated at 5.7 percent of GDP at end-2002).
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ These factors include net receipts of the government pension and social security funds, privatization receipts, and changes in local government debt.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Ireland: Net Investment Position
(In percent of GDP)

	1998	1999	2000	2001
Assets	469	609	659	725
Direct investment abroad	22	28	29	33
Portfolio investment abroad	211	314	355	433
Other investment abroad	227	261	270	253
Reserve assets	8	6	6	6
Liabilities	430	546	652	735
Direct investment to Ireland	69	81	124	137
Portfolio investment to Ireland	169	239	292	362
Other Investment to Ireland	192	226	237	236
Net investment position	39	63	7	-11
Direct investment abroad	-46	-53	-95	-104
Portfolio investment abroad	43	75	63	71
Other investment abroad	34	35	33	16
Reserve assets	8	6	6	6
Net investment position, excluding direct investment	85	116	101	93

Source: CSO.

Ireland: Statistical Issues

Ireland is subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the European Central Bank (ECB). Ireland has cooperated fully with the Fund in providing monetary, international reserves, and selected other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered comprehensive, reliable, timely, and well documented. Ireland has subscribed to the Fund's Special Data Dissemination Standard (SDDS).

1. Quarterly national accounts on an ESA 1995 basis have been introduced and are currently published within 4 months of its reference period. Real sector data are sometimes published with a lag of 3–6 months, but some non-SDDS series even one and a half years later (e.g., household disposable income). Lags are particularly long for employment, earnings, unit wage costs, and national income and expenditure data. These data are available with a 3–7 month lag. However, Ireland does not have an overall earnings index or comprehensive sectoral balance sheet data.

2. While the authorities publish Exchequer returns on a monthly and quarterly basis, only annual data on the general government balance are currently available. Furthermore, some discrepancies remain between the general government data reported by the Department of Finance and the Central Statistics Office.

3. The Irish authorities began publication of the current account of the balance of payments within three months of the reference quarter, although recent reports have been published with slightly longer lags. The balance of payments data are in line with the *Balance of Payments Manual*, 5th edition (BPM5), although the historical data covers only years starting from 1998. The Irish authorities have also started to publish on the country's International Investment Position (IIP).

Ireland: Core Statistical Indicators
(As of July 3, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	External (Non-euro denominated) Debt	GDP/ GNP
Date of Latest Observation	7/3/2003	May 2003	May 2003	May 2003	May 2003	7/3/2003	May 2003	Apr 2003	4th Quarter 2002	2002	2002	4th Quarter 2002
Date Received	7/3/2003	6/30/2003	6/30/2003	6/30/2003	6/30/2003	7/3/2003	6/12/2003	6/26/2003	4/9/2003	3/21/2003	Apr. 2003	5/1/2003
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	Central Bank	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Publication	Internet / Publication	Internet / Publication	Internet	Internet/ Publication	Internet/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2003 Article IV Consultation

Supplementary Information

Prepared by the European I Department

Approved by Ajai Chopra and Leslie Lipschitz

July 25, 2003

1. This supplement reports on information that has become available since the issuance of the staff report (SM/03/243). This information does not change the thrust of the staff appraisal.

2. Revised national income accounts data indicate that real GNP grew by 0.1 percent in 2002, somewhat lower than the preliminary 0.6 percent estimate shown in the staff report (see Table 1 below). Given revisions to the previous year's GNP, the deceleration in growth in 2002 was less sharp than previously suggested. GDP growth in 2002 was revised upwards to 6.9 percent, compared with 6.3 percent in the staff report. The revised data thus widen the difference between the growth rates of GDP and GNP in 2002, owing to larger net factor income outflows than previously reported (consistent with revised balance of payments data; see below). Growth in domestic demand was raised somewhat, while the contribution from net exports was lowered, reflecting a proportionally larger upward revision to imports compared with exports.

3. Balance of payments data for 1998–2002 have also been revised, with the path of current account balances lowered for the whole period, reflecting updated merchandise trade data. The current account deficit in 2002 was revised to 0.7 percent of GDP from the previous estimate of 0.1 percent of GDP (the largest revision), in part due to larger debits on net factor income. New data for the first quarter of 2003 indicate a widening of the current account deficit compared with the same quarter a year ago, due to a sizeable decline in net exports, which was partly offset by a reduction in net factor outflows.

4. Due to the revision of the National Accounts and consequent adjustments to staff's potential output estimates, the general government structural budget balances are estimated to have improved somewhat in 1999–2001. The fiscal stance in 2002 is thus estimated to be slightly more expansionary, with the fiscal impulse (i.e., change in the structural balance) revised to 1.2 percent of GDP from 1 percent of GDP (see Table 1).

5. Harmonized consumer price inflation decelerated further to 3.8 percent (year-on-year) in June, narrowing tbe differential over the euro area average to 1.8 percentage points.

6. The unemployment rate (claimant count basis) edged up to 4.7 percent in June.

7. The volume of retail sales fell by 2.2 percent (year-on-year) in May, following an increase of 3.4 percent in April. Excluding motor trades, volume of sales declined by 0.1 percent in May.

Table 1. Ireland: Revised Indicators
(Annual change unless otherwise stated)

	1999	2000	2001	2002	2003 Proj.
National accounts (constant prices) 1/					
GNP	8.9	10.2	3.8	0.1	1.5
GDP	11.3	10.1	6.2	6.9	2.5
Domestic demand	8.7	8.6	4.4	2.9	1.2
Private consumption	9.6	8.5	5.5	2.7	2.2
Pnblic consumption	7.7	7.4	11.1	9.4	1.5
Gross fixed investment	14.5	6.8	0.1	1.7	-1.5
Net exports (contribution to GDP growth)	4.3	2.3	2.9	4.6	0.7
Exports of goods and services	15.2	20.6	8.3	6.2	1.5
Imports of goods and services	12.1	21.3	6.5	2.3	1.0
Prices, wages and employment					
Harmonized Index of Consumer Prices (annual average)	2.5	5.3	4.0	4.7	4.0
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.1
Pnblic finance (In percent of GDP)					
General Government Balance 2/	4.1	4.3	1.1	-0.1	-0.9
Structural budget balance 2/	2.6	2.0	-0.6	-1.8	-1.2
Balance of payments					
Balance of goods and services (Percent of GDP)	13.4	13.0	15.0	18.7	18.7
Current account (Percent of GDP)	0.3	-0.4	-0.7	-0.7	-1.3

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.
1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures. Structural balance is presented in percent of potential GDP and it excludes UMTS receipts of 0.2 percent of GDP in 2002.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/93
FOR IMMEDIATE RELEASE
August 6, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Ireland

On July 30, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Over the past decade, Ireland has experienced a sustained expansion in output and employment that has raised its per capita income above the EU average. During 1991-2001, income growth, measured by real GNP, averaged 6.5 percent, while the unemployment rate plummeted from almost 16 percent to below 4 percent. The fiscal position strengthened, with the public debt ratio falling from close to 100 percent of GDP in the early 1990s to well below 40 percent of GDP in 2001. Substantial gains in competitiveness, particularly in the multinational dominated manufacturing sector, kept the current account in surplus or close to balance.

Growth began to slacken in mid-2001 as the global economy started to slow. While GDP growth remained robust at 6.9 percent in 2002, GNP growth slowed sharply from 10.2 percent in 2000 to just 0.1 percent in 2002. Private consumption and export growth weakened from their previous rapid pace while investment increased marginally mainly because strong residential investment offset a fall in business investment. Yet the unemployment rate rose only slightly to 4.4 percent, while the current account remained in a small deficit. Recent indicators suggest that economic activity remains sluggish in 2003—industrial confidence and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

orders have fallen, retail sales remain weak, and consumer and service sector confidence have deteriorated further. Inflation eased to 3.8 percent in June, still well above the euro area average of 2 percent, while wage growth moderated somewhat.

Monetary conditions have remained easy for several years. Interest rates fell markedly in the run up to joining European Monetary Union in 1999 and credit to the private sector rose sharply. With inflation persistently above the euro area average, short- term interest rates have been negative since late 2001. Credit to households has grown in real terms at rates of 15–30 percent each year since 1996, but the average household debt to income ratio is still not high by international comparison. The decline in interest rates and increasing financial sector competition as well as rapidly rising disposable income and high rates of household formation have fuelled a spectacular increase in house prices, with real house prices rising by over 130 percent since 1993.

The prolonged economic expansion bolstered fiscal revenue in the late 1990s, allowing the government to maintain sizeable budget surpluses, while simultaneously cutting taxes and increasing expenditure rapidly. As growth slowed in 2001, revenue fell short of expectations, but spending rose sharply (by 12.6 percent in real terms), shifting the fiscal balance to a structural deficit for the first time in many years. In 2002, when adjusted for the effects of the economic cycle, the general government balance turned out somewhat weaker than budgeted mainly due to the underperformance of structural revenues—particularly in personal and corporate taxes. After an initial rapid increase, expenditure was brought under control and ended the year below budget. The cyclically-adjusted general government deficit increased to 1.8 percent of GDP, resulting in a fiscal expansion in excess of 1 percent of GDP.

Staff projects a gradual recovery in line with the expected pick up in global growth. Real GNP is projected to grow by 1.5 percent in 2003 and to rebound to about 3 percent in 2004 as private consumption and exports recover in late 2003, with the improvement in external demand. Given the information and communication technology overhang, investment would continue to decline in 2003 before reviving in 2004 as growth prospects improve. Monetary conditions would remain supportive, as the effects of euro appreciation so far would be largely offset by the European Central Bank's recent rate cuts. Over the medium-term, output is projected to grow at a trend rate of about 4-5 percent a year reflecting slower labor force and productivity growth compared with the late-1990s due to income convergence and lower foreign direct investment flows following the bursting of the global ICT bubble.

Executive Board Assessment

Directors commended the Irish authorities for their exemplary track record of sound economic policies, which have resulted in a dynamic, open, and robust economy—with growth notably above the EU average over the past decade—and resilience to external shocks. Directors saw signs, however, that trend growth was beginning to moderate toward euro-area levels, with implications for macroeconomic policy implementation and the expectations of economic agents. The likelihood of sustained slower growth in the period ahead calls for a sharper policy focus on reducing inflation further toward the euro-area average, improving competitiveness, safeguarding financial sector soundness and flexibility, and securing the medium-term fiscal position, in line with the Stability and Growth Pact (SGP) objective.

Directors expected activity to pick up with the recovery in world demand towards the end of this year and to accelerate thereafter to a sustainable rate. Nevertheless, they saw some risks to the outlook. The global recovery could be more anemic than expected and the euro may continue to appreciate, adversely affecting competitiveness and employment, particularly in indigenous, employment-intensive industries. A sharp rise in unemployment could, moreover, pose risks to the housing market and to the financial sector. Given Ireland's prolonged credit boom, Directors noted that there is a significant risk that house prices could be overvalued, although financial sector risks appear to be manageable.

Directors observed that high levels of capitalization and profitability have strengthened banks' capacity to absorb the effects of potential macroeconomic shocks without systemic distress. However, credit risks related to investor-owned housing properties, the concentration of exposures in the commercial property market among a few institutions, and the health of the insurance industry merit close attention. Directors stressed the need for continued supervisory vigilance to ensure the stability of the financial system, and they welcomed the unification of supervision under the Irish Financial Services Regulatory Authority (IFSRA) within the central bank, which has enhanced the supervisory regime. They also welcomed the authorities' plans to improve insurance supervision and the consolidated supervision of complex financial groups. Directors encouraged the authorities to continue strengthening the monitoring of forward-looking systemic risks.

Directors emphasized that wage growth must moderate in order to preserve external competitiveness and avoid risks to output and employment. They welcomed the new national wage agreement in this regard, but emphasized that the wage norm for the agreement's second phase would need to reflect closely changes in productivity and economic conditions. With temporary factors adding to inflation this year, Directors felt that real wage declines may need to be accepted in that phase, especially in the public sector and publicly-owned enterprises. Directors noted the importance of having substantive and publicly verifiable evidence of productivity improvements in order to support benchmarking pay increase recommendations. They suggested that the compensation system for public pay be based on private sector comparators, and that merit and skill differences be taken into account.

Following several years of procyclical fiscal expansion, Directors welcomed the somewhat contractionary fiscal stance envisaged for 2003. Since structural revenue could continue to underperform, they stressed that spending should be held to budgeted levels, and that any revenue shortfalls be offset by restraint with respect to the wage bill and transfers; given the pressing need to invest in infrastructure, capital spending should be protected. Barring major adverse shocks to output and employment, the fiscal stance should—at a minimum—be neutral in 2004, with no increase in the cyclically-adjusted deficit, and with the automatic stabilizers allowed to operate freely.

Directors agreed that the authorities' medium-term fiscal target of overall structural balance is appropriate. However, the authorities should not rely on continued strong output growth to eliminate the deficit. In the view of most Directors, implementation of moderate contractionary measures once the economic recovery is established, would protect policy credibility and secure the path toward achieving the medium-term objective. However, a few Directors noted the urgency of targeting the medium-term balance decisively and early, and recommended that adjustment measures be taken soon.

Directors observed that restraining current expenditure was preferable to increasing taxes as a means to improve the fiscal balances. In that vein, they urged limiting public sector wage increases, raising productivity, and continuing to strengthen public expenditure management across all levels of general government. They noted that greater competition and private provision of public services could also foster efficiency and reduce costs. They welcomed the recently announced plans to reform healthcare. If a compelling need to address taxation arose, broadening the tax base and the scope of user fees, with targeted transfers to the poor when appropriate, would be less distorting than increasing tax rates. Directors drew attention to the considerable improvements to the tax system made in recent years, which should be preserved.

Directors considered that the adoption of a formal medium-term fiscal framework at the general government level would improve transparency and policy predictability. Such a framework could include an overall fiscal constraint consistent with the SGP, and budget projections based on a medium-term expenditure framework. Directors welcomed the planned multi-year departmental capital spending envelopes, and recommended extending them to cover all non-cyclical primary expenditure, with safeguards to protect capital spending from budget pressures. They urged more extensive publication of public service commitments and ex-post evaluations of the effectiveness of public services. A few Directors suggested that the authorities undertake a fiscal Reports on Observance of Standards and Codes to identify ways to further improve fiscal transparency.

Directors agreed that enhancing competition and lowering regulatory obstacles will be important for sustaining medium-term productivity and income growth. Regulatory reform should be oriented firmly toward serving consumer welfare. Directors welcomed the strengthening of the Competition Authority's powers and the legal framework governing competition. They also welcomed the Competition Authority's scrutiny of restrictive practices in services, and encouraged the government to address the issues identified.

Directors noted the progress made in the provision of statistics, and encouraged the authorities to make further improvements, especially regarding the timeliness of general government accounts, and development of a national earnings index and sectoral balance sheets.

Directors encouraged the authorities to adopt a more supportive stance within the EU in favor of trade liberalization, in particular on the Common Agricultural Policy. They commended the authorities for their progress toward achieving the U.N.'s target for official development assistance by 2007.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Ireland is also available.

Ireland: Selected Economic Indicators

	1999	2000	2001	2002	2003 1/
Real Economy (change in percent)					
Real GDP	11.3	10.1	6.2	6.9	2.5
Real GNP	8.9	10.2	3.8	0.1	1.5
Domestic demand	8.7	8.6	4.4	2.9	1.2
Exports of goods and services	15.2	20.6	8.3	6.2	1.5
Imports of goods and services	12.1	21.3	6.5	2.3	1.0
HICP	2.5	5.3	4.0	4.7	4.0
Unemployment rate (in percent)	5.6	4.3	3.9	4.4	5.1
Public Finances (percent of GDP) 2/					
General government balance	4.1	4.3	1.1	-0.1	-0.9
Structural balance 3/	2.6	2.0	-0.6	-1.8	-1.2
General government debt	49.3	39.3	36.7	33.0	33.6
Money and Credit (end-year, percent change)					
M3E 4/	...	14.7	17.2	9.3	8.8 5/
Private sector credit	21.3	21.3	15.9	15.0	16.0 5/
Interest rates (end of period)					
Three-month	3.3	4.8	3.3	2.9	2.1 6/
10-year government bond yield	5.6	5.1	5.1	4.3	3.8 6/
Balance of Payments (percent of GDP)					
Trade balance (goods and services)	13.4	13.0	15.0	18.7	18.7
Current account	0.3	-0.4	-0.7	-0.7	-1.3
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	3.9	4.2	4.5	4.0	2.8 5/
Exchange Rate					
Exchange rate regime		Member of euro area			
Present rate (July 30, 2003)		US$ per euro 1.1346			
Nominal effective rate (1995=100)	94.0	88.3	89.2	90.7	95.9 7/
Real effective rate (1996=100, CPI based)	93.9	90.9	94.3	98.7	106.6 7/

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics

1/ Staff projections, except where noted.

2/ In percent of GDP. In 1999 the overall balance of 4.1 percent does not take account of discharging future pensions liabilities at a cost of 1.8 percent of GDP.

3/ The balance for 2002 excludes UMTS receipts of 0.2 percent of GDP.

4/ ME3 was discontinued in December 1998 and the methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 1999.

5/ End-May 2003.

6/ End-June 2003.

7/ End-April 2003.

November 2004
IMF Country Report No. 04/348

Ireland: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ireland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 20, 2004, with the officials of Ireland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 22, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 29, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Ireland.

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives of the 2004 Consultation with Ireland

Approved by Ajai Chopra and Martin Fetherston

September 22, 2004

- The Article IV consultation discussions were held in Dublin during July 8–20, 2004. The mission comprised Mr. Chadha (head), Mr. Hunt, Ms. Koeva and Ms. Moreno-Badia (all EUR). Ms. Honjo (EUR) assisted the mission at headquarters. The mission met with the Minister for Finance, the Governor of the Central Bank, other senior officials, the employers' federation, trade unions, and members of the financial and academic communities. Mr. Bennett (Executive Director) attended the concluding meeting.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions, other than those in accordance with U.N. Security Council resolutions and EU regulations (Appendix I).

- Ireland has subscribed to the Special Data Dissemination Standard (SDDS).

- The authorities intend to publish the staff report.

- A coalition government headed by Prime Minister Ahern, which has been in power since June 1997, was re-elected in May 2002.

- At the conclusion of the last consultation in August 2003, Directors commended the authorities for Ireland's outstanding economic performance. They emphasized, however, the need for wage growth to moderate in order to preserve competitiveness and cautioned there was a significant risk that house prices could be overvalued. Following several years of procyclical fiscal expansion, Directors welcomed the consolidation measures envisaged in the 2003 Budget.

Contents Page

Executive Summary

Background and Outlook: Over the last half of the 1990s, incomes in Ireland grew quickly and converged to the EU average as output and employment expanded. A sound macroeconomic policy framework encouraged large inflows of FDI that served as a catalyst to growth. In 2001, growth in Ireland slowed along with the slowing in the world economy. The downturn, however, was relatively mild, particularly in employment, and the economy began to recover in 2003. Inflation, which had been running well above that in the euro area for several years, converged to the average euro area rate in early 2004, although the rate of house price inflation continues to significantly exceed sustainable rates. Currently, indicators point to a continued rebound in growth to rates above those in many other industrial countries, but significantly lower than those experienced in Ireland during the late 1990s. While fiscal policy appears to have adjusted to slower growth, there are signs that expectations in other markets may still not have fully adjusted.

Policy discussions focused on the following key issues:

- What are sustainable medium-term growth rates?
- To what extent have expectations in product, labor, housing markets and fiscal policy adjusted to slower growth?
- Avoiding a procyclical fiscal policy.

There was broad agreement on the diagnostics:

- Recovery is well underway and growth in 2004 and 2005 will be between 4 percent and 5 percent, the range that appears to be sustainable over the medium term.
- Inflation will remain close to the ECB's target as resource constraints have abated and the catch-up of the Irish price level to key trading partners appears complete.
- House-price inflation continues to run well above sustainable rates and the longer it takes for them to moderate the greater the risk of a disorderly correction.
- Competitiveness has deteriorated. Although there is little evidence that this has yet had a significant negative impact, wage moderation going forward will be important to avoid further deterioration.

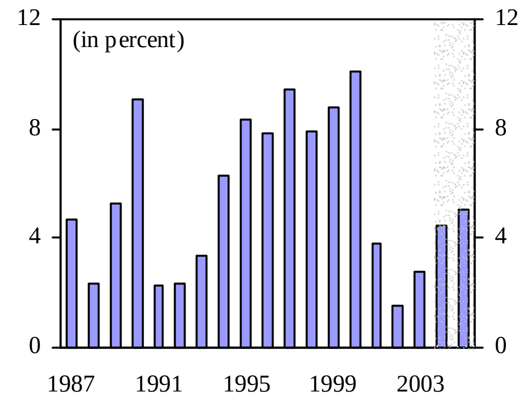
The key policy recommendations are:

- A modest tightening in the structural fiscal balance in the next budget to avoid a procyclical fiscal policy.
- The authorities should continue to communicate their views about potential overheating in the housing market to help achieve a soft landing, and look to removing the subsidies to housing over the medium-term to help moderate house-price cycles in the future.
- Shortening the duration of the wage component of the social partnership agreements to increase flexibility in nominal wages.

I. Background and Key Issues

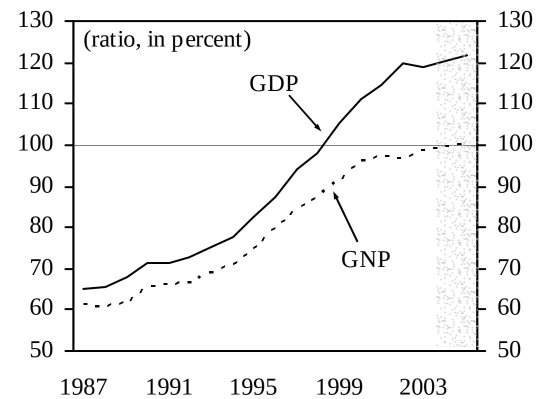
1. **Ireland experienced a remarkable economic boom in the 1990s.** Output growth averaged 10 percent a year in 1995–2000 and per capita income rapidly caught up with the EU average. A salient feature of this "Celtic Tiger" era was large increases in the proportion of the population at work (Figure 1). This reflected both favorable demographic trends that increased participation rates and a dramatic decline in unemployment, which fell from a 16 percent rate in the early 1990s to less than 4 percent by the end of 2000. Employment growth was facilitated by successive social pacts that contributed to wage moderation. Fiscal consolidation during this period, which reduced the public debt from over 100 percent of GDP in 1988 to 36 percent by 2001, provided an important impetus to growth. Rapid revenue growth combined with prudent public spending created the scope for cutting taxes, with reductions in income tax facilitating agreements on wage moderation, while low corporate tax rates encouraged foreign investment. Membership of the EU provided structural funds for infrastructure investment while EMU lowered interest rates and encouraged FDI, particularly from the US, with local operations providing access to a large market. The global ICT boom further boosted FDI, while the depreciation of the euro following its inception aided competitiveness. The latter part of the boom was associated with sharp increases in inflation and property prices, raising concerns about a hard landing and financial system soundness.

Real GNP Growth



Sources: CSO, staff estimates.

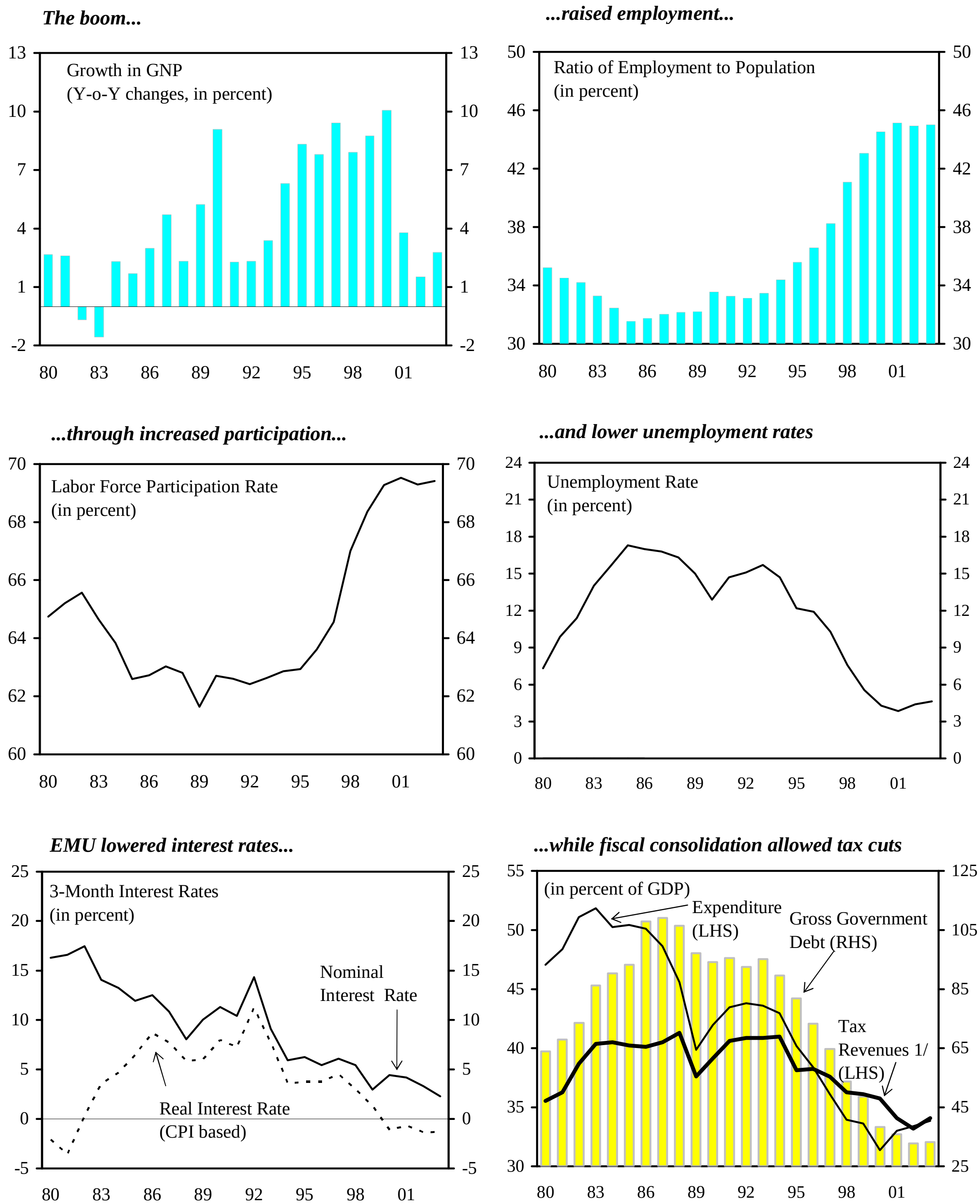
Per Capita Output in Ireland versus the EU



Source: AMECO.

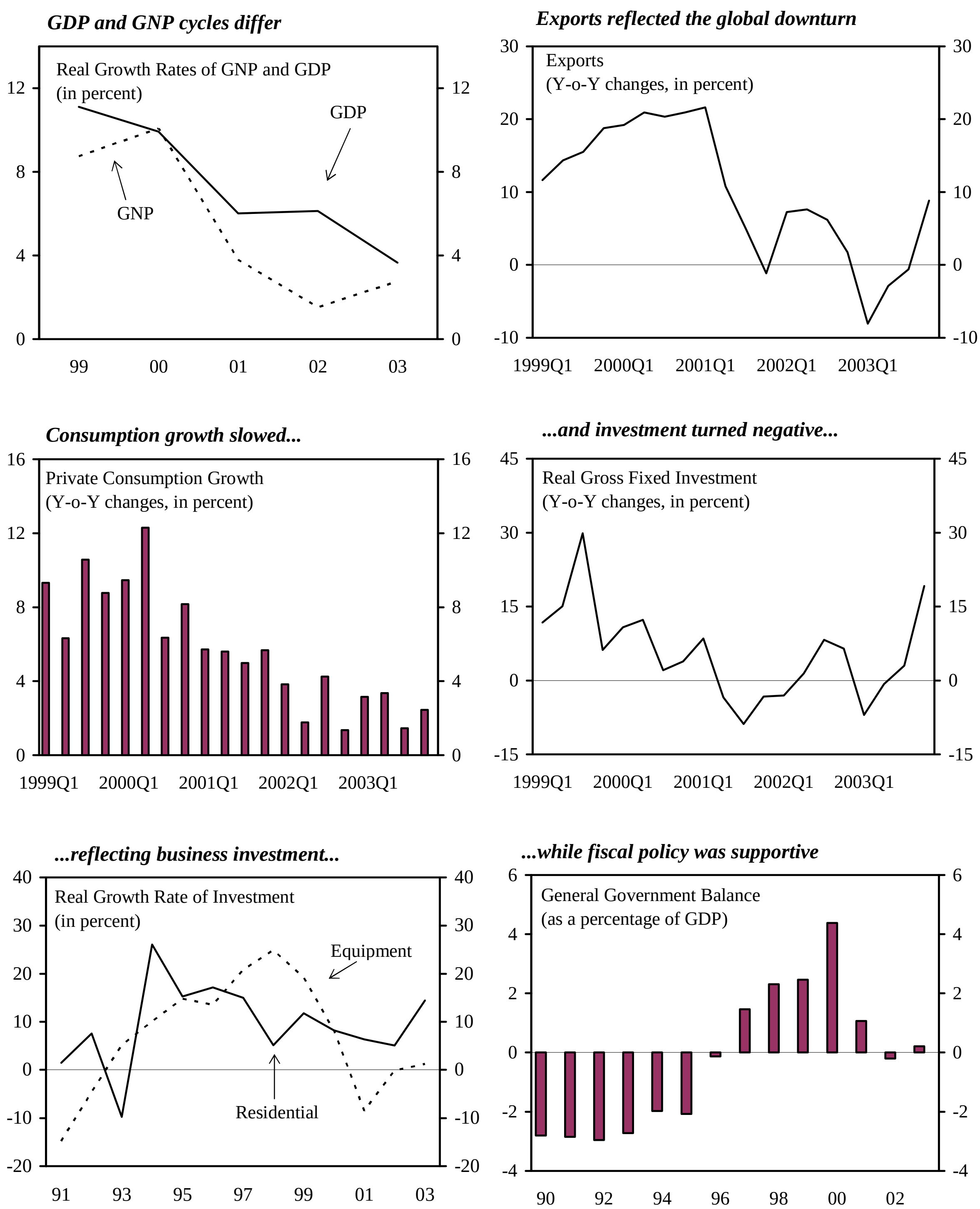
2. **In the event, following the global downturn, growth slowed sharply in mid-2001.** The substantial contribution of multinationals to Irish output and associated profit flows creates significant differences between measures of output, and the recent cycles in GDP and GNP have not been synchronized (Figure 2). When measured by GNP, which excludes payments to foreign factors of production and better reflects domestic economic activity, growth decelerated from around 10 percent in 2000 to 1½ percent in 2002. Household consumption growth slowed, while business investment collapsed in the aftermath of the

Figure 1. Ireland: The Boom.



Sources: AMECO, Central Statistics Office, MBTS, OECD, and staff estimates.
1/ Tax revenues including Social Security Contributions and Capital Taxes.

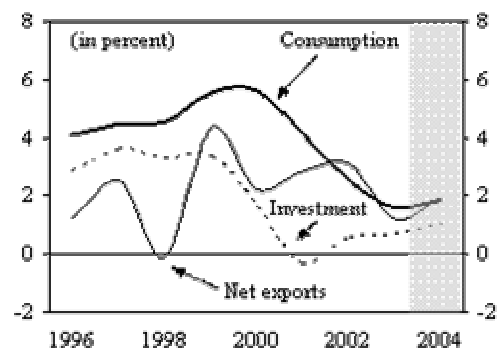
Figure 2. Ireland: The Slowdown.



Source: Central Statistics Office.

bursting of the global ICT bubble but residential investment remained robust. The labor market was relatively resilient to the slowdown (Figure 3). Cushioned by slower increases in labor force participation rates, increases in public sector employment and in part-time work, unemployment gradually inched up from a low of 3.7 percent in January 2001 to 4.8 percent by July 2003. Domestic demand was supported by the ECB's easing of monetary policy and an expansionary fiscal policy. Even as export growth decelerated sharply in 2001–02, net exports remained a significant positive contributor to growth as import growth, especially of capital goods, fell more.

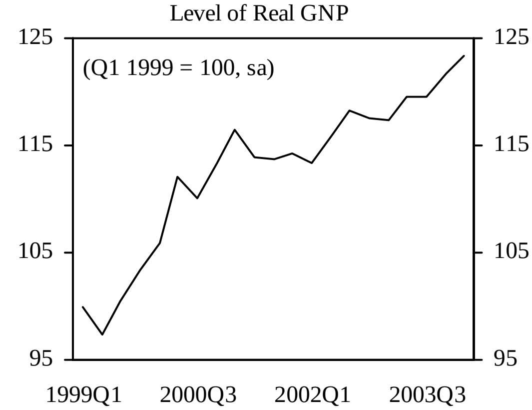
Contributions to Growth



Sources: CSO, staff estimates.

3. **In sync with the global upturn, growth picked up in 2003.** In line with the global recovery in manufacturing, industrial production rose steadily over the year, while rising new export orders saw the PMI rebound strongly in the second half (Figure 4). Private consumption was supported by a recovery in consumer confidence from its trough in the summer and a gradual inching down of unemployment. The drop off in nonresidential investment slowed through the year while residential investment accelerated sharply. Overall GNP growth was 2.8 percent in 2003.

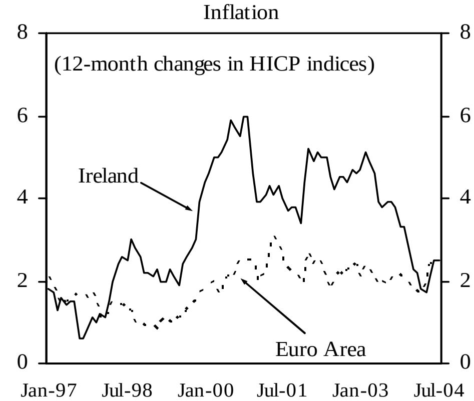
Level of Real GNP



Source: CSO.

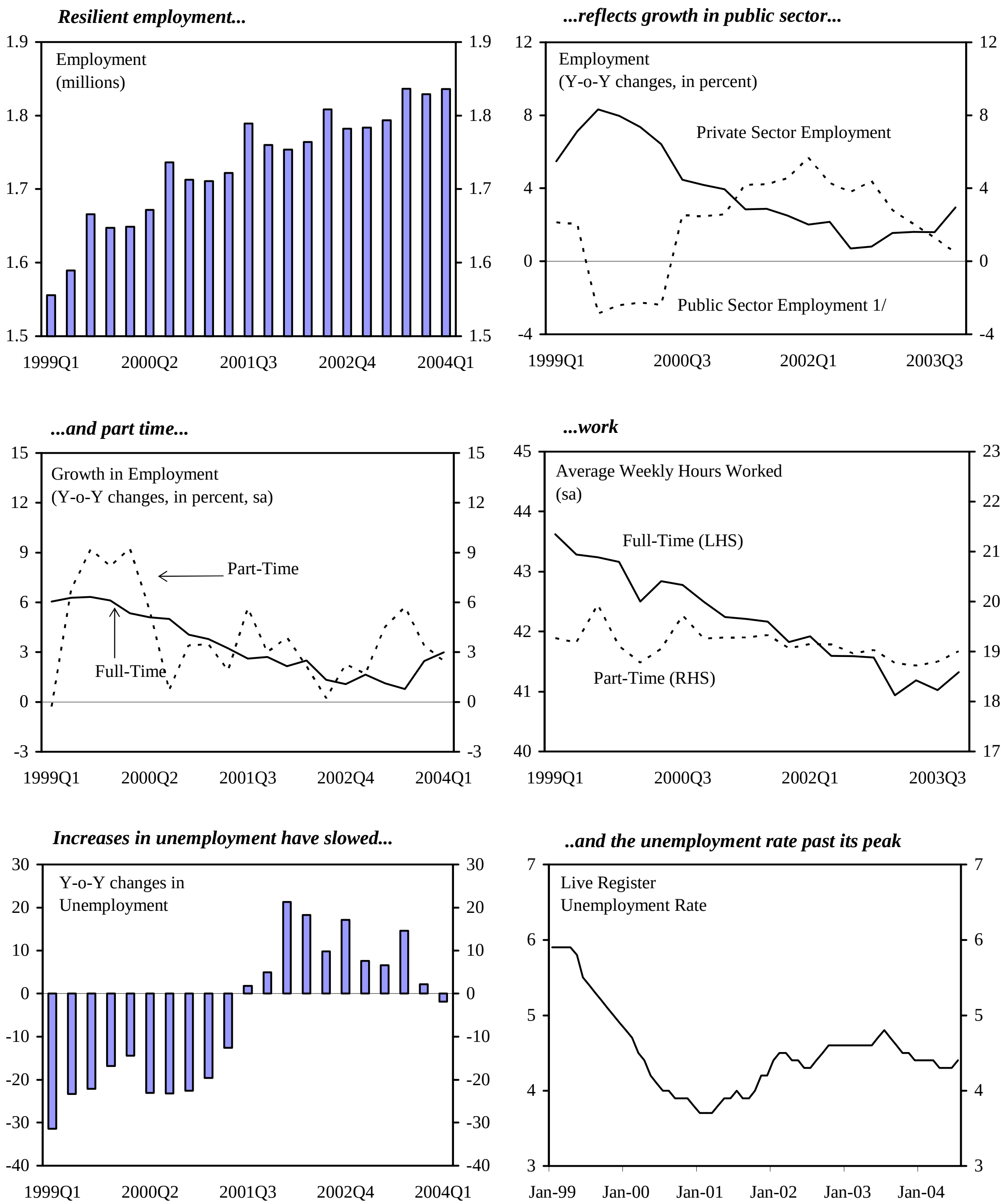
4. **With a lag, consumer price and wage inflation eased but house price inflation rekindled.** Having substantially exceeded the euro area average since 1998, consumer price inflation decelerated sharply during the course of 2003 (Figure 5). As the lagged effects of easing resource pressures and especially the appreciation of the euro (Figure 6) fed through, HICP inflation fell from around 5 percent in February 2003 to 1¾ percent in April this year, below the euro area average, before picking up to 2½ percent most recently reflecting higher oil prices. Wage growth also eased, falling from an average of around 9 percent in 2001 to some 5 percent in 2003. Following a significant slowing in late 2001, the rate of house price increases rose to around 15 percent in 2003 and is running just below this presently (Figure 7).

Inflation



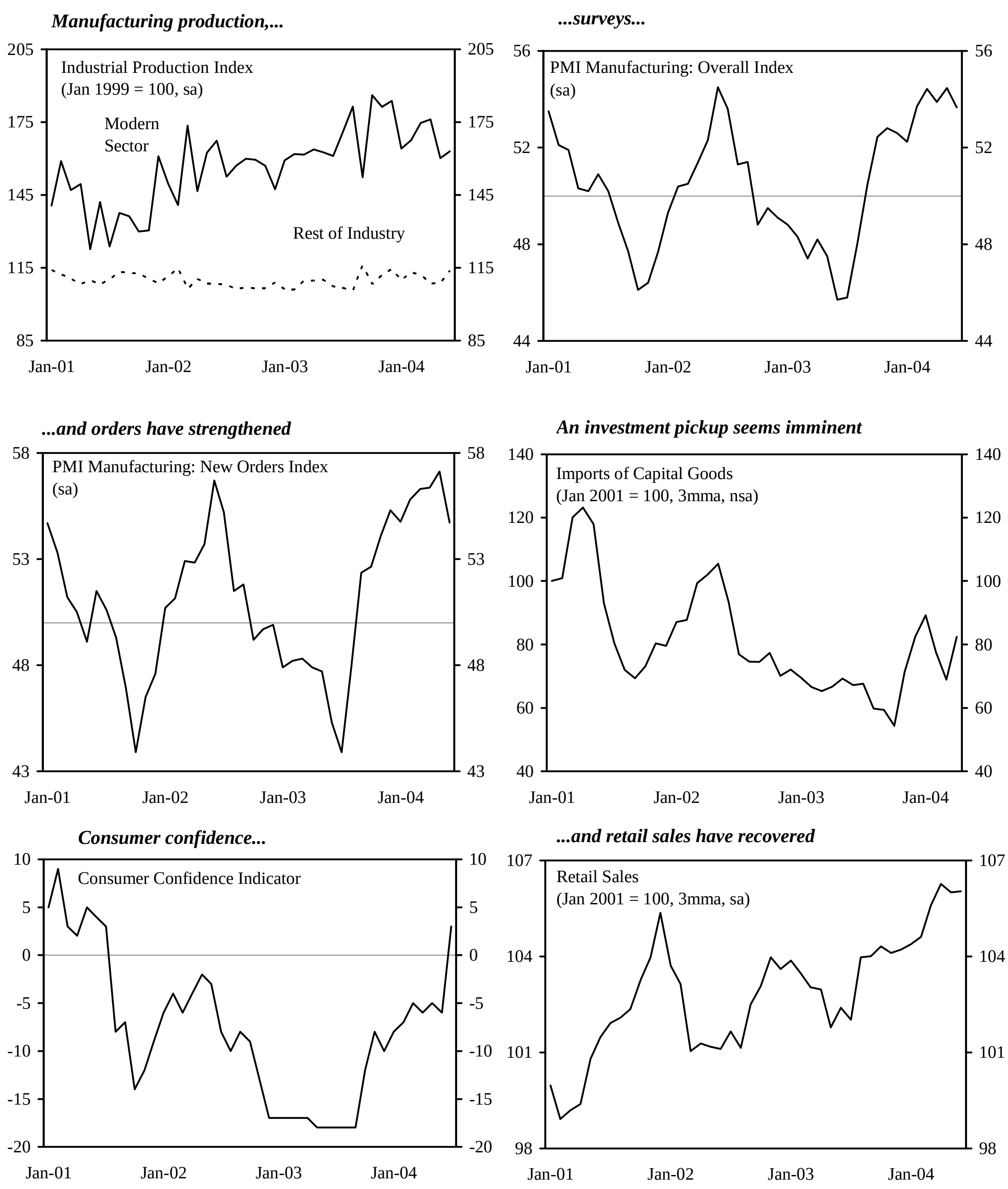
Source: EuroStat.

Figure 3. Ireland: The Labor Market has been resilient.



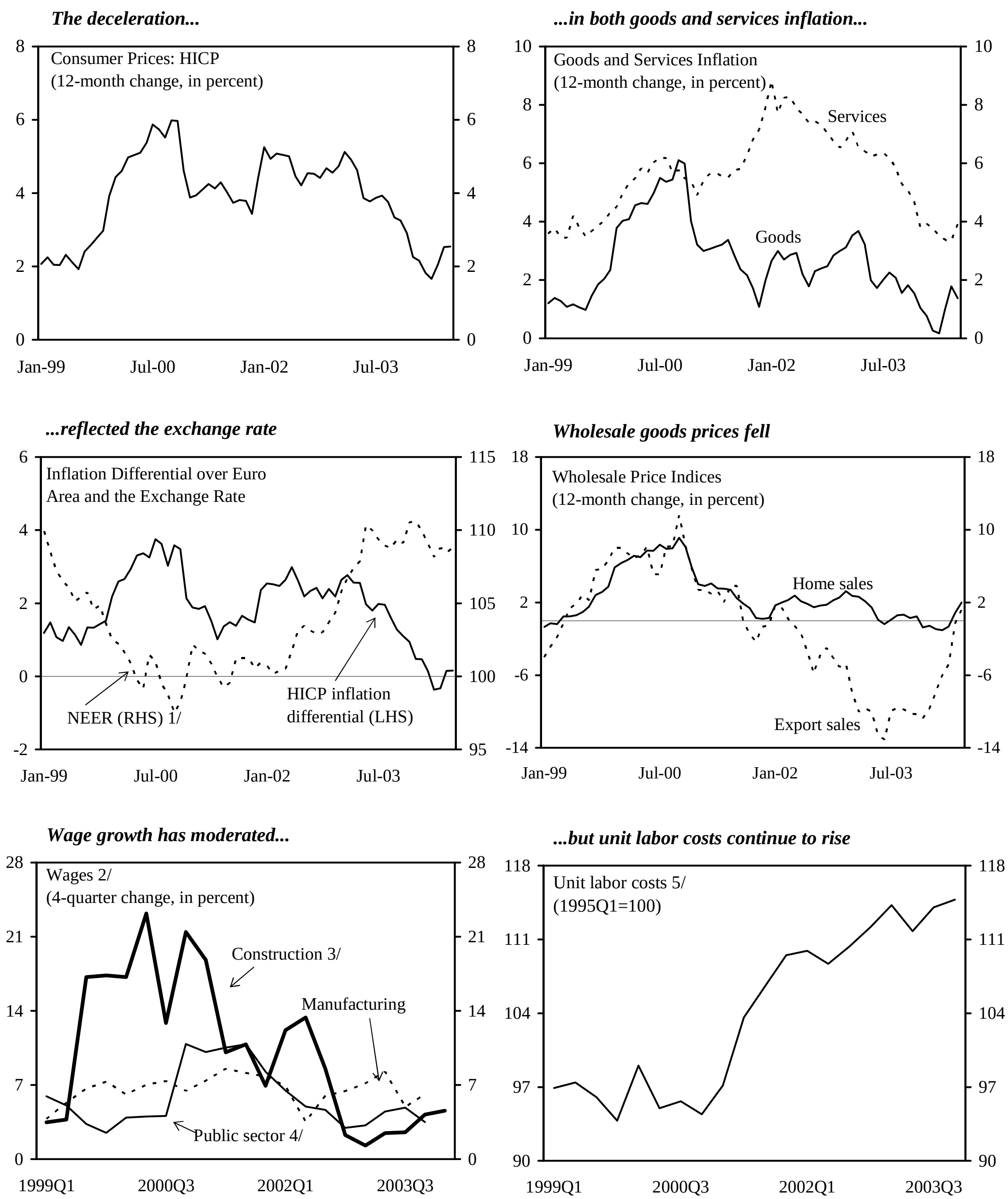
Source: Central Statistics Office.
1/ Excluding health.

Figure 4. Ireland: Signs of Recovery.



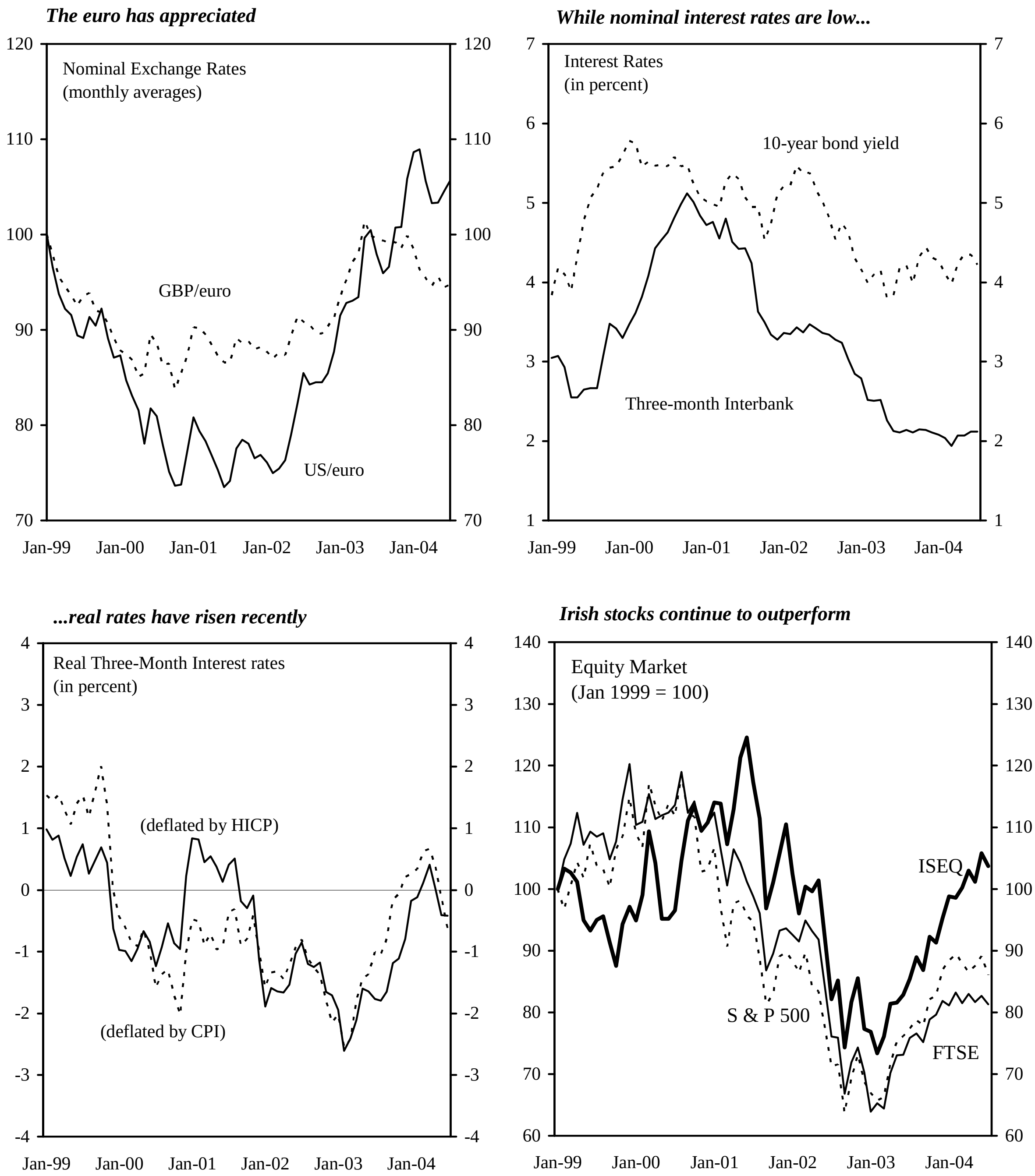
Sources: Central Statistics Office, EuroStat, and NCB Stockbrokers Limited.

Figure 5. Ireland: Inflation has fallen



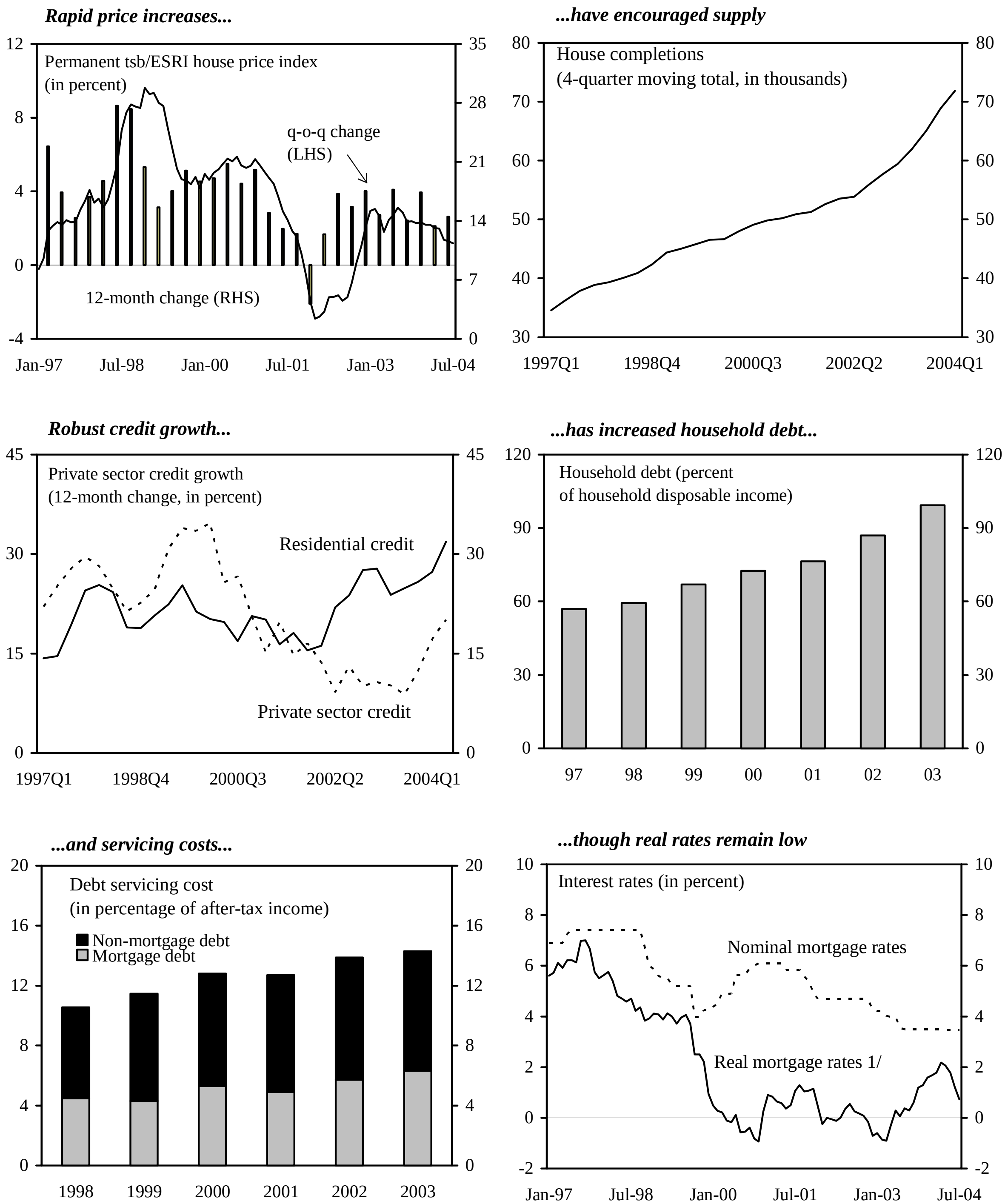
Sources: Central Statistics Office, Eurostat, IFS, and staff estimates.
1/ Nominal effective exchange rate based on ULC.
2/ Average weekly earnings, seasonally adjusted.
3/ Building and construction (unskilled)
4/ Public sector excluding health.
5/ Unit labor cost in manufacturing weighted by employment shares in subsectors.

Figure 6. Ireland: Exchange and Interest Rates



Source: Bloomberg, DataStream, MBTS.

Figure 7. Ireland: Housing is booming



Sources: Central Bank and Financial Services Authority of Ireland, Central Statistics Office, Davy Stockbrokers, the Department of the Environment, Heritage and Local Government, OECD, and Permanent tsb.
1/ Nominal mortgage rates deflated by the CPI.

5. **Ireland has generally responded appropriately to policy challenges identified in previous Article IV consultations.** Fiscal policies were expansionary in 2000–02, contrary to Fund advice. However, beginning with the 2003 Budget, the authorities took steps consistent with Fund advice towards consolidating the public finances and the 2004 Budget has held the line. Furthermore, no new temporary fiscal initiatives have been introduced that attempt to fine tune the housing market. In contrast to its predecessors, the present social partnership agreement signed in spring 2003 offered no fiscal concessions, a step in line with the Fund's recommendation. The latest agreement on wage increases presents a considerable degree of wage moderation relative to the past. Financial supervision has and continues to be strengthened along the lines recommended in the 2000 FSAP. Progress in improving public expenditure efficiency, controlling public sector wages, and increasing domestic competition has been more limited.

6. **The relative resilience of activity during the global downturn and the abatement of inflationary pressures suggest a remarkably soft landing from the boom but there are significant challenges and risks in managing the transition to slower growth.** With many of the factors accounting for the boom such as the increased employment rate and productivity catch up being one-off by nature, medium-term growth prospects are decidedly lower than in the Celtic Tiger era. Indications are that competitiveness has deteriorated significantly and there are risks from further euro appreciation, while house price increases continue at a rapid pace and there are risks of an abrupt unwinding. There remain large infrastructure needs and a strong demand for higher quality public services. Against this background, this year's discussions focused on:

- What are sustainable medium-term growth rates?
- To what extent have expectations in product, labor, housing markets, and fiscal policy adjusted to slower growth? Are the risks being factored in?
- Avoiding a procyclical easing of fiscal policy and achieving value-for-money in public expenditures.

II. Report on the Discussions

A. The Outlook: Recovery to Lower Potential Rates

7. **In the near term, the shared prospect is for the recovery to strengthen and become more broad-based.** Staff's baseline forecast sees GNP growth picking up to 4½ percent in 2004, with a slightly higher increase in GDP (Table 1). External demand continues to improve though the euro's appreciation last year will be a restraining influence. With consumer confidence recovering, household spending will rise along with disposable incomes and employment. The recovery in equipment investment is expected to strengthen, while residential investment could well exceed last year's vigorous pace. At the time of the mission, the authorities agreed with the qualitative characterization of improved growth

prospects, and the Department of Finance's recent update of prospects for 2004 is largely in line with staff's forecasts.

8. **There is broad agreement on the overall prospects for 2005.** Staff forecasts GNP growth to rise to 5 percent in 2005 and the authorities acknowledged that their latest official projections of around 4 percent, made at the time of the budget in December 2003, would need to be revised. The outlook reflects the balance of countervailing forces. The widely held expectation is that residential investment should at least decelerate from its extraordinary pace. External demand is projected to also slow as excess capacity in the world economy gets utilized and growth falls to trend rates. Household spending will be supported by increasing incomes and a tightening labor market but a key issue is the extent to which consumption will be restrained by higher debt-servicing costs as interest rates begin to normalize, with the staff emphasizing the implications of the rapid run up in household debt levels. Equipment investment is expected to rebound strongly from substantially depressed levels.

9. **The shared outlook is for inflation to remain moderate.** Barring major exchange rate changes, staff sees underlying or "core" inflation remaining in the vicinity of 2 percent on a HICP basis, though headline rates will be buffeted by oil prices, while the authorities saw a somewhat higher average rate. From a cyclical viewpoint, staff estimates that the build up of slack during the slowdown was limited and is dissipated under the baseline by next year with little implication for inflation. While sharing the assessment of slack as being limited, the authorities saw faster prospective tightening in the labor market and saw greater potential for wage inflation picking up. From a secular viewpoint, there was agreement that the "catch up" of the Irish price level to other developed countries appears complete and should not be a factor.

10. **While the risks to the near-term growth outlook are broadly balanced, further out the staff sees the risks as being on the downside.** In the near term, downside risks to external demand from the euro area are offset by upside risks elsewhere, particularly the UK. Looking ahead, significant further euro appreciation in response to global imbalances presents an important downside risk. Staff emphasized and the authorities acknowledged the risks to growth from the potential unwinding of the spectacular booms in house prices and construction (see Section II. C below). On inflation, the slow adjustment of expectations to lower productivity growth and inflation prospects and the potential feed-through of oil price increases to wages and services inflation tilts the risks to the upside.

11. **There is strong agreement that medium-term growth prospects are decidedly lower than they were in the second half of the 1990s.** Many of the factors that accounted for the 1990s boom are best thought of as raising the level rather than the growth rate of output. Using a growth accounting framework that embodies a tapering off in productivity catch up and labor force participation rates, staff estimates medium-term potential GNP growth to be at the mid-

Output per hour (US = 100)

	GDP per hour		Working hours per person	
	1970	2000	1970	2000
USA	100.0	100.0	100.0	100.0
Ireland	39.2	97.7	116.2	90.5
Ireland (GNP)	39.9	84.2	...	...
UK	58.7	80.3	103.5	88.0
EU-15	64.8	90.7	101.0	85.6

Source: EU Commission Sapir Report (2003) p. 23.

point of the typically cited range of 4–5 percent.[1] Such rates are less than half the average experienced in 1995–2000. There was agreement that potential growth in Ireland is endogenous to a greater degree than in other advanced countries in that capital accumulation is affected importantly by FDI and, therefore, competitiveness, while increases in labor supply depend on migration flows and increasing participation rates, both of which have proved responsive to market conditions. In the budget and official projections, the authorities work with estimates of potential growth obtained from the methodology agreed between EU countries and the European Commission. This methodology currently yields estimates of current potential growth that are significantly above the 4–5 percent range reflecting the weight given by the filtering techniques employed to the boom period. The authorities did not disagree with staff views that the methodology likely overstated potential growth over the medium term and they noted that conditions in the labor market suggested that there was only limited slack in the economy presently.

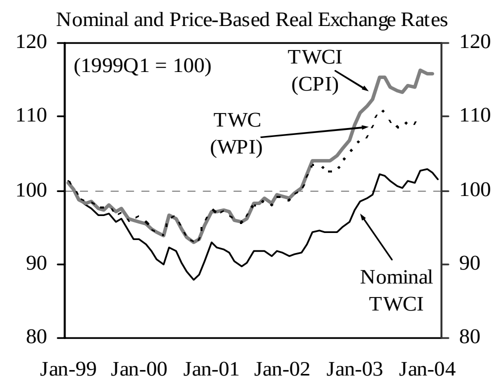
Potential Growth Rates in Stability Programmes

	2000	2001	2002	2003	2004	2005	2006
SP 2001	7.7	7.4	7.1	6.8	6.5	-	-
SP 2002	-	7.5	7	6.5	6.3	5.8	-
SP 2003	-	-	7.0	6.3	5.9	5.6	5.2

Source: Department of Finance.

B. Competitiveness and Incomes Policy Requirements

12. **The rapid reduction and convergence of inflation is encouraging, but concerns about the erosion of competitiveness have grown.** On a number of measures, competitiveness has eroded significantly. With the strengthening of the euro during 2002–03, the nominal effective exchange rate has now essentially reverted to its level during the relatively stable 1995–98 period. However, with inflation rates persistently in excess of those in partner countries for six years, Ireland's price level has risen well above those in its main trading partners and the consumer-price-based real exchange rate now stands some 15 percent above its level during 1995–98.

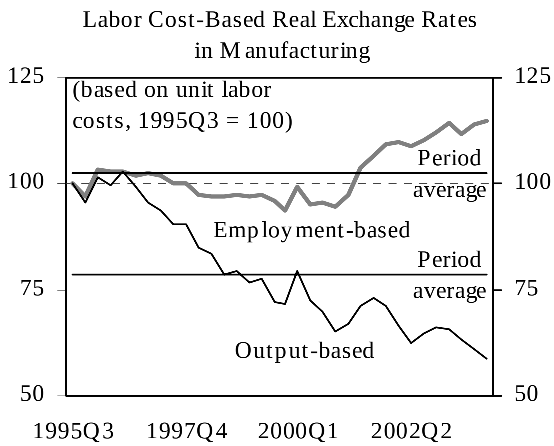


Source: Central Bank of Ireland.

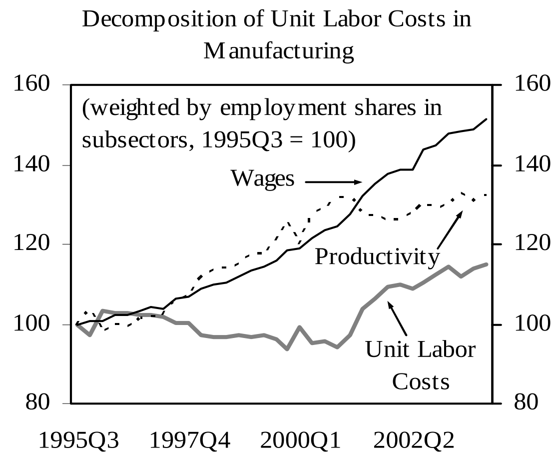
13. **Staff estimates a deterioration in the competitiveness of the manufacturing sector of a similar order.** The traditional output-weighted real exchange rate for manufacturing suggests only a pause in the rate of trend real depreciation, but this measure is not representative of broad competitiveness developments in the sector. As is now widely recognized, aggregate manufacturing measures for Ireland are distorted by the presence of a handful of sectors dominated by multinationals with limited employment whose gains in productivity often represent returns from intangible foreign inputs into production such as

[1] See *Selected Issues* paper "Potential Growth After the Boom".

returns on past R&D, patents and advertising campaigns abroad.[2] In contrast, the more relevant employment-weighted real exchange rate index for manufacturing has appreciated by some 15 percent over 1995–98 levels. This deterioration has reflected entirely increases in wages in excess of those in productivity since the slowdown began in 2001.



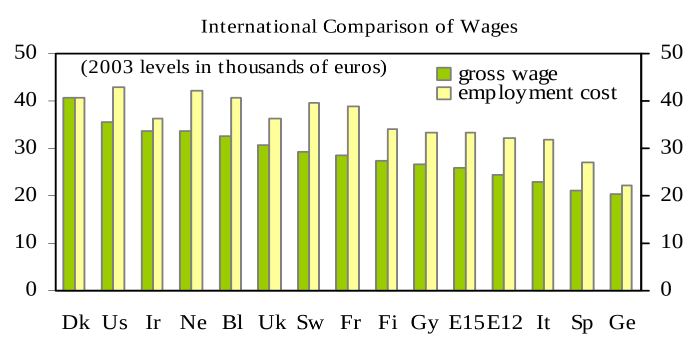
Sources: CSO, staff estimates.



Sources: CSO, staff estimates.

14. **Encouraging recent export and FDI performance has allayed concerns in some quarters about the losses in competitiveness, but staff and the authorities agreed that risks remain.** First, the authorities indicated that the muted effects of declines in competitiveness in part reflect a willingness on the part of firms to temporarily absorb declines in profit margins and a lagged adverse response of output and employment could be forthcoming. Second, erosions in competitiveness increase the speed with which the composition of FDI flows needs to move to higher value added activities. Here a proactive industrial policy has been effective in facilitating such a shift but the necessary upgrading of skills will have to keep pace. The loss of indigenous industries also increases the reliance on the modern and inherently more mobile high-technology sector. Third, high rates of services inflation may deter labor supply as suggested by the recent slowdown in female labor force participation rates as childcare costs rose. Finally, there is anecdotal evidence of high relative house prices deterring inward migration.

15. **The increase negotiated in the recent wage agreement is moderate.** The wage increase recently negotiated in the second phase of the Sustaining Progress agreement, which forms a benchmark for wage expectations and negotiations in the economy of 5½ percent over 18 months (averaging 3⅔ percent a year) is in



Source: European Commission.

[2] See *Selected Issues* paper "The Competitiveness of Irish Manufacturing: An Update".

line with lower prospective core inflation and productivity developments. There was agreement that with wages in Ireland now amongst the highest in the world, there is a strong case for these agreements not to be exceeded as they often have been in the past.

16. **The three-year national wage agreements have served Ireland well but the tradeoff between greater wage flexibility and the costs of renegotiation is likely to shift.**[3] The recent trend of not relying on granting fiscal concessions within the social partnership to facilitate agreement has been welcome and there is agreement that both the scope for offering further concessions and their potential benefits were now limited. The present three-year agreement is the first to have broken up the wage negotiations into two sub-periods. This change was agreed by the social partners at the time on the grounds of the prevailing economic uncertainty following the Iraq conflict. Staff argued for its maintenance going forward on the grounds of the benefits of greater flexibility in wages in the face of a limited potential for persistent upside surprises in growth than had been the case in the late 1990s. While recognizing the importance of increasing wage flexibility within the social partnership framework, the authorities noted the significant logistical and practical difficulties associated with more frequent negotiations, and the heavy burden this would place on the social partnership process.

17. **Competitive and flexible markets are critical to sustaining high levels of macroeconomic performance.** Ireland compares well with other countries on indicators of labor market regulation, regulatory burden, levels of bureaucracy, and the administrative burden for start-up firms, but ranks poorly on competition legislation and the intensity of local competition. Improving competition in the non-traded sector, both public and private, is essential for containing the growth of input costs into the traded sector and maintaining external competitiveness. The authorities indicated a number of steps that continue to be taken in this direction. Specifically, two of the reviews of restrictive practices in the professions have been completed and the governing bodies have agreed to the removal of the major restrictions identified. However, the staff noted

Indicators of Regulation and Competition

	Regulation Indicators				Competition Indicators	
	Labour Market	Burden of regulation	Levels of bureaucracy	Administrative burden for start-up firms	Intensity of local competition	Competition legislation
Ireland	**4**	**2**	**6**	**6**	**13**	**10**
Denmark	2	8	2	8	13	2
Finland	6	1	1	1	9	1
France	15	13	13	16	15	9
Germany	16	14	15	11	2	3
Hungary	3	5	9	5	11	15
Italy	11	16	14	15	12	12
Japan	8	14	12	12	4	11
Korea	14	9	11	8	5	13
Netherlands	9	11	7	7	5	5
New Zealand	7	7	5	3	5	4
Poland	13	12	16	14	15	16
Spain	10	5	8	12	9	14
Sweden	12	10	3	8	5	7
UK	5	3	10	3	2	8
US	1	4	4	1	1	6

Source: Annual Competitiveness Report 2003, National Competitiveness Council, Dublin, Ireland.
Note: The lower the rank the lower the burden of regulation and the more competitive the business environment.

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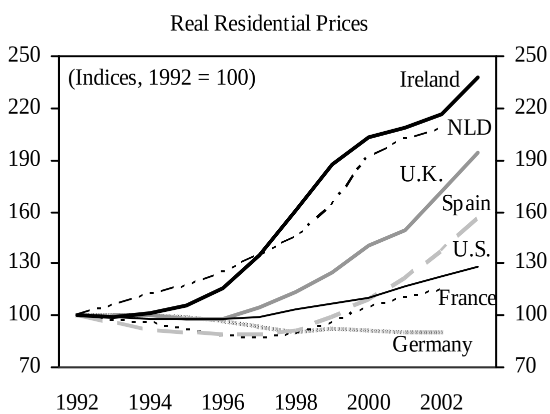
[3] See *Selected Issues* paper "The Role of Social Partnership Agreements in Ireland".

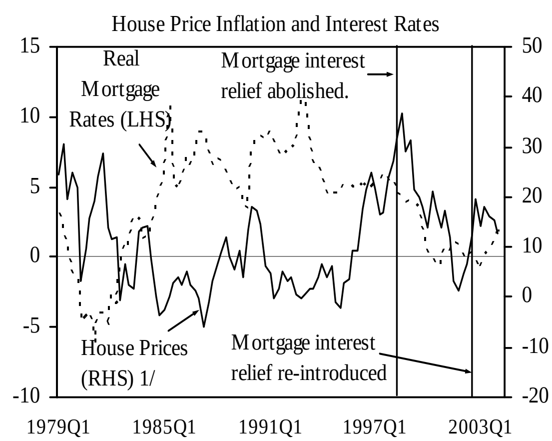
that progress on the reviews of the remaining six professions has been slow and that steps toward improving efficiency in public transportation have been met with resistance by public sector unions. Overall, results appear to have been limited and the scope for hastening progress in these areas seems considerable.

C. Continued Ebullience in the Housing Market

18. **Rapidly rising property prices in the face of slow growth have been a feature in many countries recently, but the extent, scale and duration of the boom in Ireland set it apart.** There is agreement that there are many fundamental reasons for why the boom in Ireland should have been bigger: the enormous increases in disposable incomes and employment during the Celtic Tiger era, demographic factors, the change in direction of migration flows, lower and less volatile interest rates following EMU, and financial liberalization and innovation that increased the supply of lending. In addition, the authorities emphasized the strong preference in Ireland for owning property as a factor. The dynamics of house prices have also been affected by tax changes, such as the re-introduction of interest tax deductibility for residential investment mortgages in the 2002 budget. Accompanying the house price boom have been record increases in mortgage credit, which reached a pace of 27 percent recently and household debt has risen to 100 percent of after-tax income, up from 60 percent in 1998. On the supply side, an enormous response has been forthcoming. Last year, some 69 thousand new homes were built, representing 17 new houses per thousand of the population, as compared to 6 in the US, less than 5 in Europe, and less than 3 in the UK.



Sources: BIS, staff estimates.

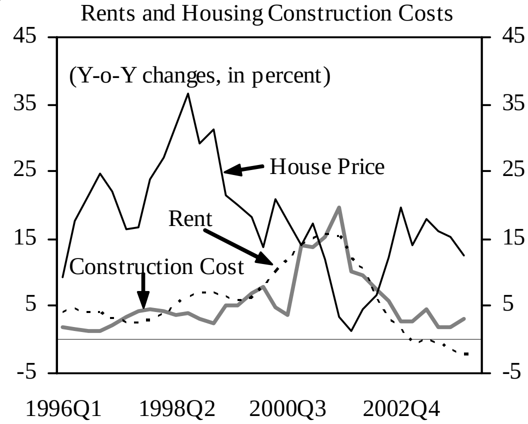


Sources: CSO, The Department of the Environment, Heritage and Local Government.
1/ Second-hand house prices, 12-month changes, in percent.

19. **The question remains whether the house price increases to date have outstripped developments in fundamentals.** During last year's consultation, the staff presented empirical evidence suggesting price increases had exceeded those that would have been suggested by developments in traditional demand-side factors (disposable incomes,

demographics and interest rates).[4] The authorities noted that a number of observers have since argued that adding supply-side factors, measured in particular by the price of building land, building costs and the availability of mortgage loans, sufficiently explain house price developments.[5] The staff, while sympathetic to the inclusion of supply-side elements, views the price of land, building costs and the expansion in mortgage lending as largely endogenous to the real estate cycle. The authorities also pointed to relatively low household headship rates (or inversely, relatively large family sizes) in Ireland compared to other EU countries and the implication for house price increases in anticipation of future demand as these rates rise over time. While accepting that it could be debated, in the staff's view there are elements of exuberance in price developments beyond those suggested by fundamentals, particularly in light of the massive increases in supply seen recently. This view is reinforced by a variety of other indicators: some 40 percent of new houses are being purchased as second or buy-to-let properties;[6] buy-to-let transactions account for 20 percent of all new mortgages; and building has accelerated despite rents and the rental yield on new construction falling sharply.

Rents and Housing Construction Costs



Sources: The Department of the Environment, Heritage and Local Government, and Euro Stat.

20. **There is greater agreement that recent rates of price increase are running above sustainable rates dictated by medium-term growth prospects and the longer they fail to moderate the greater the vulnerability to a possibly disorderly correction.** The staff argued that because real estate represents an asset price whose valuation depends not only on current but also on future demand and supply conditions, future income growth is an appropriate benchmark against which to gauge the sustainability of price developments.[7] Recent rates of house price increase of 12–15 percent are out of line with medium-term income-growth prospects of 4–5 percent in real, and 6–7 percent in nominal terms. There was agreement that the predominance of mortgages at variable rates and significantly increased household debt levels made the housing market in Ireland vulnerable to sharp increases in

[4] See "Can Fundamentals Explain the Growth of House Prices in Ireland?" in Country Report 03/242.

[5] See "Will there be a crash in Irish house prices?", Maurice Roche, ESRI, Winter 2003, and "A Model of the Irish Housing Sector" by Kieran McQuinn, Research Technical Paper, CBFSA, April 2004.

[6] See "Where have all the houses gone?", Davy Stockbrokers, November 2003.

[7] See *Selected Issues* paper "Adjustment in the Housing Market".

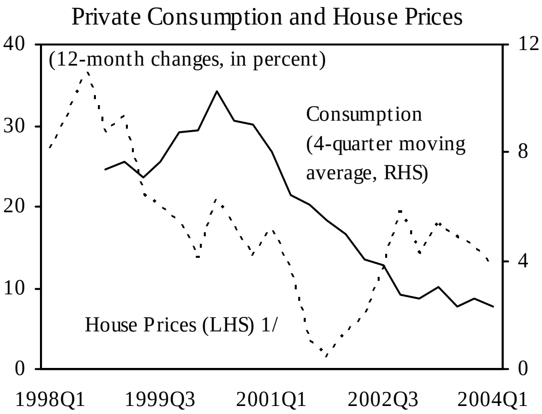
interest rates, though market expectations of the monetary policy tightening cycle in the euro area are for moderate and gradual increases.

21. **In the near term, public communication can play an important role in taming expectations and help induce a soft landing in the housing market but over the medium-term structural aspects of the housing market must be addressed.** The staff strongly supports the Central Bank's public expressions of concern regarding recent rates of house price increase and credit growth. Beyond the present conjuncture, the staff argued that policy needs to confront the basic issue that the oft-cited strong preference for home ownership and asset-of-choice for saving in Ireland is an argument against subsidizing housing as such incentives exacerbate price movements when ability-to-buy rises. There is thus a strong case for removing the interest-deductibility of mortgage payments on primary dwellings and for introducing a market-value-based wealth tax on property. Although second homes are not subsidized, they are not taxed either and, given the still scarce infrastructure being provided to these homes, there is a good argument that they should be. The authorities noted the political, likely insurmountable, difficulties of removing interest-deductibility of mortgages or introducing taxation on property given the electorate's long history of strong attachment to, and preference for owning, property.

22. **High profitability and capitalization levels have bolstered the capacity of the domestic banking system to withstand shocks without creating systemic stress.** Following rapid increases in lending, the property sector now represents about half of banks' loan books (residential mortgages 34 percent; commercial property 12 percent; and construction 4 percent). The authorities noted that the results of stress tests indicated that strong capitalization levels provided a significant cushion for absorbing sharp declines in property prices with simultaneous increases in unemployment and interest rates, a view shared by the rating agencies. The authorities and private banks also noted that low effective loan-to-value ratios meant that prices would have to fall considerably before negative equity considerations came into play and there is a strong culture of servicing mortgages in Ireland, as evidenced by the low (1 to 20 basis points) rates of bad or nonperforming mortgages despite the recent growth slowdown. Nearer term, the staff welcomed strengthened surveillance by the supervisory authority to ensure that sufficient account is taken of prudential concerns in banks' lending behavior. Staff argued that greater attention needs be paid to factoring in the effects of the normalization of interest rates from their present cyclical lows and efforts made to increase borrower awareness of the prospects for interest rates and their impact on debt servicing costs.

23. **A sharp correction in the housing market could have macroeconomic consequences, although financial stability is likely not a concern.** The authorities noted that while increases in house prices have undoubtedly increased the perceived wealth of homeowners, unlike in some other countries, mortgage equity withdrawals are not prevalent in Ireland. There has not been a strong identifiable relationship between aggregate consumption and house prices either, with the former following more closely developments in disposable income. Thus there is reason to doubt that a correction in house prices would directly slow consumption appreciably. The authorities acknowledged though that such a

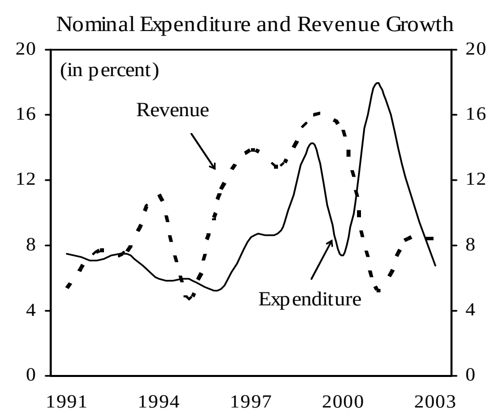
correction could harm consumer confidence. The authorities stressed that the more relevant channel for a potential impact was through unemployment with coincident large increases in interest rates being the scenario of greatest concern. With new house building representing some 12 percent of GNP last year as compared, for example, to 5 percent in the US and 3 percent in the UK, depending on the severity of the correction, the associated employment losses could have a macroeconomic dimension. A key question is the likely size and duration of the up-tick in unemployment. The authorities and other observers in Ireland noted they were encouraged by the flexibility in the labor market evident during the recent downturn which suggested that labor shed by the construction sector could be absorbed quickly elsewhere in the economy. The staff was more agnostic, noting that the construction boom had been ongoing prior to the slowdown and gathered momentum during the downturn spurred by lower interest rates and tax changes, while increases in public employment had also helped mitigate the effects on unemployment. It is not clear whether a significant autonomous increase in unemployment in the non-traded sector could be absorbed by the traded sector as easily since there was certainly no reason to expect a coincident upswing there and skill-matching would likely be an issue.



Sources: CSO, The Department of the Environment, Heritage and Local Government.
1/ Second-hand house prices.

D. Fiscal Policy: Avoiding Procyclical Pressures and Getting Value for Money

24. **Following two years of disappointing outcomes and larger-than-anticipated deficits, the 2003 Budget took measures to adjust to slower growth and halt the deterioration.** Nominal expenditure growth was lowered from clearly unsustainable rates of 18 percent and 12 percent in 2001 and 2002, respectively, to 7 percent in 2003, and indirect taxes were raised. In the event, the budget outturn surprised considerably on the upside, which the authorities attributed largely to factors unrelated to the economic cycle. Higher-than-expected receipts from changes in the capital-gains tax regime and from stamp duties reflecting the buoyancy of the property market yielded a nominal surplus of 0.2 percent of GDP, almost 1 percent of GDP better than budgeted.



25. **The 2004 Budget continued the pattern of holding expenditure growth down in line with lower revenue and economic growth but revenue outturns so far have again exceeded expectations.** The budget, framed before the final outturn for 2003 was available, envisaged a small improvement in the cyclically-adjusted balance of about ¼ percent of GDP and a nominal deficit of 1.1 percent of GDP. The authorities attribute the well-above-expected revenue performance so far this year to one-off successes with anti-fraud measures as well as the continued buoyancy of the property market. They believe both current and capital expenditures will continue to be broadly in line with the budget. These developments have prompted staff to revise its projections to a nominal fiscal deficit of ⅓ percent of GDP this year. Excluding one-off effects, the staff projects a structural or underlying deficit this year of about ½ percent of GDP (Table 5).

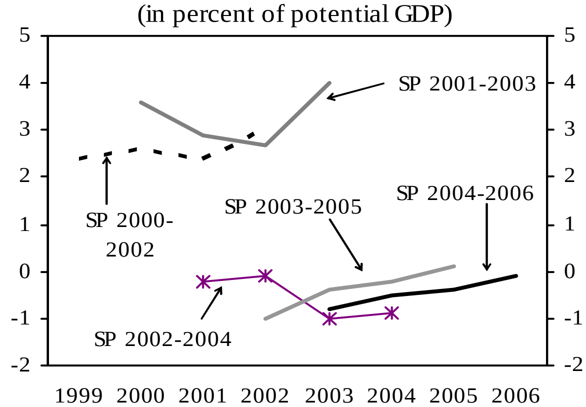
Projected and Actual Growth in Tax Receipts

Tax category	Jan-July 2004 Outturn (y-o-y)	2004 Budget (y-o-y)
Income	24.9	10.0
VAT	10.6	6.7
Corporate	-15.7	3.6
Excises	12.0	6.4
Stamp duties	17.8	-5.2

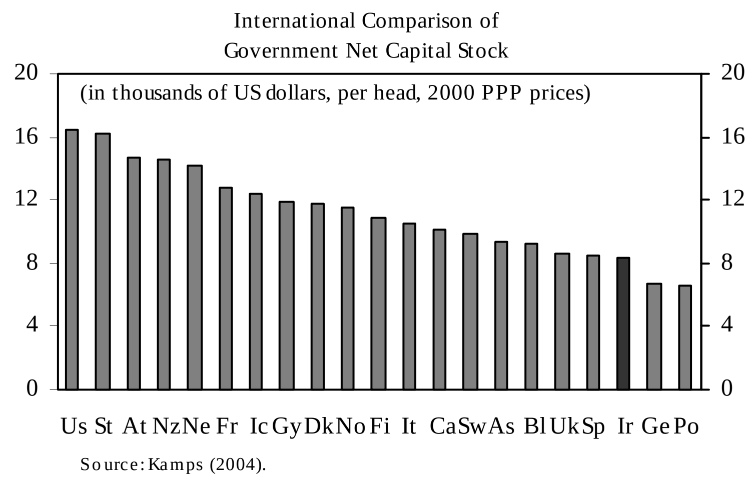
Source: Department of Finance; staff calculations.

26. **The staff argued that cyclical considerations presented a strong case for beginning the required modest longer-run fiscal tightening in the next budget.** The authorities emphasized their commitment to the SGP, including achieving a zero structural balance over the medium term, which the staff fully supports. The projected structural balances in the 2004 Stability Program are in line with commitments under the SGP and would maintain sufficient margin against the risk of breaching the 3 percent of GDP deficit limit. Given staff's estimate of this year's underlying deficit of ½ percent of GDP, a modest adjustment would be required over the next few years to reach this target. From a cyclical perspective, with growth picking up, little spare capacity in the economy and the possibility of a larger-than-expected slowing in the property market that could lower stamp duty and capital gains revenues significantly, the staff argued there was a strong case for beginning adjustment in the next budget. From a longer perspective, fiscal policy should be well placed to deal with the pressures from aging. The build-up of assets in the National Pension Reserve Fund (annual contribution of 1 percent of GNP) will help alleviate the budgetary cost of aging. Also, Ireland is in a comparatively good position to meet these costs given the high degree of pension funding and the relatively low tax burden.

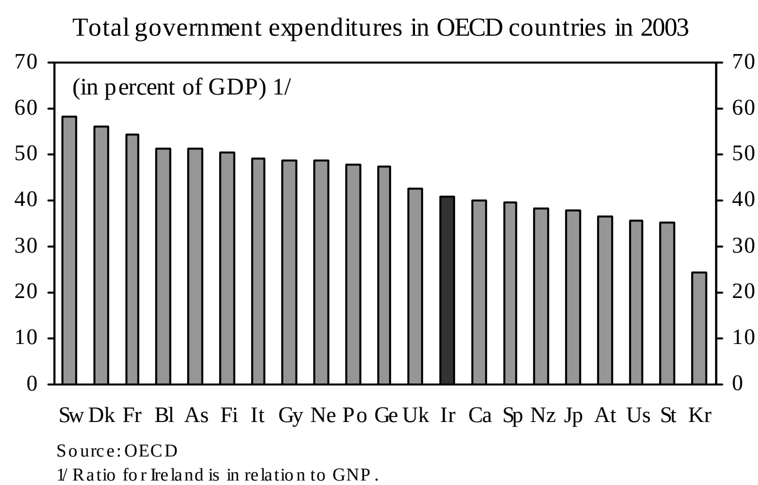
Cyclically-adjusted Fiscal Balances in Stability Programmes (SP) (in percent of potential GDP)



27. **But political pressures to reduce taxes or spend the recent improvements in the public finances are likely to grow, especially in the event of upside surprises to growth, and staff called for an overall multi-year spending framework.** There was agreement that any loosening of fiscal policy at this juncture would be procyclical, with deleterious effects on inflation, value for money in government expenditures and competitiveness. In line with the staff's calls in the past, the authorities extended the use of rolling multi-year spending envelopes from the transportation sector to all public capital spending in the last budget. Multi-year spending envelopes limit the potential for procyclical expenditure changes, increase the predictability and transparency of expenditure policy, improve planning and management of expenditures and thereby encourage efficiency. Staff urged that these be extended to encompass current spending. The authorities viewed the need for expectations to adjust completely to the lower medium-term growth prospects as a necessary precondition for adopting medium-term spending envelopes well-aligned to perspective resource growth.

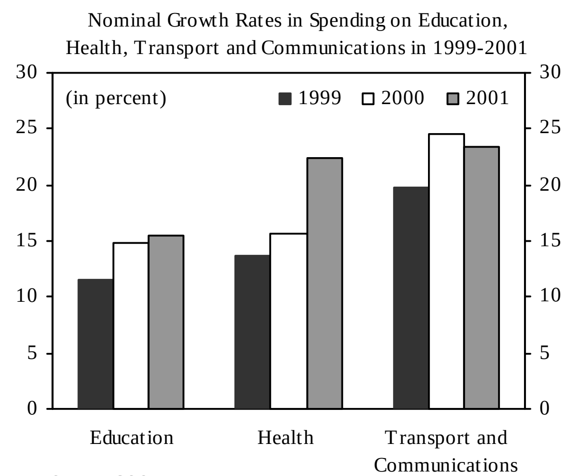


28. **The mission agreed with the authorities' view that meeting the demand for higher quality public services and infrastructure does *not* require higher taxes and spending.** The size of government is *not* small in comparison with other OECD countries when compared to GNP, the more relevant measure of domestic economic activity in Ireland. Lower tax rates in Ireland as compared to the EU reflect favorable demographics that require substantially lower social security taxes, prudent fiscal policies that have delivered lower debt and debt-servicing costs, smaller defense requirements and lower unemployment-related social spending. Government



capital spending, at the targeted 5 percent of GNP, is well above levels elsewhere. Faster increases risk running up against bottlenecks and serious inefficiencies, as in the late 1990s when spending exceeded this level, leading to double digit rates of associated price inflation.

29. **Providing higher quality public services requires improving the value for money in public expenditures.** Popular dissatisfaction with the quality of public services in health, education and infrastructure runs high despite double-digit rates of growth, suggesting significant expenditure inefficiencies or inadequate information on outputs. The authorities have taken a number of initiatives to improve the efficiency and control of expenditures, including monthly reviews of departmental expenditures, new guidelines to improve the management and appraisal of capital projects, and better contractual arrangements for construction projects that shift risks to contractors. The authorities noted the fundamental reform of administrative structures begun in the health sector which would foster accountability and rationalize service provision, and the program for the modernization of public service delivery. Staff argued for shifting the focus in public services delivery from inputs to outputs. In particular, an emphasis on quantified performance targets would motivate efficiency gains, while demonstrable improvements in the quality of public services will be necessary over time to reduce pressures for additional spending increases, arguing for better monitoring and measurement of public outputs.



Source: CSO

E. Other Issues

30. **Ireland's statistics are being improved to meet international requirements.** Staff welcomed the newly-introduced data on external debt and stressed the need to improve fiscal reporting at the general government level and to publish a national earnings index as well as sectoral balance sheets. The authorities are extending the scope and consistency of earnings data and compiling sectoral balance sheets, which should be completed by 2005.

31. **Ireland has been a strong supporter of trade liberalization in the context of the EU.** On the CAP, however, the authorities noted that having agreed to two reforms in preparation for the WTO they were unlikely to agree to further reforms. They noted that the priority is to ensure a balanced agreement in agriculture across the three pillars of domestic support, market access and export subsidies. They feel agriculture is one element of the negotiation of a new WTO round that should not be sacrificed as the price for an overall agreement.

32. **The authorities remain committed to reaching the UN target of 0.7 percent of GNP for official development assistance (ODA) by 2007**. As in 2003, ODA is budgeted at 0.4 percent of GNP in 2004.

III. Staff Appraisal

33. **In the face of substantial global shocks over the last few years, the economic performance of Ireland has been enviable.** Despite being one of the most open economies in the world, growth proved remarkably resilient to the global downturn. Contrary to concerns, flexibility in the labor market limited increases in unemployment. After running well above trading partner country rates for several years, aided by the euro's appreciation, inflation slowed rapidly, converging to euro area rates.

34. **The near-term prospect is for stronger and broader-based growth and for inflation to remain moderate.** Growth will be supported by external demand and a continued rebound in business investment but private consumption will be restrained by increases in debt servicing costs as interest rates begin to normalize and residential investment should slow from unusually high rates. Underlying or core inflation should remain in the vicinity of 2 percent though headline rates will be buffeted by oil prices. The potential for further euro appreciation in response to global imbalances and an abrupt unwinding of the housing boom represent key risks to the outlook.

35. **Medium-term growth prospects are markedly lower than experienced in the second half of the 1990s.** Many of the one-off factors that accounted for the 1990s boom have raised the level of output rather than imparted a lasting influence on growth prospects and staff forecasts medium-term growth of 4½ percent in GNP. Such rates remain amongst the highest in the world but are less than half the average experienced in 1995–2000.

36. **The key challenge for both the private and public sectors is managing the transition, in particular of expectations, to slower growth.** Indeed, the external downturn helped initiate a necessary adjustment of expectations and policies to lower growth. However, with medium-term growth prospects significantly lower and the economy not operating far from potential, it is important that these adjustments be viewed as required for longer-term structural reasons rather than as having been necessary for cyclical reasons only. From this vantage point, there are varying degrees of concern about the adjustments to date across sectors.

37. **Safeguarding competitiveness must be a key priority of economic policy and the social partnership.** In goods and labor markets, the deceleration of inflation indicates expectations have been adjusting but the lagged response means the level of competitiveness has deteriorated significantly. Wage and goods-price inflation rates persistently in excess of those in partner countries represented in part a warranted catch-up as incomes and productivity rose. This process has to, however, be near completion if it has not already overshot. Ireland's price level has risen well above that in its main trading partners and wages are now amongst the highest in the world. The wage increase negotiated recently by

the social partnership is in line with prospective core inflation and productivity developments. It does not, however, take into account past erosions in the level of competitiveness or the risks of further euro appreciation. An extended period of wage restraint is therefore warranted. The desirability of increased wage flexibility also provides a case for shortening the duration of national wage agreements from three years. The costs of more frequent negotiations can be reduced by separating wider social partnership issues from the wage negotiation process.

38. **At this conjuncture, public policy should aim to engineer a soft landing in the housing market, but over the medium-term reforms will need to improve the stability of the sector.** As house price increases continue to exceed reasonable prospects for medium-term growth, the Central Bank's communications to tame expectations in both the credit and housing markets are appropriate and welcome. In the event of an abrupt unwinding of the housing market boom, though financial stability is likely not a concern, there is a likelihood of a protracted slowdown in private consumption. With variable rate mortgages predominant and household debt levels having risen, more can and should be done to increase borrower and lender awareness of the prospects for interest rate increases from current cyclical lows and their implications for debt-servicing costs. The strong preference in Ireland for owning property is a compelling reason for *not* providing additional incentives in the form of subsidies to home ownership. Removing the interest-deductibility of mortgage payments on primary dwellings and introducing a market-value-based wealth tax on property is therefore important. Given still scarce infrastructure, second homes should be taxed at higher rates.

39. **Fiscal policy has adjusted well to slower medium-term growth prospects, but cyclical considerations argue for frontloading the remaining necessary longer-run consolidation.** The 2003 Budget began the process of adjusting to the new growth realities and the 2004 Budget has held the line, with planned expenditure growth within typical ranges of medium-term potential nominal GDP growth. The overall outturn for 2003 and early returns in 2004 have exceeded expectations, but this reflects in part windfall receipts from changes in the capital-gains tax regime and successes with anti-fraud measures, as well as higher-than-expected revenues from the buoyancy of the property market. Excluding these one-off effects, there is an underlying deficit in 2004 of ½ percent of GDP. With limited slack in the economy and growth picking up, the required adjustment to the medium-term objective of balance should begin in Budget 2005. Political pressures to spend the improvement in the public finances should be resisted as such an easing would be procyclical, raise inflation, hurt competitiveness, and limit the value for money from such expenditures.

40. **Concerns about the level and quality of public services and infrastructure in Ireland should be addressed by improving delivery rather than by raising taxes and expenditures.** At its present levels of 5 percent of GNP, government capital spending is well above levels elsewhere, and faster increases would risk running up against bottlenecks and inefficiencies. The introduction of multi-year spending envelopes for department's public capital spending is particularly welcome because it should safeguard such spending from procyclical pressures, improve planning and predictability, and encourage efficiency. There

is a strong case for extending such envelopes speedily to encompass current spending. The fundamental reforms begun in the health sector and the modernization of public service delivery hold promise. There should be a shift in focus across public services from inputs to outputs.

41. **Scope remains for improving the provision of statistics**. Ensuring the timeliness of general government accounts and developing a national earnings index should be priorities.

42. **The authorities should adopt a more supportive stance within the EU in favor of further CAP reform**, particularly in view of the adverse impact of this policy on developing countries and EU consumers. This would complement the welcome commitment towards achieving the UN's ODA target by 2007.

43. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Ireland: Selected Economic Indicators, 2000-05
(Annual change unless otherwise stated)

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
National accounts (constant prices) 1/						
GNP	10.1	3.8	1.5	2.8	4.5	5.0
GDP	9.9	6.0	6.1	3.7	4.7	5.0
Domestic demand	9.1	3.8	3.4	3.3	3.3	3.6
Private consumption	9.0	5.5	2.8	2.6	3.2	3.8
Public consumption	8.0	10.9	8.6	2.5	2.2	2.3
Gross fixed investment	7.3	-1.6	3.0	3.4	5.1	4.0
Net exports (contribution to GDP growth)	2.2	2.8	3.1	1.2	2.0	1.3
Exports of goods and services	20.4	8.4	5.7	-0.8	5.0	4.9
Imports of goods and services	21.3	6.7	3.3	-2.3	3.8	4.6
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	5.2	4.0	4.7	4.0	2.3	2.1
Average hourly earnings , manufacturing	6.2	10.3	8.5	5.5	...	...
Output, manufacturing 2/	15.7	10.2	8.4	6.4	...	...
Unit wage costs (manufacturing) 2/	-4.7	-2.6	-8.9	-4.8	...	...
GNP/Employment	5.0	0.6	-0.3	0.9	3.0	3.5
Employment	4.8	3.1	1.8	1.9	1.5	1.5
Unemployment rate (in percent)	4.3	3.9	4.4	4.7	4.4	4.1
Money and credit (end-period)						
M3 3/	14.7	17.2	9.3	9.6	8.3 6/	...
Private sector credit 4/	21.3	15.1	15.0	17.9	24.8 6/	...
Financial and asset markets (end-period)						
Three-month treasury bill	4.8	3.3	2.9	2.1	2.1 7/	...
10-year government bond	5.1	5.1	4.3	4.3	4.2 7/	...
ISEQ index	14.0	-0.3	-30.0	23.2	21.4 7/	...
House prices (permanent tsb index/ESRI)	21.3	4.4	13.3	13.8	11.3 7/	...
Public finance (In percent of GDP)						
General Government Balance 5/	4.4	1.1	-0.2	0.2	-0.3	-0.5
Primary balance 5/	6.4	2.6	1.2	1.6	1.1	0.8
General government debt	38.3	35.9	32.7	33.2	32.5	32.0
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	13.2	15.0	16.6	15.4	15.3	15.5
Current account (Percent of GDP)	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3
Official reserves (In billions of SDRs, end-period.)	4.1	4.5	4.0	2.8	1.6 6/	...
Effective exchange rates (1995=100, annual average)						
Nominal	88.3	89.2	90.7	96.7	96.7 6/	...
Real (CPI based)	91.0	94.4	98.9	106.8	106.5 6/	...
Memorandum items for 2003						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
Natural rate of increase (percent change)	1.9					
GDP per capita (in SDRs)	28,792					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and staff calculations.
1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.
3/ The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.
4/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.
5/ Estimated prior to allocations for financing of future pensions liabilities and one-off expenditures, but including contingency provision for 2005.
6/ As of June 2004
7/ As of July 2004

Table 2. Ireland: Summary of Balance of Payments, 2000-07

	2000	2001	2002	2003	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
				(In millions of euro)				
Current account balance	-379	-757	-1,617	-1,894	-2,250	-2,077	-2,026	-2,344
Trade balance	27,266	30,493	35,443	33,421	35,996	39,272	42,311	45,630
Exports of goods	79,971	86,690	89,495	79,186	83,671	90,330	96,169	102,391
Imports of goods	-52,705	-56,197	-54,052	-45,765	-47,674	-51,058	-53,857	-56,761
Services	-13,656	-13,151	-14,250	-12,643	-13,861	-15,094	-16,208	-17,856
Credit	20,749	26,952	30,206	33,573	34,095	34,720	35,649	36,192
Debit	-34,405	-40,103	-44,456	-46,216	-47,955	-49,814	-51,857	-54,048
of which Royalties								
Credit	701	207	262	147	...	...	...	...
Debit	-9,051	-10,578	-10,991	-12,704	...	...	...	...
Balance on goods and services	13,610	17,342	21,193	20,778	22,136	24,178	26,104	27,774
Net factor incomes	-14,750	-18,295	-23,515	-23,112	-25,186	-27,117	-29,053	-31,107
Credit	30,089	32,228	27,835	28,086	...	...	...	...
Debit	-44,839	-50,523	-51,350	-51,198	...	...	...	...
Balance on goods, services and income	-1,140	-953	-2,322	-2,334	-3,050	-2,939	-2,950	-3,333
Current transfers (net)	994	305	707	440	801	862	924	989
Capital and financial account	9,602	384	425	1,828	...	...	...	...
Capital account balance	1,182	703	512	370	...	...	...	...
Financial account	8,420	-319	-87	1,458	...	...	...	...
Direct investment	22,957	6,242	21,796	20,684	...	...	...	...
Portfolio investment	-5,358	-25,158	-38,373	-49,114	...	...	...	...
Other investment	-9,037	19,039	19,287	21,078	...	...	...	...
Reserve assets	-142	-441	343	1,770	...	...	...	...
Net errors and omissions	-9,223	372	464	768	...	...	...	...
				(In percent of GDP)				
Memorandum items:								
Current account balance	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3	-1.2	-1.3
Trade balance	26.5	26.4	27.7	24.8	24.8	25.2	25.3	25.5
Services	-13.2	-11.4	-11.1	-9.4	-9.6	-9.7	-9.7	-10.0
Net factor incomes	-14.3	-15.8	-18.4	-17.1	-17.4	-17.4	-17.4	-17.4
Balance on goods, services and income	-1.1	-0.8	-1.8	-1.7	-2.1	-1.9	-1.8	-1.9
Transfers	1.0	0.3	0.6	0.3	0.6	0.6	0.6	0.6

Sources: The Central Statistics Office; and staff estimates.

Table 3. Ireland: Contribution to GDP Growth, 2000-05
(In percent) 1/

	2000	2001	2002	2003	2004 Proj.	2005 Proj.
Domestic demand	7.8	3.2	2.9	2.7	2.7	2.9
Private consumption	4.6	2.8	1.4	1.3	1.6	1.8
Public consumption	1.0	1.4	1.1	0.3	0.3	0.3
Fixed investment	1.6	-0.3	0.6	0.7	1.0	0.8
Structures	0.8	0.5	0.6	0.6	0.6	0.2
Residential investment	0.5	0.3	0.3	0.8	0.5	0.1
Equipment	0.9	-0.9	0.0	0.1	0.4	0.6
Change in stocks	0.6	-0.6	-0.2	0.4	0.0	0.0
Net exports	2.2	2.8	3.1	1.2	2.0	1.3
Exports	19.9	9.0	6.2	-0.8	5.2	5.1
Imports	-17.7	-6.1	-3.1	2.0	-3.2	-3.9
Statistical discrepancy	-0.1	-0.1	0.1	-0.2	0.1	0.0
GDP (annual percent change)	9.9	6.0	6.1	3.7	4.7	5.0
GNP (annual percent change)	10.1	3.8	1.5	2.8	4.5	5.0
Memorandum item:						
Current account (as a percent of GDP)	-0.4	-0.7	-1.3	-1.4	-1.6	-1.3

Source: Staff estimates.
1/ Rounding may affect totals.

Table 4. Ireland: General Government Finances, 1991-2004
(In percent of GDP)

	1999	2000	2001	2002	2003	Proj. 2004
Current balance	6.9	8.0	5.5	3.9	3.9	3.4
Current revenue, of which	34.7	34.6	32.9	32.0	33.0	33.1
Tax revenue (including taxes on capital)	27.1	26.9	25.0	24.3	25.1	25.4
Social security receipts	4.1	4.2	4.3	4.3	4.4	4.4
Miscellaneous	3.5	3.5	3.6	3.4	3.5	3.3
Current expenditure, of which	27.8	26.6	27.4	28.1	29.1	29.7
Interest payments	2.5	2.0	1.5	1.4	1.4	1.4
Goods and services	5.2	5.2	5.4	5.9	5.9	5.9
Compensation of employees	8.1	8.0	8.4	8.3	8.6	8.9
Current transfers	11.3	10.7	11.3	11.7	12.3	12.4
Depreciation	0.7	0.7	0.8	0.8	0.9	1.0
Current expenditure, excluding interest and transfers	14.0	13.9	14.5	15.0	15.5	15.8
Capital balance 1/	-4.4	-3.6	-4.5	-4.1	-3.7	-3.7
Capital receipts (excluding taxes on capital)	1.4	1.1	1.2	1.2	1.1	1.0
Gross capital formation	3.2	3.7	4.5	4.4	3.8	3.8
Capital transfers 1/	2.7	1.1	1.2	0.9	0.9	0.9
General government balance 1/	2.5	4.4	1.1	-0.2	0.2	-0.3
Primary balance	4.9	6.4	2.6	1.2	1.6	1.1
Memorandum items:						
Structural (as a percent of potential GDP):						
Revenue 2/	36.0	35.6	34.0	33.1	34.1	34.0
Expenditure	35.1	33.4	34.7	34.9	33.6	34.3
Government balance	0.9	2.2	-0.7	-1.8	0.5	-0.2
Primary balance	3.4	4.2	0.8	-0.4	1.9	1.2
General government gross debt (as percent of GDP)	48.7	38.3	35.9	32.7	33.2	32.5
Growth in nominal GDP	15.3	15.2	12.0	10.9	5.3	7.5

Sources: Department of Finance and staff estimates.

1/ Including a capital transfer related to the repayment of the government's pension liabilities with respect to An Post and Telecom Eireann of 1.8 percent of GDP in 1999.
2/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2003	2004	2005	2006	2007	2008	2009
			Staff Projections				
Total revenue	34.1	34.0	33.0	33.0	33.0	33.0	33.0
Taxes and social security contributions	29.5	29.7	28.9	29.0	29.0	29.0	29.0
Other revenue	4.6	4.3	4.1	3.9	3.9	3.9	3.9
Total expenditure	33.9	34.4	33.5	33.4	33.4	33.5	33.5
Primary expenditure, of which:	32.5	33.0	32.2	32.0	32.0	32.0	32.0
Gross fixed investment	3.8	3.8	3.9	3.8	3.8	3.8	3.8
Government consumption	15.5	15.8	15.5	15.7	15.7	15.7	15.7
Current transfers	12.3	12.4	12.0	11.6	11.6	11.6	11.6
Capital transfers	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Interest payments	1.4	1.4	1.3	1.5	1.5	1.6	1.6
Budget balance	0.2	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5
Memorandum:							
Nominal GDP growth in percent	5.3	7.5	7.7	7.1	7.1	7.1	7.2
Gross debt	33.2	32.5	32.0	31.6	31.3	31.1	30.8
Structural budget balance, including one-offs 2/	0.5	-0.2	-0.5	-0.5	-0.5	-0.5	-0.5
Structural budget balance, excluding one-offs 2/	0.1	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5
Output gap	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0
			Stability Program December 2003 Update				
Total revenue	34.1	33.5	32.9	32.5	...	...	...
Total expenditure	34.6	34.6	34.2	33.6	...	...	...
of which:							
Collective consumption	5.8	5.9	5.8	5.7	...	...	...
Individual consumption	10	10.2	10	9.9	...	...	...
Social transfers other than in kind	9.1	9.2	9.1	8.9	...	...	...
Gross fixed investment	3.9	3.8	3.9	3.8	...	...	...
Interest payments	1.5	1.4	1.4	1.4	...	...	...
Subsidies	0.6	0.6	0.6	0.6	...	...	...
Other	3.6	3.6	3.4	3.3	...	...	...
General government balance	-0.4	-1.1	-1.4	-1.1	...	...	...
of which due to contingency	...	...	0.4	0.8	...	...	...
Memorandum:							
Nominal GDP growth in percent	4.5	7.1	7.7	7.7	...	...	...
Gross debt	33.1	33.3	33.5	33.3	...	...	...
Structural budget balance 2/	-0.8	-0.5	-0.4	-0.1	...	...	...
Output gap	1.0	-1.5	-2.3	-2.3	...	...	...

Sources: Staff estimates and Department of Finance
1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2005–06, but are adjusted for the difference between the government's and staff's growth assumptions. From 2007 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2004 are based on the latest available official information, whereas projections for 2005–06 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.
2/ As a percent of potential GDP.

Table 6. Ireland: Indicators of External and Financial Vulnerability, 1999-2003
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003
External Indicators					
Exports (annual percent change, value in U.S. dollars)	12.2	10.3	9.5	11.5	13.0
Imports (annual percent change, value in U.S. dollars)	9.3	12.8	7.1	8.3	12.0
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5
Current account balance	0.3	-0.4	-0.7	-1.3	-1.4
Capital and financial account balance,	-1.8	9.3	0.3	2.4	2.2
Of which:					
Inward portfolio investment	71.2	81.4	86.0	58.3	69.2
Inward foreign direct investment	19.1	27.1	9.3	24.1	17.7
Other investment liabilities (net)	-1.1	-8.8	16.5	14.7	21.7
Total external debt 1/	2.8	2.0	1.8	0.6	0.0
Of which:					
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0
US dollar per euro (period average)	1.07	0.92	0.89	0.94	1.13
UK £ per euro (period average)	0.66	0.61	0.62	0.63	0.69
Financial Markets Indicators					
General government debt	48.7	38.3	35.9	32.7	33.2
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5
Financial Sector Risk Indicators					
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	55.6
(excluding financial intermediation and government)					
Of which:					
House mortgage finance	39.7	39.0	38.8	42.4	44.4
Other housing finance	0.9	1.0	0.9	0.8	0.4
Other personal lending	13.0	12.2	12.5	12.0	10.8
Annual mortgage credit growth rates	22.4	19.3	17.4	22.5	25.5
Commercial property lending as a percent of total loans					
(excluding financial intermediation) 2/	18.2	20.5	21.6	22.1	24.4
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7
Non-performing loans (in percent of total loans) 4/	1.0	1.0	1.0	1.0	0.9
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9
Bank return on assets	1.3	1.2	0.9	1.0	0.9
Bank return on equity	23.0	22.0	16.0	18.0	17.8
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2
Deposits to M3 ratio 5/	1.03	1.03	1.02	1.02	1.04
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 6/	1.29	1.36	1.44	1.43	1.46
vis-à-vis total 2/ 6/	1.47	1.54	1.59	1.51	1.56
Concentration ratios in the banking sector					
No. of banks accounting for 25 percent of total assets	3	3	3	3	2
No. of banks accounting for 75 percent of total assets	23	23	21	19	18
Share of state-owned banks in total assets	3	2	1	0	0
Share of foreign-owned banks in total assets	37	39	42	29	31

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and staff calculations.
1/ Represents non-euro debt of the government sector.
2/ Includes lending for construction, hotels and restaurants, and real estate activities.
3/ Credit equivalent values.
4/ Owing to differences in classification, international comparisons of non-performing loans are indicative only.
5/ Non-government deposits vis-à-vis Irish and non-residents to M3 ratio.
6/ Non-government loans/non-government deposits ratio.

Fund Relations
(As of June 30, 2004)

I. **Membership Status**: Joined 8/08/57; Article VIII

II. **General Resources Account:**

General Resources Account:	SDR Million	% Quota
Quota	838.40	100.00
Fund holdings of currency	535.53	63.88
Reserve position in Fund	302.89	36.13
Holdings Exchange Rate		

III. **SDR Department:**

SDR Department:	SDR Million	% Allocation
Net cumulative allocation	87.26	100.00
Holdings	55.18	63.23

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest	0.29	0.59	0.59	0.59	0.59
Total	0.29	0.59	0.59	0.59	0.59

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland and the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564.

VIII. **Article IV Consultations**

The discussions for the last Article IV consultation were conducted in Dublin during May 6–15, 2003. The staff report (Country Report No. 03/242) was considered by the Executive Board on July 30, 2003 (EBM/03/75). Article IV consultations with Ireland are currently on the standard 12-month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Sustainability Exercise

Fiscal Sustainability

The sustainability of Ireland's fiscal position was assessed under alternative scenarios regarding key macroeconomic and fiscal assumptions, as well as several bound tests (Table A1). In the baseline, gross general government debt declines gradually from about 34 percent in 2003 to slightly below 31 percent in 2009. This occurs despite continued increases in assets, such as those accumulated in government pension and social security funds.[8] The primary balance remains in surplus during the period, leading to a favorable medium-term fiscal outlook.

The alternative scenarios and bound tests show that Ireland's medium-term fiscal debt position is resilient to a variety of shocks (see panels A and B of Table A1). The worst outcome—a rise in the debt ratio from 32½ percent in 2004 to around 40 percent in 2009—is achieved under the assumption that there is a 10 percent of GDP increase in other debt-creating flows in 2005.

External Sustainability

With a net external position (excluding direct investment) showing substantial claims on the rest of the world (around 90 percent of GDP), external debt sustainability does not seem to be an issue (Table A2). The net external position, including direct investment, is in a relatively small deficit given the very strong continued FDI inflows into Ireland. The fact that Ireland is a net creditor with regard to portfolio suggests little vulnerability to interest rate shocks or to a sudden reversal in short-term capital flows. The large gross assets and liabilities in portfolio and other investments reflect the activities of the International Financial Service Center, which the 2000 FSAP noted does not appear to pose a systemic risk to the domestic financial system.

[8] These items are included in the category "other identified debt-creating flows."

Table A1. Ireland: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009
								I. Baseline Projections					
1 **Public sector debt 1/**	48.7	38.3	35.9	32.7	33.2			**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
2 Change in public sector debt	-5.1	-10.4	-2.4	-3.2	0.5			-0.7	-0.5	-0.4	-0.3	-0.3	-0.2
3 Identified debt-creating flows (4+7+12)	-9.6	-10.8	-5.2	-3.3	-1.9			-2.0	-1.8	-1.7	-1.6	-1.6	-1.5
4 Primary deficit	-4.9	-6.4	-2.6	-1.2	-1.6			-1.1	-0.8	-1.0	-1.0	-1.0	-1.0
5 Revenue and grants	36.1	35.7	34.1	33.2	34.1			34.0	33.0	33.0	33.0	33.0	33.0
6 Primary (noninterest) expenditure	31.2	29.3	31.5	32.0	32.5			33.0	32.2	32.0	32.0	32.0	32.0
7 Automatic debt dynamics 2/	-4.7	-4.4	-2.6	-2.1	-0.3			-0.9	-1.0	-0.7	-0.6	-0.5	-0.5
8 Contribution from interest rate/growth differential 3/	-4.7	-4.4	-2.6	-2.1	-0.3			-0.9	-1.0	-0.7	-0.6	-0.5	-0.5
9 Of which contribution from real interest rate	0.5	-0.2	-0.5	-0.1	0.9			0.6	0.5	0.7	0.7	0.8	0.8
10 Of which contribution from real GDP growth	-5.2	-4.2	-2.1	-2.0	-1.1			-1.5	-1.5	-1.4	-1.3	-1.3	-1.3
16 Residual, including asset changes (2-3)	4.5	0.5	2.8	0.1	2.3			1.3	1.3	1.3	1.3	1.3	1.3
Public sector debt-to-revenue ratio 1/	134.8	107.2	105.4	98.6	97.4			95.5	96.9	95.9	95.0	94.2	93.5
Gross financing need 4/	-2.5	-4.4	-1.1	0.2	-0.2			0.3	0.5	0.5	0.5	0.5	0.5
in billions of U.S. dollars	-2060.9	-4886.7	-1371.0	271.2	-247.6			410.5	630.5	632.3	681.4	821.7	895.3
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	11.1	9.9	6.0	6.1	3.7	8.0	2.5	4.7	5.0	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 5/	5.3	4.8	4.5	4.5	4.4	5.6	1.0	4.6	4.4	4.9	5.0	5.3	5.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.5	0.0	-1.1	0.0	2.8	1.8	2.1	1.9	1.9	2.4	2.5	2.8	2.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	5.3	15.5	3.1	-5.1	-16.5	0.6	8.8	-8.2	0.2	-0.1	-0.2	-0.2	-0.2
Inflation rate (GDP deflator, in percent)	3.8	4.8	5.7	4.5	1.6	3.8	1.7	2.7	2.5	2.5	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	13.7	3.4	13.8	7.8	5.4	6.7	4.0	6.2	2.6	3.9	4.3	4.5	4.5
Primary deficit	-4.9	-6.4	-2.6	-1.2	-1.6	-4.0	1.8	-1.1	-0.8	-1.0	-1.0	-1.0	-1.0
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2005-09 6/								**32.5**	**27.9**	**23.6**	**19.4**	**15.5**	**11.7**
A2. No policy change (constant primary balance) in 2005-09								**32.5**	**31.7**	**31.3**	**30.9**	**30.6**	**30.3**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 7/								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
A4. Selected variables are consistent with market forecast in 2005-09								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**32.5**	**33.2**	**34.0**	**33.6**	**33.3**	**33.1**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**32.5**	**33.3**	**34.6**	**35.3**	**36.2**	**37.0**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**32.5**	**32.4**	**32.5**	**32.2**	**31.9**	**31.7**
B4. Combination of 2-4 using one standard deviation shocks								**32.5**	**31.1**	**29.7**	**29.4**	**29.1**	**28.9**
B5. One time 30 percent real depreciation in 2005 8/								**32.5**	**32.0**	**31.6**	**31.3**	**31.1**	**30.8**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**32.5**	**42.0**	**41.4**	**40.9**	**40.5**	**40.1**

1/ Gross general government debt. Although official figures for net government debt are not available, its level is considerably lower given the accumulation of assets, such as the National Reserve Fund.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

5/ Derived as nominal interest expenditure divided by previous period debt stock.

6/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

7/ The implied change in other key variables under this scenario is discussed in the text.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Ireland: Net Investment Position
(In percent of GDP)

	1998	1999	2000	2001	2002
Assets	469	611	658	727	684
Direct investment abroad	22	28	29	34	26
Portfolio investment abroad	211	315	354	428	421
Other investment abroad	227	262	269	260	233
Reserve assets	8	6	6	6	4
Liabilities	443	559	661	745	708
Direct investment to Ireland	69	81	124	142	138
Portfolio investment to Ireland	182	251	301	347	322
Other Investment to Ireland	192	227	236	257	248
Net investment position	26	52	-3	-18	-23
Direct investment abroad	-46	-53	-94	-108	-112
Portfolio investment abroad	30	64	53	80	100
Other investment abroad	34	35	33	4	-15
Reserve assets	8	6	6	6	4
Net investment position, excluding direct investment	72	105	91	90	89

Source: CSO.

Statistical Issues

Ireland is subject to the statistical requirements and timeliness and reporting standards of the Eurostat and the European Central Bank (ECB). Ireland has cooperated fully with the Fund in providing monetary, international reserves, and selected other financial statistics related to its membership in the European Economic and Monetary Union (EMU). These data are considered comprehensive, reliable, timely, and well documented. Ireland has subscribed to the Fund’s Special Data Dissemination Standard (SDDS).

1. Quarterly national accounts on an ESA 1995 basis have been introduced and are currently published within 4 months of its reference period. Real sector data are sometimes published with a lag of 3–6 months, while some non-SDDS series are published with a lag of one and a half years (e.g., household disposable income). Lags are particularly long (3–7 months) for employment, earnings, unit wage costs, and national income and expenditure data. Ireland does not have an overall earnings index or comprehensive sectoral balance sheet data.

2. While the authorities publish Exchequer returns on a monthly and quarterly basis, only annual data on the general government balance are currently available.

Core Statistical Indicators
(As of August 12, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govern-ment Balance	External Debt	GDP/ GNP
Date of Latest Observation	8/12/2004	June 2004	June 2004	June 2004	June 2004	8/12/2004	July 2004	May 2004	1st Quarter 2004	2003	1st Quarter 2004	1st Quarter 2004
Date Received	8/12/2004	7/30/2004	7/30/2004	7/30/2004	7/30/2004	8/12/2004	8/12/2004	7/30/2004	7/1/2004	3/4/2004	7/1/2004	7/1/2004
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	Commercial	Central Bank	Central Bank	Central Bank	Central Bank	Commercial	CSO	CSO	CSO	Dept. of Finance	CSO	CSO
Monthly Reporting	Internet	Internet	Internet	Internet	Internet	Internet	Internet / Publication	Internet / Publication	Internet / Publication	Internet	Internet/ Publication	Internet/ Publication
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Biannual	Quarterly	Quarterly

Statement by Charles X. O'Loghlin, Alternate Executive Director for Ireland
October 29, 2004

Key Points

- ***My authorities broadly share the analysis and conclusions of the well-balanced Staff Report.***
- ***The Irish economy has proved remarkably resilient to the global downturn, with growth well above the EU average through 2002/03 and strengthening more recently.***
- ***To sustain this performance going forward, my authorities:***
  - ***agree that safeguarding competitiveness is essential;***
  - ***are committed to managing public expenditure within the overall constraint of growth in current resources, and welcome the staff assessment that fiscal policy has adjusted to slower medium-term growth prospects; and***
  - ***are alive to the potential implications of strong house-price and household credit growth.***
- ***My authorities agree that the medium-term growth potential of the economy – with continuing economy-wide commitment to sound policies – is in the 4-5 percent range and note that, in the context of prospective population growth, this suggests annual per capita growth potential in the 3-3 ½ percent range.***

My authorities thank the staff for this year's positive Article IV discussions and Report…

1. At the outset, my authorities wish to thank the staff for the conciseness and sharp focus of this year's Article IV discussions – mirrored in their Report and in the accompanying Selected Issues document. **They broadly share the analysis and conclusions of the well-balanced Staff Report**.

Policy has generally paralleled past Fund advice…

2. In common with many Article IV Reports this year, the staff provides an assessment of the consistency of policy with their past advice. The considerations which underlay their recommendations in Reports over the past year or two were also foremost in the minds of Irish policy-makers as global and domestic growth faltered. It is, therefore, no surprise that policy developments over recent times, as indicated in Paragraph 7 of the Report, largely coincided with those recommendations.

Near-term economic prospects are encouraging…

3. Economic performance through this year has been significantly exceeding our expectations as 2004 began. My authorities now anticipate full-year GDP growth of the order of 4¾ percent (GNP 4¼ percent). A balanced budget is foreseen, rather than the 1.1 percent of GDP fiscal deficit initially forecast, underpinning a further fall in Ireland's already-low debt ratio. Despite some strengthening in personal consumption and the

significant imports associated with recovering machinery and equipment investment – adding further to Irish output capacity – the balance on our external current account is expected to show little change, with exports picking up in line with growth in world trade. **Overall, the Irish economy has proved remarkably resilient to the global downturn, with growth remaining well above the corresponding EU averages through 2002/03 and strengthening more recently**.

Aided by a continuing focus on competitiveness and bringing inflation down…

4. Indications are that employment will expand by about 2 percent through 2004. Despite this, unemployment is expected to ease only slightly from last year's level of 4.6 percent, reflecting ongoing net inward migration and – encouragingly – further increases in labor force participation. Still more encouraging, this progress is taking place in the context of a significant easing of EU-HICP-measured inflation, which should average about 2¼ percent this year – not far from the prospective euro area average for 2004. I might add that this improvement does not reflect (budget-damaging) easing of indirect taxes: net excise changes in Budget 2004 broadly approximated consumer price inflation. Instead, ongoing efforts to enhance competition in domestic markets and the wage provisions of the current social partnership agreement are key factors in the moderating pace of domestic cost increases, with the appreciating euro also playing a role.

My authorities agree that safeguarding competitiveness is essential going forward…

5. The staff provides an interesting assessment of competitive developments in the manufacturing sector. My authorities do not demur from its thrust – the strong output growth per labor-hour in a few technologically modern sectors[1] needs to be carefully interpreted in assessing manufacturing, or economy-wide, competitiveness. Different approaches to discounting this effect will offer differing assessments of competitiveness trends. However, my authorities would agree that all reasonable interpretations point to competitive loss over recent times.

Through a strong focus on cost developments…

6. They fully accept that Ireland cannot afford to worsen an already-deteriorated competitive position. This was a *key* focus of discussions on the current social partnership agreement – the outcome of which, as the staff note, "is in line with prospective core inflation and productivity developments". My authorities are insistent that, as a minimum, wage increases must be limited to those recently negotiated; and that regaining lost competitiveness must be a key priority of economic policy and of Social Partnership going forward. As to the suggestion to (permanently) move to shorter-

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[1] Measured labor productivity growth in these sectors reflects both (a) increases in labor efficiency in existing businesses and (b) the "birth" of new, *more* capital-intensive and *higher*-labor-productivity, businesses. Many of the latter reflect FDI flows – notably from the US – pushing measured labor productivity in those sectors towards US levels [e.g. O'Mahony & van Ark, quoted by the staff, report labor productivity in Ireland in Office Machinery and Electronic valves etc. at 40-60 percent above EU averages, but 10-20 percent below US levels, in 2001]. An employment-weighted interpretation of output-per-labor-hour largely adjusts for this effect – and takes substantial account, also, of developments in capital intensity [the US Bureau of Economic Analysis reports that total assets employed per worker in Irish-based (non-banking) affiliates of US entities in 2002 were 2¾ times the level of assets per person employed in the average EU15-based affiliate].

duration wage components in social partnership agreements[2], they recognize the merits of achieving greater wage flexibility but also note the significant logistical and practical difficulties associated with more frequent negotiations, and the heavy burden this would place on the social partnership process.

And on enhancing competitive forces, in particular to bear down on services costs…

7. My authorities' ongoing efforts to enhance competition in product and services markets aim in the same direction. With a few exceptions, product markets are exposed to strong competition – given Ireland's openness to imports: the exceptions are being narrowed gradually, not least under the aegis EU-wide deregulation of utilities markets. The focus of domestic effort, therefore, is on markets for "non-traded" services. These efforts are being given strong impetus by a growing public realization that Irish prices have caught up with, and passed, EU averages – an awareness bolstered by the ease with which individual and overall price levels can be contrasted in a common currency area.

Supported by a fiscal policy consistent with slower medium-term growth prospects…

8. The staff notes that the size of government in Ireland is *not* small in comparison with other OECD countries. My authorities agree that concerns about the level and quality of public services and infrastructure should be addressed by improving the efficiency and effectiveness of delivery rather than by raising tax and expenditure ratios. Apart from contributing to public welfare in the shorter run, they view this approach, also, as a crucial element in fully realizing Irish growth potential**. They are committed to managing public expenditure within the overall constraint of growth in current resources, and welcome the staff assessment that fiscal policy has adjusted to slower medium-term growth prospects**.

And a strong financial sector...

9. Ireland's sustained strong expansion of the past decade is testament to a robust, capable domestic banking system which, given continuing good health, is well-placed to support future economic expansion. In the light of rapid house-price and private sector credit growth, **it is appropriate to stress the staff conclusion that, even "in the event of an abrupt unwinding of Ireland's housing market boom, financial stability is likely not a concern"**. This parallels the view of our Central Bank and Financial Services Authority. At the launch of its recently-published "Financial Stability Report, 2004", my authorities noted that – based on extensive stress-testing – the shock-absorption capacity of the banking system is currently adequate, even in the face of a sudden and unanticipated fall in residential property prices accompanied by an increase in default rates. The capacity of the domestic banking system to withstand shocks without systemic stress, were they to arise, is bolstered by high profitability and strong capitalization. As to the risks of such an eventuality, the analyses reported by the staff give mixed signals

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[2] My authorities note (with respect to page 51 of "Selected Issues") that the excess in actual pay changes over the wage terms of the various social partnership Agreements is attributable, in part, to the impact on average earnings of structural change – the replacement of lower-productivity employment by higher-productivity, thus higher-paying, jobs – rather than "slippage" versus the pay terms of those Agreements. It is difficult, however, to satisfactorily measure the extent of this effect.

on the question whether, and if so to what extent, house prices are overvalued relative to "the fundamentals". What is more certain in my authorities' view, however – as also suggested by the staff – is that if house prices were to continue to increase at the double-digit pace of recent times, the risk of a sharp correction would become more pronounced.

10. My authorities are not complacent. Work to strengthen the effectiveness of financial sector supervision continues apace (assisted by the recommendations of the 1999/2000 FSAP – which, it has been agreed with the Fund, will be revisited in the coming year). Likewise, efforts are ongoing to heighten the awareness of all economic agents – including mortgagors and mortgagees – of the potential implications of rising household indebtedness, especially in the context of the prevailing low interest rate environment. My authorities fully agree with the staff that "public communication can play an important role in taming expectations and help to induce a soft landing in the housing market".

Given these, the staff estimate of "potential growth after the boom" seems realistic…

11. Like the staff, my authorities have no illusions that Irish growth over the years ahead could sustainably emulate the unprecedented expansion of the 1990s. Several factors which contributed greatly to the "Celtic Tiger" performance *cannot repeat* in the future (certainly, at nowhere near the same pace, nor to anything like the same extent). No significant contribution to growth can be expected from further reducing unemployment, which is now around 4½ percent. The spectacular gains in labor force participation of recent years mean that space for future gains, while there, is far less than a decade ago. They also recognize that the prospective reversal of the hitherto declining trend in overall dependency – which allowed living standards to rise more rapidly than income-per-person-at-work during the "tiger" years – will slow *per capita* economic growth. **My authorities, therefore, agree that medium-term growth potential – with continuing economy-wide commitment to sound policies – is in the 4-5 percent range and that, in the context of prospective population growth, this points to annual *per capita* growth potential in the 3-3 ½ percent range.**

INTERNATIONAL MONETARY FUND
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November 4, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with Ireland

On October 29, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Over the last half of the 1990s, incomes in Ireland converged quickly to the EU average owing to sustained expansions in output and employment. In the 1995–2000 period, growth averaged 10 percent a year while unemployment declined from almost 13 percent to below 4 percent. The fiscal position also strengthened considerably and the ratio of government debt to GDP fell from over 80 percent in 1995 to less than 40 percent in 2000. Strong export performance kept the current account in surplus or close to balance. Toward the end of the boom period, resource constraints tightened sharply and inflation accelerated to a peak of 6 percent in 2000.

In 2001, growth slowed sharply following the global downturn. Growth in GNP, which best reflects domestic economic activity because it excludes multinational profit flows, fell from 10 percent in 2000 to 1½ percent in 2002. While goods market activity slowed considerably, unemployment rose modestly to a peak of 4.8 percent in mid-2003. Inflation, although moderating slightly from its peak, remained well above the euro area average during the slowdown.

In 2003, the economy rebounded with GNP growing by almost 3 percent. Recent indicators suggest that activity has continued to strengthen in 2004. During 2003, inflation decelerated and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 29, 2004 Executive Board discussion based on the staff report.

is now close to the euro area average. Most recently, however, oil price increases have led to a mild pickup in inflation.

Monetary conditions have been accommodative for a sustained period as nominal interest rates declined considerably in the run-up to EMU. Further, with inflation in Ireland exceeding the euro area average until just recently, real interest rates declined even more. Low interest rates and financial market liberalization have resulted in a rapid expansion in household credit which combined with rapid growth in disposable incomes fuelled a boom in the housing market. Real house prices have risen by 187 percent since 1995.

The rapid economic expansion of the late 1990s increased fiscal revenues sufficiently to allow for substantial budget surpluses in spite of significant expenditure increases and tax cuts. Expenditure increases, however, failed to moderate as growth slowed in 2001 and the fiscal balanced slipped into deficit by 2002. In 2003, expenditure growth was lowered considerably and indirect taxes were increased, leading to a surplus of 0.2 percent of GDP.

Going forward, staff project that the economic recovery will gain momentum with GNP growth of 4½ percent in 2004 accelerating slightly to 5 percent in 2005. Core inflation is forecast to stay close to 2 percent. Although monetary conditions are expected to continue to be supportive, it is anticipated that interest rates will increase toward more normal levels as the global recovery firms. Over the medium term, real growth is expected to be in the 4 to 5 percent range.

Executive Board Assessment

Executive Directors commended the continued impressive performance of Ireland's economy, which is based on sound economic policies, providing useful lessons for other countries. Growth remained remarkably resilient in the face of substantial global shocks over the last few years. Flexibility in the labor market limited increases in unemployment, and inflation slowed rapidly, converging to euro area rates, after running well above trading partner country rates for several years. Looking ahead, as medium-term growth prospects are expected to be less buoyant than during the Celtic Tiger era of the 1990s, the key challenge for Ireland will be to manage the transition to slower growth.

In the near term, Directors expected the economic recovery to become stronger and broad-based, supported by external demand and a continued rebound in business investment. Core inflation is expected to remain moderate. The main risks to this outlook stem from the potential for further euro appreciation in response to global imbalances and the possibility of an abrupt unwinding of the housing boom.

In the medium term, Directors expected growth to be markedly lower than that experienced in the second half of the 1990s, as many of the factors that accounted for the 1990s boom were one-off in nature. However, at around 4-5 percent, growth will still remain high by international standards. The transition to slower growth will require adjustments in expectations in labor and housing markets, and also in fiscal policy. Directors stressed that while the global downturn helped initiate such adjustments, these should be viewed as required for longer-term structural reasons rather than for cyclical reasons only, and clear communications will remain important in this regard.

Directors concurred that safeguarding competitiveness should be a key priority of Ireland's economic policy and social partnership. Although inflation in goods and labor markets has decelerated—suggesting that expectations have adjusted to lower growth—the level of competitiveness has deteriorated. The outcome of the wage negotiations of the latest round of the social partnership, in line with prospective core inflation and productivity developments, is welcome. Nevertheless, Directors noted that the agreed increases do not take into account past erosions in the level of competitiveness or the risks of further euro appreciation. To address this potential source of vulnerability, Directors called for an extended period of wage restraint as well as for increased wage flexibility within the social partnership. This could be achieved by shortening the duration of national wage agreements from three years. Directors also noted that improving domestic competition, especially in the services sector, would help to contain input costs in the export sector.

Directors underscored the importance of achieving a soft landing of the housing market, given that recent house price increases continue to exceed medium-term growth prospects. While in the event of an abrupt unwinding of the housing market boom, financial stability would likely not be a concern, Directors cautioned that the impact of such an unwinding on employment and private consumption could be significant. They therefore welcomed the central bank's communications to curb expectations in credit and housing markets, and encouraged further efforts to increase borrower and lender awareness of the prospects for interest rate increases and their implications for debt-servicing costs. Many Directors also viewed the strong preference in Ireland for owning property as a compelling reason not to provide additional incentives in the form of subsidies to home ownership. Steps, which the authorities were advised to consider in a medium-term context, included removing the interest-deductibility of mortgage payments on primary dwellings, and introducing a market-value-based wealth tax on property, graduated to tax second homes at higher rates. Directors welcomed the authorities' continuing efforts to strengthen financial supervision, including by implementing the FSAP recommendations.

Directors concurred that fiscal policy has adjusted well to slower medium-term prospects. To avoid a procyclical fiscal policy, they called for a modest, front-loaded tightening in the structural fiscal balance in the next budget, in line with the authorities' commitment to achieve a structural balance over the medium term. Although the overall outturn for 2003 and early returns in 2004 have been better than expected, Directors noted that this performance is in part due to one-off receipts from changes in the capital-gains tax regime and successes with anti-fraud measures, and the buoyancy of the property market. It will therefore be important to resist political pressures for increased spending as a result of this improvement in public finances, as such an easing would be procyclical, raise inflation, hurt competitiveness, and limit value for money.

Directors shared the authorities' view that concerns about the level and quality of public services and infrastructure should be addressed by improving delivery rather than by raising tax and expenditure ratios. Directors welcomed the introduction of multi-year spending envelopes for departments' public capital spending. Ireland's government capital spending of 5 percent of GNP is already high by international standards and further increases would risk running up against bottlenecks and inefficiencies. The new framework should safeguard capital spending from procyclical pressures, improve planning and predictability, and encourage efficiency. Given these potential benefits, most Directors saw merit in extending the multi-year spending envelopes to cover current expenditures, as well. Directors supported the fundamental reforms begun in the health sector and the modernization of public service delivery, and encouraged a shift in focus across public services from inputs to outputs. They welcomed the ongoing efforts to strengthen budget controls and monitoring and to improve management and appraisal of capital projects. Directors considered Ireland well-placed to deal with the impact of population ageing, through both its sound fiscal position and the high degree of pension funding.

While commending the authorities' support of multilateral trade liberalization, Directors encouraged Ireland to adopt a more supportive stance within the EU in favor of further reform of the Common Agricultural Policy. They welcomed the authorities' commitment to raising official development assistance to attain the UN target of 0.7 percent of GNP by 2007.

Directors encouraged the authorities to continue their efforts on improving the provision of statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Ireland: Selected Economic Indicators

	2000	2001	2002	2003	2004 1/	
Real Economy (change in percent)						
Real GDP	9.9	6.0	6.1	3.7	4.7	
Real GNP	10.1	3.8	1.5	2.8	4.5	
Domestic demand	9.1	3.8	3.4	3.3	3.3	
Exports of goods and services	20.4	8.4	5.7	-0.8	5.0	
Imports of goods and services	21.3	6.7	3.3	-2.3	3.8	
HICP	5.2	4.0	4.7	4.0	2.3	
Unemployment rate (in percent)	4.3	3.9	4.4	4.7	4.4	
Public Finances (percent of GDP) 2/						
General government balance	4.4	1.1	-0.2	0.2	-0.3	
Structural balance 3/	2.2	-0.7	-1.9	0.5	-0.2	
General government debt	38.3	35.9	32.7	33.2	32.5	
Money and Credit (end-year, percent change)						
M3 4/	14.7	17.2	9.3	9.6	8.3	6/
Private sector credit 5/	21.3	15.1	15.0	17.9	24.8	6/
Interest rates (year average)						
Three-month	4.8	3.3	2.9	2.1	2.1	7/
10-year government bond yield	5.1	5.1	4.3	4.3	4.2	7/
Balance of Payments (percent of GDP)						
Trade balance (goods and services)	13.2	15.0	16.6	15.4	15.3	
Current account	-0.4	-0.7	-1.3	-1.4	-1.6	
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	4.1	4.5	4.0	2.8	1.6	6/
Exchange Rate						
Exchange rate regime		Member of euro area				
Present rate (August 12, 2004)		US$ per euro 1.2256				
Nominal effective rate (1995=100)	88.3	89.2	90.7	96.7	96.7	6/
Real effective rate (1996=100, CPI based)	91.0	94.4	98.9	106.8	106.5	6/

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics

1/ Staff projections, except where noted.

2/ In percent of GDP.

3/ In percent of potential GDP.

4/ The methodology for calculation of Ireland's contribution to the Euro area money supply was amended in January 2000.

5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.

6/ As of June 2004.

7/ As of July 2004.

October 2005
IMF Country Report No. 05/369

Ireland: 2005 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Ireland, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 16, 2005, with the officials of Ireland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 11, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of September 30, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 5, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below have been separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with Ireland

Approved by Alessandro Leipold and Michael Hadjimichael

July 11, 2005

- The Article IV consultation discussions were held in Dublin during May 5–16, 2005. The mission comprised Mr. Morsink (head), Ms. Honjo, Ms. Iakova, and Ms. Moreno Badia (all EUR). The mission met with Finance Minister Cowen, Central Bank Governor Hurley, CEO of the Financial Services Regulatory Authority O'Reilly, other senior government officials, the employers' federation, the trade unions, and members of the financial and academic communities. Messrs. Lynch and O'Loghlin (OED) attended most meetings.

- Ireland has accepted the obligations of Article VIII, Sections 2, 3, and 4, (Appendix I) and has subscribed to the Special Data Dissemination Standard (Appendix II).

- The authorities have agreed to the publication of the staff report.

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EXECUTIVE SUMMARY

Background

Economic performance has been impressive, due in significant measure to sound policies. In line with the global cycle, growth picked up strongly in 2004. Rapid employment growth was supported by immigration, so the unemployment rate was roughly unchanged and wage growth remained moderate. House price appreciation has slowed, but house prices are high on various measures. Real effective exchange rate appreciation over the past few years has raised Ireland's cost levels above those of its main trading partners.

Key policy issues

Outlook: The authorities and staff agreed that economic growth is likely to be very strong in the short term. The housing market was regarded as headed for a soft landing, though the risk of a sharp decline was acknowledged. The authorities and staff agreed that a further erosion of external competitiveness would be a concern. The shared view was that the economy is at about full employment, so rapid growth could give rise to overheating, though there are uncertainties about supply potential. The risks to the forecast are balanced.

Fiscal policy: While public finances are strong, the 2005 budget implies sizable fiscal stimulus, which is ill-advised for an economy close to full employment. There was agreement that fiscal tightening would be desirable to dampen aggregate demand in the short term and to build a cushion in the event that downside risks materialize in the medium term. The shared view was that further efforts are needed to improve value for money in the delivery of public services. Views diverged on the extent of institutional innovation needed to enhance the focus on strategic issues in the public debate of fiscal policy.

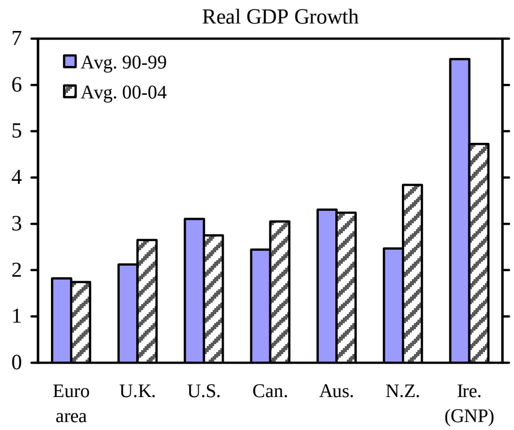
Labor market and wage policy: Labor market flexibility in Ireland is good. However, as labor costs are high, the authorities and staff agreed that wage moderation is needed in both the upcoming national wage agreement and the next public sector benchmarking exercise. Moreover, the methodology and transparency of benchmarking could be improved.

Financial stability: While banking system profitability and capitalization are strong, vulnerabilities exist, so there was agreement that continued efforts are needed to maintain financial stability. The priorities are to further strengthen stress-testing and credit standards, and to prepare an update to the *Financial Stability Report*.

Structural issues: Important progress has been made in preparing for population aging, but there are concerns that households are not saving enough for retirement. The authorities and staff discussed options to raise household saving. While product market reform is well-advanced, there was agreement that better regulation is needed to stimulate competition in some sectors, including banking and insurance, professional services, and retail.

I. BACKGROUND

1. **Economic performance in Ireland was extraordinary during the 1990s and has remained impressive in recent years**. Real GNP grew by 6½ percent per year on average between 1990–99 and by 4¾ percent per year during the 2000–04 cycle.[1] The unemployment rate fell sharply to one of the lowest rates among industrial countries. HICP inflation is now

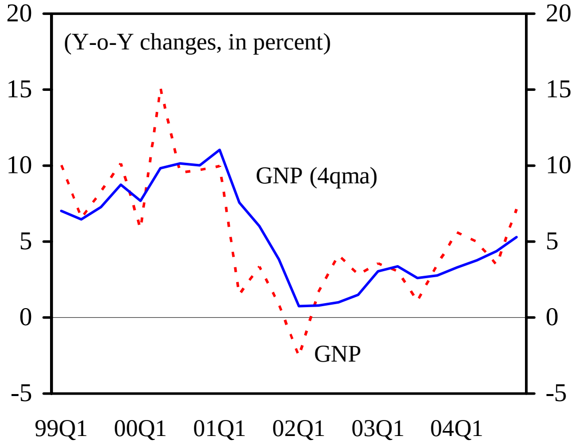


close to the euro area average. This remarkable performance reflected both good policies and fortunate circumstances. Prudent government spending created the scope for reductions in both public debt and taxes. Social partnership agreements and income tax cuts supported wage moderation, which—along with low corporate tax rates, EU membership, and the global ICT boom—encouraged investment. The EU provided funds for infrastructure investment, and participation in EMU lowered interest rates. Favorable demographics increased the share of the working-age population.

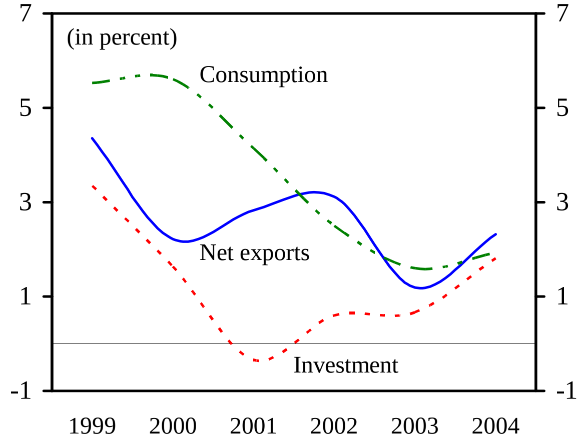
2. **Following a downturn in 2001–02, real GNP growth picked up in 2003–04** (Table 1). Notwithstanding the appreciation of the euro, export growth rebounded in line with the global upturn, and net exports made an increased contribution to growth. Investment accelerated strongly, supported by improving business confidence and low ECB interest rates. Consumption growth was somewhat less buoyant, reflecting contractionary fiscal policy and a slow recovery of consumer confidence from its post-ICT boom decline. All in all, real GNP expanded by 5½ percent in 2004.

[1] The substantial contribution of multinationals to Irish output and the associated profit repatriation create a large difference between GDP and GNP. GNP excludes payments to foreign factors of production and is a better measure of national income.

Real GNP Growth



Contributions to Growth

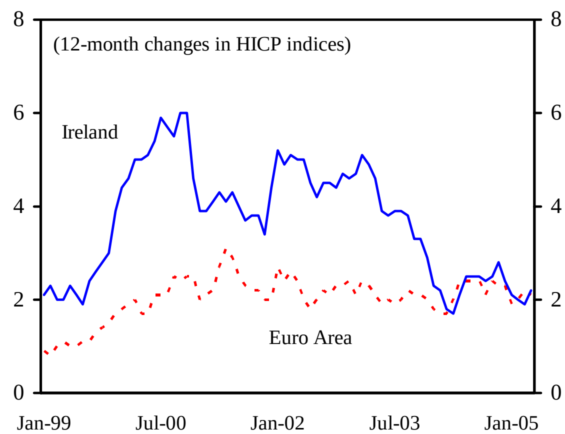


3. **In line with the economic upturn, labor demand strengthened in 2004**. Employment grew by 3 percent, boosted by immigration, especially from new EU member states. As a result, the unemployment rate was roughly unchanged at 4½ percent, and wage growth in the private sector remained moderate. However, with the appreciation of the euro, compensation per employee is now higher in Ireland than in the EU-15 or the U.K. The dampening impact of euro appreciation on consumer prices more than offset upward pressure from higher oil prices, so average HICP inflation fell to 2¼ percent.

Gross Compensation per Employee

Source: AMECO.

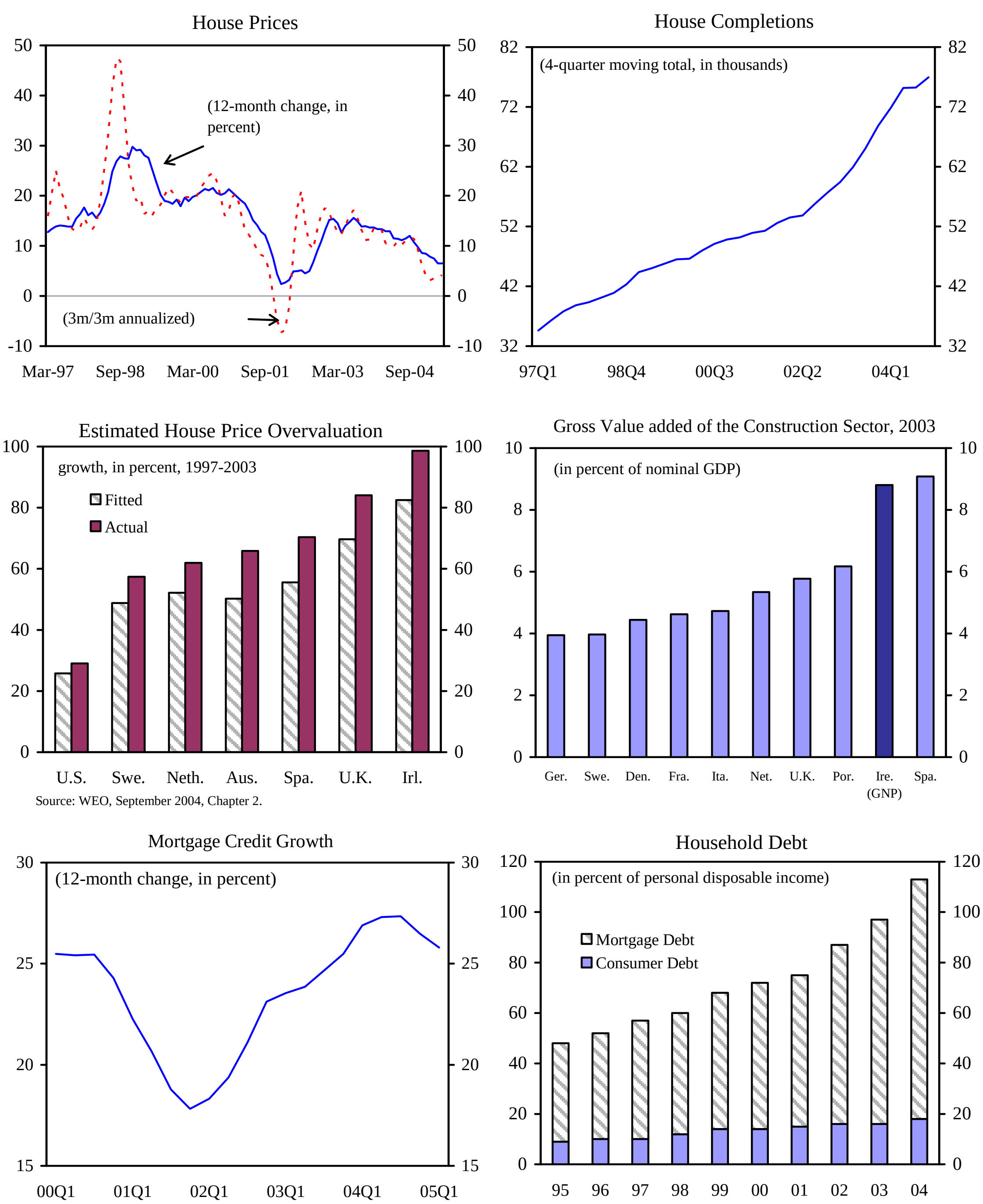
Inflation



Source: EuroStat.

4. **House price appreciation has slowed, but house prices remain relatively high.** The pace of house price increases has slowed gradually since mid-2003 to 3–5 percent (annual rate) in recent months (Figure 1). In line with easing house price appreciation, the rise in house completions has slowed. However, staff analysis suggests that not all of the increase in house prices over the past several years can be attributed to fundamentals and that the estimated house price overvaluation in Ireland is relatively large compared to other

Figure 1. Ireland: Housing Market Indicators



countries (though—given the inherent uncertainties in these types of calculations—it is difficult to be precise about the degree of overvaluation).[2] The size of the construction sector is correspondingly large, with the ratio of gross value added in construction to GNP surpassed only by Spain in Europe. Despite slowing house price appreciation, mortgage credit growth remains high, and household debt as a share of disposable income continues to rise sharply.

5. **A center coalition government has been in power since June 1997 and was re-elected in May 2002**. Fianna Fail, the senior coalition partner, lost ground at the local and European elections in June 2004. In the subsequent cabinet reshuffle, a new minister for finance was appointed. General elections must take place by mid-2007.

II. Report on the Discussions

6. **Ireland's continuing economic success reinforces the view that good policies have powerful effects**. Indeed, the economy is enviably well positioned to sustain strong growth over the medium term. Nonetheless, the authorities and staff acknowledged that even good policies can be improved, that turbulence from various disturbances—both domestic and external—is always a risk, and that population aging presents challenges. As in recent years (Box 1), the discussions focused on attuning policies to the key challenges to maintaining strong economic performance:

- Given rapid real GNP growth recently, could the continuation of very strong growth give rise to pressures on capacity constraints?
- How can fiscal policy help to relieve potential overheating and build a cushion in the event that downside risks, notably in the housing market, materialize?
- Is competitiveness at risk, and how can the forthcoming national wage agreement and public sector benchmarking exercise help to safeguard it?
- With credit growth—especially to the property sector—remaining high, what further efforts are needed to maintain financial stability?
- From a longer-term perspective, how can households be encouraged to save for retirement, given Ireland's relatively frugal state pension system?

[2] Selected Issues Paper, 2004, *Adjustment in the Housing Market*; and WEO, September 2004, *The Global House Price Boom*.

Box 1. Fund Policy Recommendations and Implementation

Ireland's impressive economic performance since the early 1990s reflects in significant measure the implementation of sound policies consistent with Fund advice. In recent years, the authorities have generally responded appropriately to policy challenges identified in previous consultations (the 2004 PIN is available at http://www.imf.org/external/np/sec/pn/2004/pn04122.htm):

Fiscal policy: The authorities are committed to the SGP, including the medium-term fiscal objective of close to balance or surplus, which the Fund fully supports. However, the fiscal stance has tended to be procyclical, contrary to Fund recommendations. To limit the potential for procyclical stimulus while increasing the predictability, transparency, and efficiency of spending, the Fund has called for a medium-term expenditure framework. Spending envelopes have been introduced for capital spending but not for current spending.

Wage policies: The present three-year national wage agreement contained a considerable degree of wage moderation relative to the past and offered no fiscal concessions, consistent with Fund recommendations. However, progress in limiting public sector wages has been more limited.

Housing market: The authorities' public communication strategy to tame expectations and help induce a soft landing in the housing market, as well as the absence of new fiscal measures to attempt to fine tune the housing market, have been in line with Fund advice.

Financial sector: Financial supervision has been and continues to be strengthened along the lines recommended in the 2000 FSAP and subsequent consultations. An FSAP Update is planned for 2006.

Competition: The pace of regulatory reform has been slower than recommended by the Fund.

A. Outlook: Strong Growth Creates Potential for Wage Pressures

7. **The authorities and the staff agreed that economic growth is likely to be very strong in the short term** (Table 2). Staff project real GNP growth in 2005–06 of about 5 percent, driven by an acceleration in private consumption, in turn supported by strong employment and income growth, fiscal stimulus in 2005, and withdrawals from the Special

Macroeconomic Projections
(Percentage change, unless otherwise indicated)

	2002	2003	2004	2005	2006
Real GNP	1.5	2.8	5.5	5.1	4.9
Real GDP	6.1	3.7	4.9	5.4	5.2
Real domestic demand	3.4	3.3	4.0	4.6	4.9
Private consumption	2.8	2.6	3.2	4.5	5.7
Public consumption	8.6	2.5	2.9	4.5	2.9
Fixed investment	3.0	3.4	9.2	4.3	4.0
Structures	5.3	5.0	7.7	3.5	2.5
Residential investment	5.1	14.4	12.2	2.0	-1.0
Non-residential investment	5.6	-3.6	2.8	5.3	6.5
Equipment	-0.1	1.2	11.3	5.5	6.0
Change in stocks 1/	-0.2	0.4	-0.5	0.1	0.1
Net exports 1/	3.1	1.2	2.3	1.7	1.3
Exports	5.7	-0.8	4.4	5.6	5.2
Imports	3.3	-2.3	2.7	5.0	5.0
Output gap 2/	2.2	-0.8	-0.5	0.0	0.7
Consumer Prices	4.7	4.0	2.3	2.3	2.5
Average unemployment rate	4.4	4.6	4.5	4.2	4.0

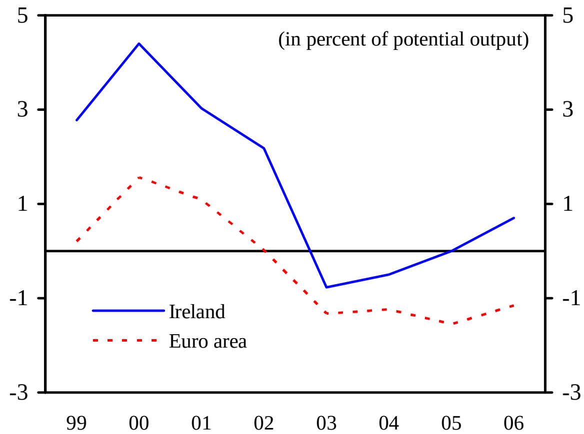
1/ Contributions to growth
2/ In percent of potential output
3/ In percent of GDP

Savings Incentive Accounts (SSIAs) that will begin in mid-2006.[3] Business investment is expected to remain robust, reflecting low interest rates and the continued strength of the global economy. With the gradual cooling of the housing market, residential investment is projected to decline modestly starting next year. Net exports are expected to continue to make significant contribution to growth, but at a declining rate, as domestic demand in Ireland is stronger than that in its main trading partners. Officials at the central bank and the Department of Finance gave broadly similar characterizations of the outlook.

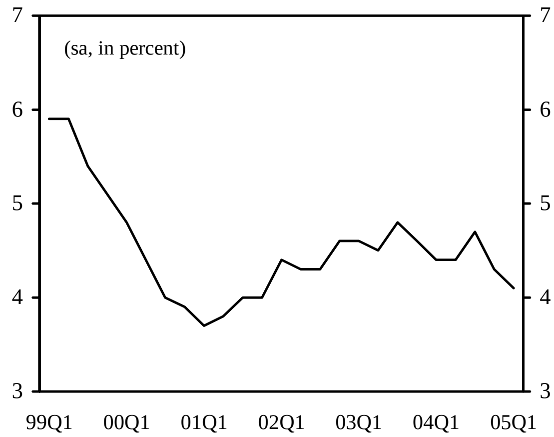
8. **The shared view was that the economy is at about full employment, so continued rapid growth could give rise to overheating.** The unemployment rate in the first quarter was 4¼ percent, not far from its historical low and in the vicinity of most estimates of the NAIRU. While there are uncertainties about the economy's supply potential, including with regard to the role of immigration in relieving incipient labor shortages, there was agreement that projected growth in 2005–06 is somewhat above potential growth, which could give rise to upward pressures on wages and prices. Staff's baseline projection is for a slight increase in HICP inflation to 2½ percent next year.

[3] Individuals receive a 25 percent tax credit on contributions to SSIAs (up to a ceiling). SSIAs were introduced in 2001–02 and must be held for five years to avoid an exit tax.

Output Gap 1/



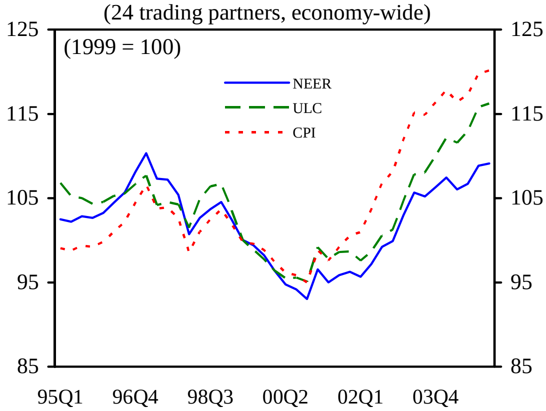
Unemployment Rate



1/ Staff Projections.

9. **The authorities and staff agreed that a further erosion of external competitiveness would be a concern**. The economy-wide ULC- and CPI-based real effective exchange rates have appreciated substantially since 2002, though the pace of appreciation slowed in 2004.[4] Real effective exchange rate appreciation has reflected a combination of nominal effective exchange rate appreciation and relatively high growth of prices and wages.

Nominal and Real Effective Exchange Rates
(24 trading partners, economy-wide)



Ireland's Export Share

Source: EuroStat

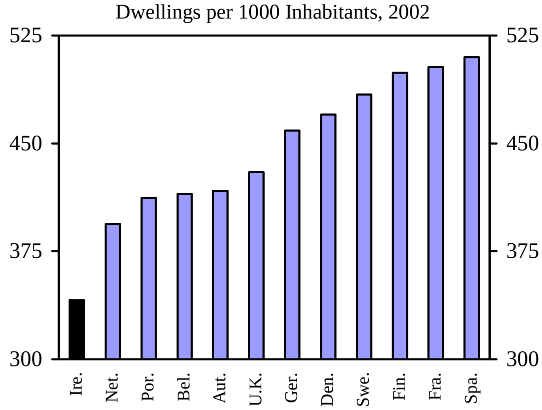
With the strengthening of the euro against the U.S. dollar and—to a lesser extent—sterling, the nominal effective exchange rate has increased by about 14 percent since 2002. At the same time, consumer price and economy-wide ULC inflation rates in excess of partner country rates have raised Ireland's cost levels above those of its main trading partners. Notwithstanding the real effective exchange rate appreciation, the authorities noted that the

[4] A 2004 Selected Issues Paper found that an appropriately weighted ULC-based REER for manufacturing has increased by a similar magnitude as the economy-wide measure.

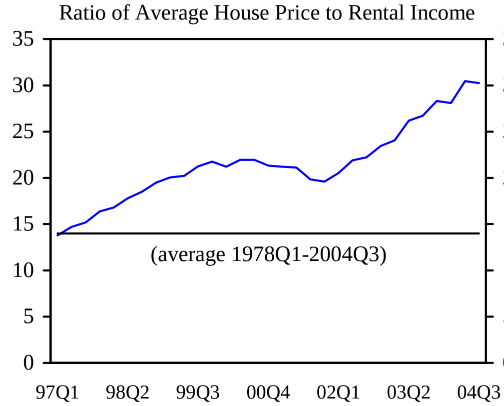
pipeline of inward foreign direct investment remains healthy and prospects for export growth continue to be strong (Table 3). Staff did not see the current level of competitiveness as an immediate, major concern, observing that Ireland's share of industrial country exports of goods and services—after rising during the late 1990s—now appears to have stabilized.

10. **The housing market is widely regarded as headed for a soft landing, though the authorities and staff acknowledged the risk of a sharp decline.** Survey evidence suggests that expectations of house price appreciation have declined in line with the easing of actual house price appreciation. The authorities argued that the underlying demand for housing is relatively strong, noting that the number of dwellings per capita in Ireland is still low compared to other advanced economies in Europe. Nonetheless, the authorities and staff agreed that house prices are relatively high on a variety of measures, including the price-earnings ratio in the housing market, which is still about double its historical average and one-and-a-half times its 2002 level. Although the authorities cited estimates that only about one sixth of the houses built between 2000–04 are second homes or buy-to-let properties, market analysts indicate that a much higher percentage of recent construction falls into these two categories.

Dwellings per 1000 Inhabitants, 2002



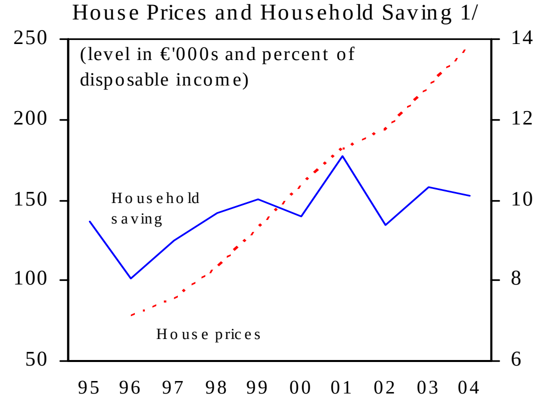
Ratio of Average House Price to Rental Income



Sources: CSO; Department of Environment; 2003 Quarterly National Household Survey; and staff calculations.

11. **The authorities and staff saw the risks to the forecast as being broadly balanced.** Upside risks include stronger-than-expected effects of fiscal stimulus and recovering confidence on domestic demand, especially private consumption and residential investment. On the downside, the key domestic risk is that the housing market could slow more quickly than currently envisaged, with adverse consequences for employment and wealth. However, the house price boom does not appear to have depressed household saving, so price declines would not

House Prices and Household Saving 1/



1/ 2003 and 2004 data are ESRI estimates.

necessarily weaken consumption directly. The main external risks are oil prices and the possibility of a disorderly resolution of global imbalances, which could sharply dampen external demand and inward foreign direct investment.

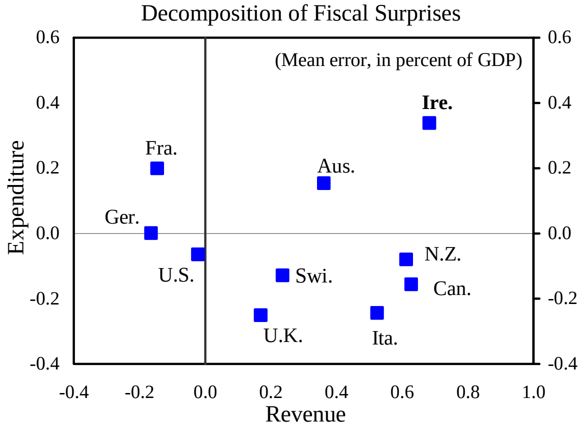
B. Fiscal Policy: Avoiding Procyclicality and Building a Cushion

12. **Ireland's public finances are currently strong, but staff noted that fiscal policy has been procyclical in recent years** (Table 4). Gross public debt is about 30 percent of GDP, among the lowest in the EU; taxes on labor and business income are relatively low; and the general government fiscal position has been either close to balance or in surplus since 1996. However, fiscal policy was expansionary during 2001–02, when economic activity was somewhat higher than potential, and contractionary during 2003–04, when the output gap was negative. In addition, staff analysis finds that between 1991–2003 revenue windfalls, reflecting higher-than-projected economic growth, were usually associated with increased spending (Box 2). The improvement in the general government balance in 2004 (of 1.1 percent of GDP to a surplus of 1.3 percent of GDP) was much stronger than expected, reflecting higher-than-projected growth and one-off factors (receipts from revenue investigations and underspending of the capital budget).

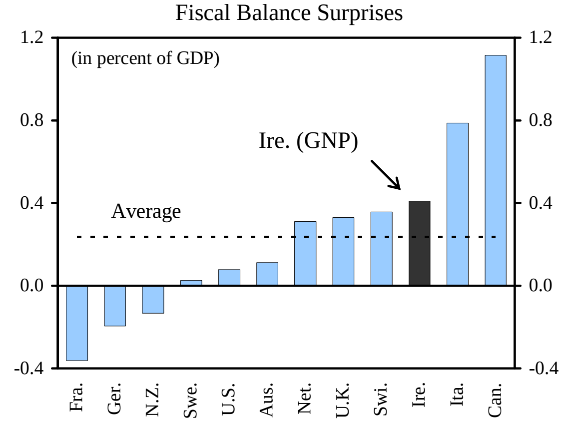
Box 2. Favorable Fiscal Surprises: Luck or Prudence?

Public debt has fallen sharply, reflecting in part favorable fiscal surprises, i.e., outcomes that exceeded budget projections. Staff analysis finds that favorable surprises between 1995–2003 reflected primarily fortunate circumstances (stronger-than-expected economic growth and buoyant asset prices) but prudence also played a role (under-projection of revenue elasticity).[1] Interestingly, revenue overperformance tended to be associated with higher-than-projected expenditure, i.e., some of the good luck was spent (more so than in other industrial countries, see left panel). As a result, the favorable surprises on the overall fiscal balance were not much greater than the average for other industrial countries (see right panel).

Decomposition of Fiscal Surprises



Fiscal Balance Surprises



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[1] Selected Issues Paper, Favorable Fiscal Outturns: Is It Just the Luck of the Irish?

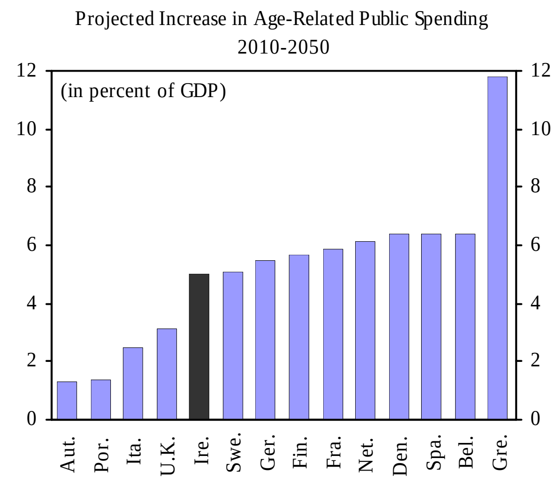
13. **The authorities acknowledged that the budget for 2005 implies a fiscal deterioration** (Table 5). The budget envisages a swing in the overall balance of 1.7 percent of GDP, reflecting mainly higher social welfare payments (0.6 percent of GDP; for old age pensions, child benefit, and unemployment assistance), increased income tax credits and rate bands (0.4 percent of GDP; to ensure that workers on the minimum wage are fully outside the tax net and to partially compensate for the lack of indexation of the bands), and higher public sector pay (0.3 percent of GDP; consistent with previously announced wage increases). Since the budget was released in December, revenues in 2004 and the first few months of 2005 have been stronger than expected. At the same time, the Supreme Court has ruled that the government must reimburse certain nursing home charges received over the past 30 years. Altogether, staff now project that the cyclically adjusted general government balance excluding one-off factors will decline by more than 1 percent of GDP to a deficit of about ½ percent of GDP. Staff observed that the size and timing of the fiscal stimulus are ill-advised for an economy that is close to full employment. While not disputing this point, the authorities noted that the fiscal expansion in 2005 followed two years of contractionary budgets, while also reflecting certain social priorities.

General Government Balances
(In percent of GDP)

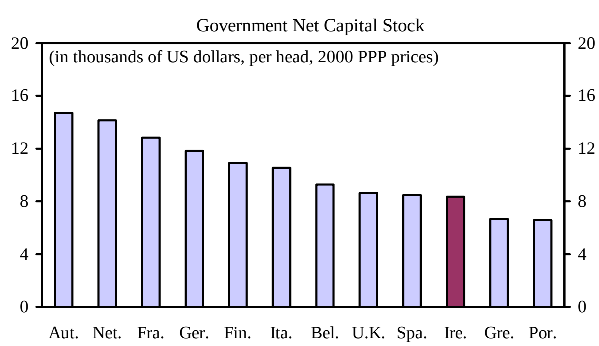
	2002	2003	2004	2005	2006	2007
				Staff projections		
Overall balance	-0.4	0.2	1.3	-1.0	-0.5	-0.5
Cyclically adjusted	-1.2	0.6	1.6	-1.0	-0.7	-0.7
Excluding one-off factors	-1.2	0.2	0.7	-0.5	-0.8	-0.8
o.w. Revenue investigations	0.0	0.0	0.5	0.1	0.0	0.0
Reimbursement of nursing home charges	0.0	0.0	0.0	-0.6	0.0	0.0
Gross public debt	32.7	32.1	29.6	29.6	29.2	29.0

14. **Staff suggested that, given Ireland's cyclically advanced position and accommodative euro area monetary policy, fiscal tightening would be desirable**. The authorities agreed that, during the remainder of 2005, budget execution should remain prudent and any revenue windfalls should be saved, as they had been in 2004. Staff recommended an improvement in the cyclically adjusted fiscal balance of ½ percent of GDP in 2006. While noting strong pressures for higher spending, the authorities said that next year's fiscal position would be in line with their medium-term objective of close to balance or surplus, though preparatory work for the 2006 budget is not yet underway. Staff noted that a balanced budget target in 2006 would be consistent with its call for fiscal tightening. The authorities shared the view that, if aggregate demand were to weaken unexpectedly and abruptly, possibly due to a sharper-than-currently envisaged slowdown in the housing market, automatic stabilizers should be allowed to operate fully.

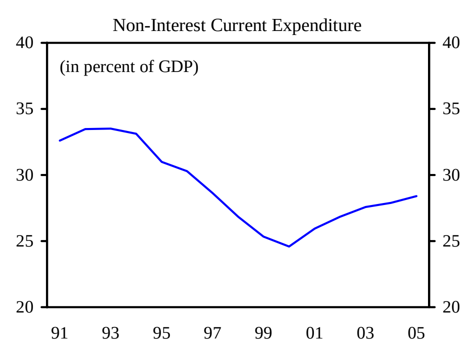
15. **The authorities concurred that fiscal restraint is needed from medium- and long-term perspectives**. They noted that a small open economy like Ireland is subject to global shocks, such as the equity market bust in 2001, which led to a 3½ percent of GDP deterioration in the fiscal balance. They also acknowledged that the cooling housing market would reduce the yield from property-related taxes, though precise quantification is difficult. With age-related spending (on health and pensions) projected to rise by about 5 percentage points of GDP by 2050, the government is setting aside every year 1 percent of GNP in the National Pensions Reserve Fund (NPRF) to prepare for future old-age and civil service pension spending (this does not affect the fiscal balance, but does add to gross debt). Staff welcomed the pre-funding, but noted that it is expected to cover only about one third of the increase in pension spending. The authorities observed that a decline in government spending on infrastructure over the long term would provide room for higher age-related spending. Staff accepted this point, but noted that the scope for reducing infrastructure spending might not be that great (between 2002–04, Ireland spent 4¾ percent of GNP while the industrial country average was 3 percent of GDP). Staff argued that, besides the pre-funding under the NPRF (which currently amounts to about 10 percent of GNP), a further gradual reduction in gross public debt would help prepare for higher age-related spending. In addition, staff suggested that the NPRF avoid potential conflicts of interests in its investment strategy, which could arise in recently authorized (but not yet undertaken) investments in domestic private public partnerships.



16. **Regarding the composition of adjustment, staff suggested that the growth of current spending should be restrained and that the tax base should be broadened.** Given Ireland's relatively low level of public capital, the authorities argued—and staff agreed—that a continued high level of government investment is appropriate. However,



Source: Kamps (2004).



staff noted that non-interest current spending had risen by more than 3 percent of GDP between 2000–04, reflecting across-the-board increases. On the revenue side, there was agreement that Ireland's relatively low levels of business and labor taxes are appropriate, and that the tax net should be broadened. The authorities noted that a review of property-related tax reliefs is currently underway, and staff observed that a useful way to curtail these reliefs would be to establish across-the-board limits on allowances. Staff also suggested preserving the nominal ceiling on mortgage interest tax relief (MITR) and introducing a property tax. The authorities noted that there are no plans at present to raise the MITR ceiling, but that the appetite for a property tax is limited, recalling the short-lived experience with a property tax on high-value homes between 1983 and 1996.

17. **The authorities agreed that further efforts are needed to improve value for money in the delivery of public services.** They noted the introduction of five-year capital envelopes and the recent publication of guidelines for the appraisal and management of capital expenditure proposals. While they acknowledged that multi-year envelopes for current spending would improve predictability and reduce the risk of procyclicality, they felt that the experience with capital envelopes should be assessed first. Staff also suggested extending the fiscal projections (currently only three years) to at least five years. Regarding construction projects, the authorities noted that they intended to increase competition at the tendering stage and improve contracting arrangements. In health services, they pointed to progress in the implementation of the government's reform plan launched in mid-2003, including the establishment of a single national entity to manage health services, the modernization of management planning, and the introduction of a plan indicating services to be delivered and the links between services and staffing.

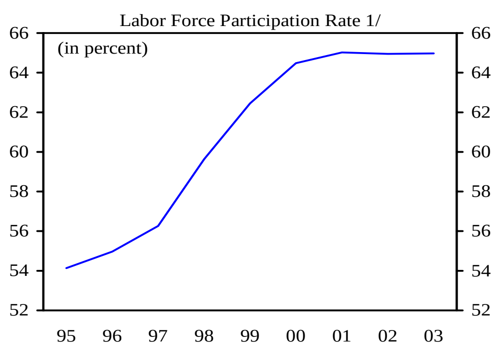
18. **The authorities disagreed with the staff's suggestion to automatically index tax credits and bands and social welfare payments to prices.** Staff argued that, because income tax credits and bands and their interaction with social welfare payments have important effects on work incentives, changes in their real burdens should be explicit policy decisions rather than an untransparent side effect of price inflation. Staff also observed that the current system gives rise to periodic, and thus lumpy, adjustments, which partly underlies the fiscal stimulus in 2005. The authorities responded that the lack of indexation provides important room for maneuver, which can be used for consolidation if necessary. They added that—for consistency—excise rates would also need to be automatically indexed. Staff recognized that the benefits of fiscal neutrality and reduced risk of procyclicality need to be weighed against the loss of fiscal discretion, but observed that most major industrial countries, including Canada, France, the U.K., and the U.S., have adopted automatic indexation to prices.

19. **Given pressures to raise spending and the softening of the SGP, staff saw a role for broader third-party assessment of fiscal policy, but the authorities were not convinced of the merits**. The authorities and staff agreed on the need to deepen public understanding of a number of fiscal issues, including the need to avoid fiscal procyclicality because it tends to exacerbate pressures on capacity when times are good and to deepen economic downturns; the desirability of building a fiscal cushion to prepare for risks over

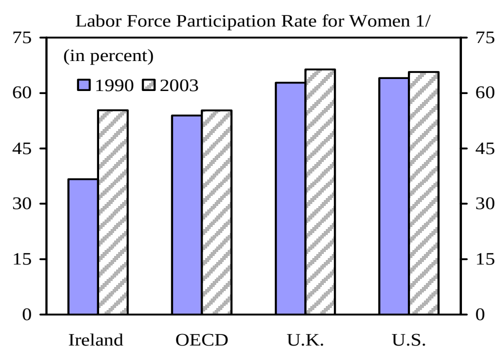
the medium term; and the need to maintain a strong underlying fiscal position so as to help Ireland face rising age-related spending over the long term. In staff's view, broader third-party assessments would enhance the public debate. This could be done by building on existing institutions, such as the National Economic and Social Council (which consists of the social partners and provides the background analysis for the national wage agreements), or by establishing a new body such as a fiscal council. The authorities agreed on the need to improve the focus of the public debate, noting the commitment in the 2005 Budget to expand parliamentary examination of existing budgetary material produced by the government. In their view, however, the key issue is not the lack of third-party assessment, observing that several academics and private analysts make their views known, but rather that the public debate tends to focus on specific budget measures instead of strategic issues. More generally, they doubted whether Ireland's budgetary performance points to the need for major institutional innovations, wondered whether fiscal councils in other countries have always been effective, and were concerned whether, at least in Ireland, a fiscal council would not end up providing a venue for special interests.

C. Labor Market and Wage Policy: Need for Wage Moderation

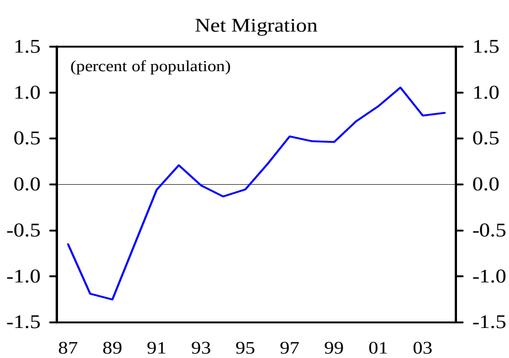
20. **Labor market flexibility in Ireland is relatively good**. Rapid employment growth since the early 1990s has been driven by rising labor force participation, including

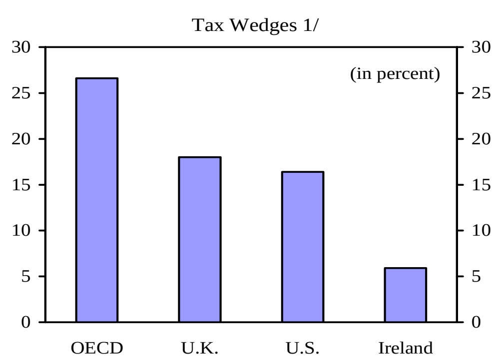


1/ Age 15-64.
Source: OECD.



1/ Age 15-64.
Source: OECD.

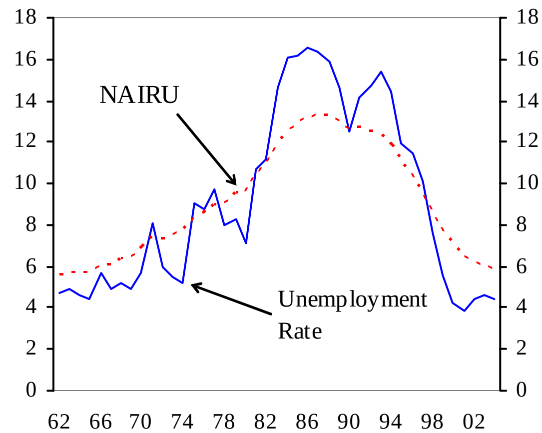




Source: OECD.
1/ Income tax plus employee and employer social security contributions less cash benefits as a percentage of labour costs.

by women, and immigration. The decline in the unemployment rate has reflected the rapid growth of aggregate demand and reforms of the tax and benefit systems (Box 3). The tax wedge is now one of the lowest among industrial countries. The authorities observed that Ireland has allowed immigrants from the new EU member states full access to the labor market, and that immigrants have played a key role in relieving labor shortages.

Box 3. What Explains the Fall in Unemployment?



The unemployment rate in Ireland declined from one of the highest to the lowest level in Europe over the past fifteen years. The improvement was broad-based: long- and short-term unemployment rates fell across age groups and education levels. Although estimates of the NAIRU are inherently uncertain, staff analysis finds that more than half of the fall in unemployment is structural.[1] Further analysis shows that the decline in the NAIRU is well explained by changes in labor market policies. Specifically, taxes on labor have been reduced to the lowest level in the OECD and the tax burden on the second earner in married couples has fallen, improving the incentives for work. In addition, the introduction of strict enforcement of eligibility for benefits, the reduction in effective net benefit replacement ratios, the adoption of a system of coordinated wage negotiations, and various active labor market policies have also contributed to the activation of the unemployed.

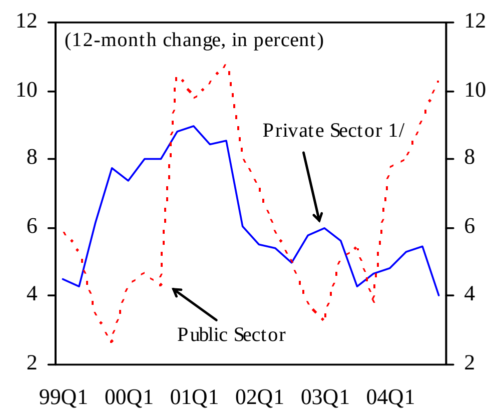
[1]Selected Issues Paper, *The Evolution of Unemployment in Ireland: The Role of Labor Market Policies.*

21. **However, with labor costs already high relative to euro area partners, the authorities and staff agreed that wage moderation is needed to preserve competitiveness going forward.** National wage agreements and public sector bench-marking exercises play important roles in the wage setting process. Regarding the national wage agreements, social partners (labor unions, employers, and the government) broadly concurred that the agreements have provided a useful vehicle for developing a common view of economic prospects, established sensible guidelines for wage increases while allowing considerable flexibility at the firm level, and preserved peaceful labor relations.

Going forward, the authorities observed that the next wage agreement (to cover 2006–08) would need to take account of lower expected inflation and lower projected productivity growth.

22. **The authorities were satisfied with the first public sector benchmarking exercise, but acknowledged that improvements are needed in the next one.** They noted that the first exercise succeeded in reducing the rigidity of pay relativities across the public sector and enhancing the delivery of public services. Looking ahead to the second exercise, beginning in the second half of 2005 and reporting in 2007, the authorities were of the view that there should be greater focus on recruitment and retention in pay determination, better valuation of pensions, and more emphasis on the flexibility of work practices, especially in education and health. To ensure public accountability, the authorities recognized the importance of making the exercise as transparent as possible, though they pointed to limits on the disclosure of confidential information. Staff noted the risk of spillovers from excessive public sector pay increases to the private sector.

Nominal Wage Growth



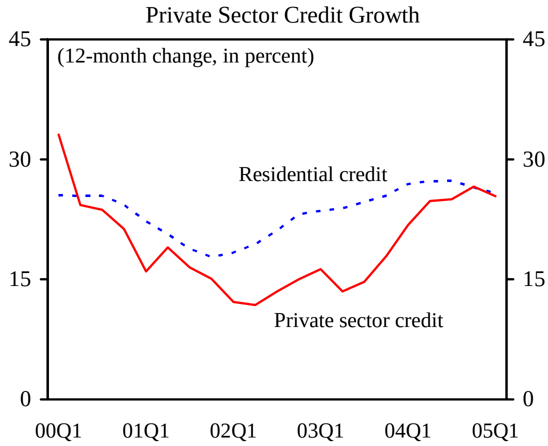
1/ Staff estimate.

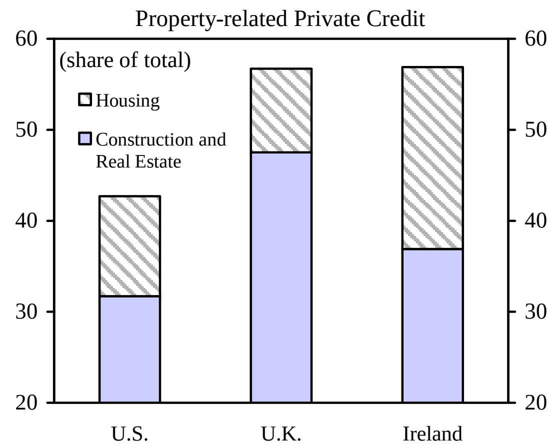
D. Financial Sector: Need for Continued Supervisory Efforts

23. **Banking system profitability and capitalization are strong, but vulnerabilities exist (Table 6)**. Credit growth—while slowing—remains high, property-related lending accounts for more than half of the stock of bank lending, and net interest margins have declined as reliance on more expensive wholesale funding has increased. Household debt has risen sharply and now exceeds 110 percent of disposable income. The authorities argued that efforts to increase awareness of risks—including the central bank's public warnings about the eventual rise in interest rates and the more recent roundtable discussions with heads of financial institutions organized by the central bank and financial regulator—have helped to cool the housing market. They said that a drop in house prices remains a possibility, but the banking system could withstand a considerable fall, as shown by the scenario analysis in the September 2004 *Financial Stability Report*. They added that only one tenth of households have debt service burdens greater than 23 percent of disposable income. The authorities observed that the international diversification of banks' assets is

Financial Indicators

	2001	2002	2003	2004
Bank Return on Equity	16.0	18.0	17.8	...
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.6	12.3	13.9	12.6
Non-performing loans (in percent of total loans)	1.03	0.97	0.93	0.82





increasing, but staff noted that much of this lending is also property-related. The central bank and financial regulator have established a financial stability committee, which recently conducted a crisis simulation exercise. The authorities noted that asset-covered securities provide relatively inexpensive funding for mortgage lenders.

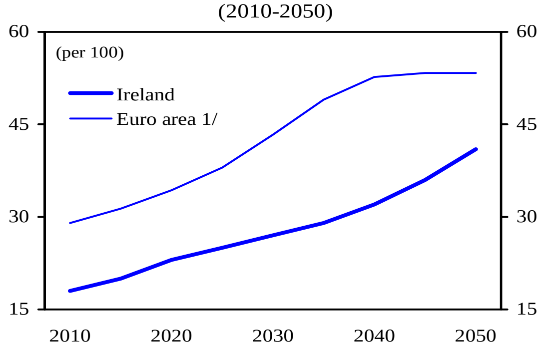
24. **Looking ahead, the authorities noted that the supervisory priorities are to implement Basel II and further strengthen stress-testing and credit standards.** Basel II requires establishing more risk-based capital requirements. The authorities were satisfied with the latest stress-testing exercise, but are considering further methodological improvements, such as incorporating second-round effects, increasing the variety of shocks, and enhancing the treatment of the realizability of collateral. A recent review of credit standards at major mortgage lenders found that—while standards are generally good—there is a need to tighten lending criteria and establish stricter guidelines for credit officers. In the insurance sector, the authorities are planning to introduce a supervisory regime for reinsurance companies in late 2005 or early 2006, in line with the EU Reinsurance Directive.

25. **The authorities agreed that there is room to further strengthen competition in the financial sector.** A recent report commissioned by the Competition Authority found obstacles to competition in personal current accounts and lending to small- and medium-sized enterprises. The authorities observed that the double stamp duty charge on switching financial cards has already been removed and that banks have recently agreed to a voluntary code of behavior on switching current accounts. This voluntary code is now being reviewed, as are other measures to increase competition. The authorities are reluctant to eliminate the legal requirement to notify fees on current accounts before they are satisfied that competition has been improved. In the non-life insurance sector, the authorities agreed that greater disclosure of information on claims histories by insurers would facilitate entry and said that they are now addressing practical issues, like the appropriate level of detail and the precise mechanism for disclosure.

E. Population Aging: How to Encourage Saving for Retirement?

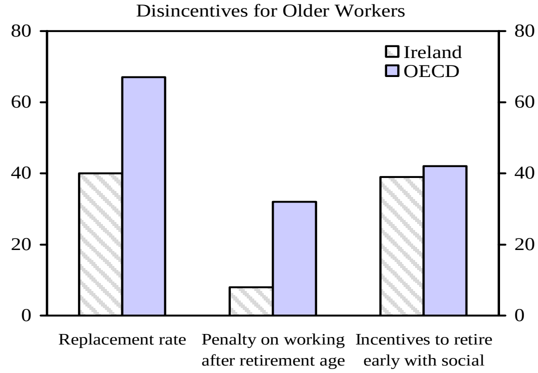
26. **Ireland has already made important progress in preparing for population aging**. The elderly dependency ratio will rise considerably over the coming half century, but the increase is back-loaded compared to the rest of the euro area. Incentives to keep older people in the workforce are relatively strong, so that the effective retirement age is one of the highest among advanced economies. The authorities noted that the pensionable age in the civil service has recently been increased and that provision of an old-age pension bonus for those who work beyond 65 is being considered. Staff suggested phasing out the Retirement Pension, which requires people to effectively stop working in order to be eligible.

Elderly Dependency Ratio
(2010-2050)



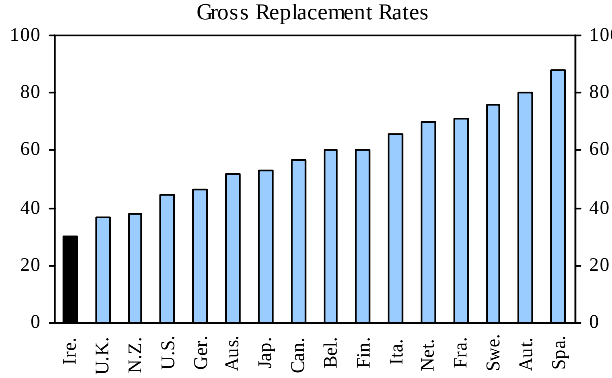
Source: U.N. World Population Prospects, The 2002 Revision.
1/ Average of France, Germany, Italy.

Disincentives for Older Workers



27. **The authorities expressed concern that households are on the whole not saving enough for retirement.** The state-funded old-age pension is relatively frugal compared to other industrial countries and provides a flat share of average earnings, which helps the elderly avoid poverty but does not provide an adequate replacement rate for the majority of workers. Private pensions cover only about half of those at work and many—especially defined-contribution schemes—provide only low replacement rates. Despite media campaigns to promote pension awareness and action, the authorities said that the take-up of Personal Retirement Saving Accounts (a tax-favored, flexible vehicle launched in 2002) has been disappointing. Overall, the Pensions Board cited estimates that, based on a desired average replacement rate of 65 percent and a number of other assumptions, the annual saving shortfall is about 5 percent of GNP. The saving shortfall is especially acute in the middle three quintiles of the income distribution. Staff observed that households at the peak of their life-cycle earnings have relatively low saving (Box 4).

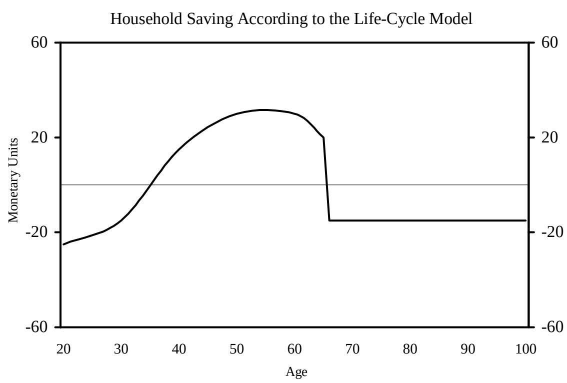
Gross Replacement Rates

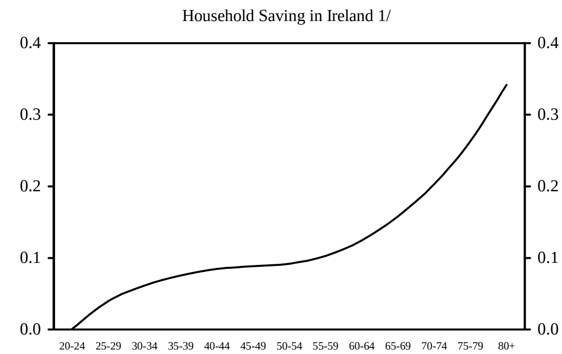


Source: OECD (2003)

Box 4. Who Saves in Ireland?

Given the relatively frugal state pension system in Ireland, an important question is whether households are saving enough for retirement. Using previously untapped microeconomic data from the Household Budget Surveys, staff analysis shows that households at the peak of their life-cycle earnings (aged 45–60) have surprisingly low saving rates compared to other cohorts, though staff find no evidence of a generational saving gap.[1] Moreover, young and poor households appear to save very little. The good news is that booming house prices do not seem to have reduced saving.





1/ Median household saving ratio by age adjusted to the national household saving rate.

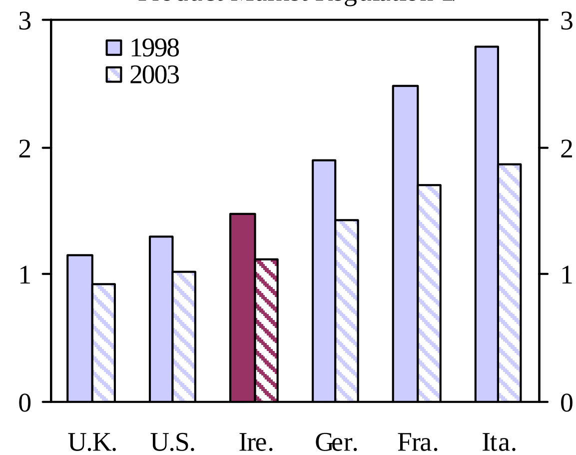
[1]Selected Issues Paper, *Who Saves in Ireland? The Micro Evidence.*

28. **Against this background, a National Pensions Review—due to be completed later this year—is examining policy options to raise household saving.** The authorities observed that there is no magic bullet: raising the state-funded old-age pension would involve considerable additional government spending and, hence, higher taxes; making additional (second pillar) saving mandatory could increase labor costs, imply a government guarantee, and lead to a race to the bottom in occupational pensions; and encouraging voluntary saving through greater tax incentives could be costly in terms of foregone revenue. Indeed, the favorable tax treatment of SSIAs has boosted saving in the form of SSIAs, but the effect on overall saving is not clear. Staff noted that automatic enrolment (with an opt-out clause) can be effective in raising voluntary saving, that the fiscal cost of tax incentives can be reduced by targeting them at lower- and middle-income workers, and that more effort could be devoted to improving financial education.

F. Other Issues

29. **While product market reform is well advanced, the authorities said that better regulation is needed in some sectors to stimulate competition**. Ireland compares well to other industrial countries on indicators of outward orientation, economic regulation, and administrative burden. However, officials at the Competition Authority said that better regulation is needed in retail and professional services. In the retail sector, the ban on below-cost selling is an obstacle to price competition, and entry is limited by planning regulations and the ban on large stores. In the legal profession, the educational monopolies should be abolished and new criteria established for entry by lawyers qualified outside of the EU; similarly, barriers to entry into the pharmacist profession should be removed.

Product Market Regulation 1/



1/ Index - a decline indicates a positive change in the regulatory environment.
Source: OECD.

30. **Statistics are being improved.** National accounts using chain-linked deflators and including financial intermediation services, a quarterly general government balance, and annual sectoral financial accounts will be published later this year. The next steps are to overhaul the earnings data and calculate a production-side estimate of GDP.

III. Staff Appraisal

31. **Economic performance in Ireland has been and continues to be impressive**. Notwithstanding the catch-up in income per capita that has occurred, real GNP growth over the coming five years is projected to remain the highest among industrial countries. The unemployment rate is one of the lowest among industrial countries. Inflation is about 2 percent. This impressive performance is due in significant measure to sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and social pacts that contribute to wage moderation.

32. **With the economy now in the neighborhood of full employment, continued rapid growth could give rise to wage pressures and further erode competitiveness.** The unemployment rate is not far from its historical low. Economic growth is likely to be very strong in the short term, driven by an acceleration in consumption and continued robust business investment, though—with the cooling of the housing market—residential investment is expected to decline modestly starting next year. While there are uncertainties

about the economy's supply potential, the rapid growth of aggregate demand could give rise to upward pressures on wages, which would undermine external competitiveness. The housing market is likely headed for a soft landing, but there is a risk of a sharp decline.

33. **The key priorities for fiscal policy are to help relieve potential overheating and to build a cushion in the event that downside risks materialize.** Public debt is low and fiscal positions have been generally prudent, but the 2005 budget is imparting considerable fiscal stimulus, which is adding to pressures on capacity constraints. Given that interest rates are set for the euro area as a whole and Ireland is relatively cyclically advanced, fiscal policy should help to forestall wage pressures. In the remainder of 2005, budget execution needs to remain prudent and any revenue windfalls should be fully saved; in 2006, underlying fiscal adjustment of ½ percent of GDP would be desirable. Fiscal restraint is also necessary from medium- and long-term perspectives. It is important to build a fiscal cushion when times are good, such as now, to be prepared in the event that downside risks materialize. If aggregate demand weakens unexpectedly and abruptly, automatic stabilizers should be allowed to operate fully and specific measures to prop up the housing market should be avoided.

34. **Regarding the composition of adjustment, the growth of current spending should be restrained and the tax base should be broadened.** There is a strong case for moderating the steep escalation in current spending, so as to limit the risk of inefficiencies. The tax base could usefully be broadened by limiting property-related capital allowances, preserving the nominal ceiling on mortgage interest tax relief, and introducing a property tax.

35. **Against the backdrop of spending restraint, further efforts are needed to improve value for money in the delivery of public services.** Five-year envelopes could be introduced for current spending and fiscal projections could be extended to five years. Government procurement practices could be improved further, and a focus on quantified performance targets in all areas of public services could help motivate efficiency gains. Separately, to improve fiscal neutrality and reduce the risk of procyclicality, it could be desirable to introduce automatic indexation of tax credits, bands and excise duties, and social welfare payments to developments in consumer prices.

36. **Development of mechanisms that build public awareness and understanding of the fiscal issues facing Ireland would be useful.** While the conduct of the fiscal policy in Ireland has been laudable over the years, pressures to raise spending are longstanding and could increase, and an enhanced public debate could help clarify both short- and longer term constraints and requirements.

37. **With labor costs already high, keeping wage growth in line with productivity growth is essential to maintaining competitiveness.** Given the slowdown in productivity growth and the entrenchment of low and stable inflation, there is a strong case for moderating overall wage increases under both the forthcoming national wage agreement and the next public sector benchmarking exercise. In addition, the wage agreement needs to preserve flexibility, given differential productivity developments across firms. The next

benchmarking exercise should avoid putting upward pressure on wages elsewhere in the economy, continue to promote verifiable modernization in the public sector, and be as transparent as possible.

38. **In the financial sector, continued efforts are needed to maintain financial stability.** While banking system profitability and capitalization are strong, vulnerabilities exist, and the authorities' efforts to increase awareness of risks are thus welcome. Looking ahead, continued supervisory efforts are essential to limit excessive risk-taking by lenders and borrowers: stress-testing could be enhanced and conducted more frequently, credit standards could be strengthened, and it is understood that an interim update on financial stability issues to complement the *Financial Stability Report i*s currently being planned.

39. **Given concerns that households are on the whole not saving enough for retirement, the authorities' further consideration of policy responses is welcome.** Beyond encouraging longer active participation in the labor force, the appropriate role of government in addressing inadequate household saving depends crucially on the tradeoff between the risk of forcing some people to save more than they wish and the risk of some people not saving enough and falling back on the government in the future. In general terms, the solution should be clearly sustainable over the long run and provide the right incentives to work and save.

40. **Strengthening competition in the domestic economy is crucial to maintaining strong productivity growth and external competitiveness.** In the banking system, codes of conduct to promote competition could usefully be extended, with the eventual objective of removing the regulation of certain fees. In the non-life insurance sector, greater disclosure of aggregate information on claims histories would be desirable. Better regulation is also needed in retail and professional services to stimulate competition and reduce prices.

41. **Timely and reliable statistics are essential to sound economic policymaking.** Work programs to improve earnings data and introduce a production-side estimate of GDP should be expedited.

42. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Ireland: Selected Economic Indicators
(Annual change unless otherwise stated)

	2001	2002	2003	2004	Proj. 2005	2006
National accounts (constant prices) 1/						
GNP	3.8	1.5	2.8	5.5	5.1	4.9
GDP	6.0	6.1	3.7	4.9	5.4	5.2
Domestic demand	3.8	3.4	3.3	4.0	4.6	4.9
Private consumption	5.5	2.8	2.6	3.2	4.5	5.7
Public consumption	10.9	8.6	2.5	2.9	4.5	2.9
Gross fixed investment	-1.6	3.0	3.4	9.2	4.3	4.0
Net exports (contribution to GDP growth)	2.8	3.1	1.2	2.3	1.7	1.3
Exports of goods and services	8.4	5.7	-0.8	4.4	5.6	5.2
Imports of goods and services	6.7	3.3	-2.3	2.7	5.0	5.0
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	4.0	4.7	4.0	2.3	2.3	2.5
Average hourly earnings , manufacturing	10.3	8.6	4.7	4.8	...	...
Output, manufacturing 2/	10.0	7.6	4.6	0.4	...	...
Unit wage costs (manufacturing) 2/	-2.6	-8.2	-4.1	0.2	...	...
GNP/employment	0.6	-0.3	0.9	2.4	3.0	3.2
Employment	3.1	1.8	1.9	3.0	2.0	1.6
Unemployment rate (in percent)	3.8	4.4	4.6	4.5	4.2	4.0
Money and credit (end-period)						
M3 3/ 4/	17.2	9.3 ...		22.5	16.8	...
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7	...
Financial and asset markets (end-period)						
Three-month treasury bill 6/	3.3	2.9	2.1	2.2	2.2	...
10-year government bond 6/	5.1	4.3	4.3	3.7	3.6	...
ISEQ index 4/	-0.3	-30.0	23.2	26.0	9.6	...
House prices (permanent tsb index/ESRI) 4/	4.4	13.3	13.7	8.6	6.5	...
Public finance (In percent of GDP)						
General government balance 7/	0.9	-0.4	0.2	1.3	-1.0	-0.5
Primary balance 7/	2.4	1.0	1.5	2.5	0.3	0.8
General government debt	35.9	32.7	32.1	29.6	29.6	29.2
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	15.0	16.6	15.4	15.6	15.0	15.1
Current account (Percent of GDP)	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2
Official reserves (In billions of SDRs, end-period.) 4/	4.5	4.0	2.8	1.9	1.7	...
Effective exchange rates (1995=100, annual average)						
Nominal 6/	89.2	90.7	96.7	99.7	99.4	...
Real (CPI based) 6/	94.4	98.9	106.8	110.2	109.6	...
Memorandum items for 2004:						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
GDP per capita (in SDRs)	31727.9					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and Fund staff calculations.

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multi
companies operating in Ireland.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the seri
4/ As of April 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companie
effects arising from exchange rate movements.
6/ As of March 2005.
7/ Excludes allocations for financing of future pensions liabilities and one-off expenditures.

Table 2. Ireland: Contributions to GDP Growth, 2001-06
(In percent) 1/

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
Domestic demand	3.2	2.9	2.7	3.3	3.7	4.0
Private consumption	2.8	1.4	1.3	1.5	2.1	2.7
Public consumption	1.4	1.1	0.3	0.4	0.6	0.4
Fixed investment	-0.3	0.6	0.7	1.8	0.9	0.8
Structures	0.5	0.6	0.6	0.9	0.4	0.3
Residential investment	0.3	0.3	0.8	0.7	0.1	-0.1
Equipment	-0.9	0.0	0.1	0.9	0.5	0.5
Change in stocks	-0.6	-0.2	0.4	-0.5	0.1	0.1
Net exports	2.8	3.1	1.2	2.3	1.7	1.3
Exports	9.0	6.2	-0.8	4.6	5.9	5.4
Imports	-6.1	-3.1	2.0	-2.3	-4.1	-4.1
Statistical discrepancy	-0.1	0.1	-0.2	-0.7	0.0	0.0
GDP (annual percent change)	6.0	6.1	3.7	4.9	5.4	5.2
GNP (annual percent change)	3.8	1.5	2.8	5.5	5.1	4.9
Memorandum item:						
Current account (as a percent of GDP)	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2

Source: Fund staff estimates.

1/ Rounding may effect totals.

Table 3. Ireland: Summary of Balance of Payments 2001-06

	2001	2002	2003	2004	Proj. 2005	2006
			(In billions of euro)			
Current account balance	-0.6	-1.6	-1.9	-0.6	-1.5	-2.0
Balance of goods and services	17.3	21.2	20.8	22.7	23.8	25.8
Goods balance	30.5	35.4	33.4	31.9	33.5	36.5
Exports of goods	86.7	89.5	79.2	79.4	83.6	89.5
Imports of goods	-56.2	-54.1	-45.8	-47.6	-50.0	-53.1
Services balance	-13.2	-14.3	-12.6	-9.1	-9.7	-10.6
Credit	27.0	30.2	33.6	37.9	38.7	40.2
Debit	-40.1	-44.5	-46.2	-47.0	-48.4	-50.8
Of which: Royalties						
Credit	0.2	0.3	0.2	0.2	...	...
Debit	-10.6	-11.7	-14.3	-14.3	...	...
Income balance	-18.3	-23.5	-23.1	-23.7	-26.2	-28.8
Credit	32.2	28.9	28.5	31.0	...	...
Debit	-50.5	-52.4	-51.6	-54.7	...	...
Current transfers (net)	0.3	0.7	0.4	0.3	0.9	0.9
Capital and financial account balance	0.4	1.1	3.0	4.8	...	...
Capital account balance	0.7	0.5	0.4	0.4	...	...
Financial account	-0.3	0.6	2.6	4.5	...	...
Direct investment	6.2	19.8	20.7	2.1	...	...
Portfolio investment	-25.2	-38.4	-49.1	-20.9	...	...
Other investment	19.0	18.8	29.3	22.0	...	...
Reserve assets	-0.4	0.3	1.8	1.2	...	...
Net errors and omissions	-0.3	-0.5	1.1	4.2	...	...
			(In percent of GDP)			
Memorandum items						
Current account balance	-0.6	-1.3	-1.4	-0.4	-1.0	-1.2
Balance on goods and services	15.0	16.6	15.4	15.6	15.0	15.1
Goods balance	26.4	27.7	24.8	21.8	21.2	21.3
Services balance	-11.4	-11.1	-9.4	-6.2	-6.1	-6.2
Income balance	-15.8	-18.4	-17.1	-16.2	-16.5	-16.8
Current transfers	0.3	0.6	0.3	0.2	0.6	0.6
Capital and financial account balance	0.3	0.9	2.2	3.3	...	...
Of which:						
Direct Investment	5.4	15.5	15.3	1.5	...	...
Portfolio Investment	-21.8	-30.0	-36.4	-14.3	...	...
Other Investment	16.5	14.7	21.7	15.0	...	...

Sources: The Central Statistics Office; and Fund staff estimates.

Table 4. Ireland: General Government Finances
(In percent of GDP)

	2000	2001	2002	2003	2004	2005 Proj.
Current balance	8.0	5.3	3.5	3.9	4.6	2.7
Current revenue, Of *which:*	34.6	32.7	31.7	32.8	33.7	33.2
Tax revenue (including taxes on capital)	26.9	25.0	24.1	25.0	25.8	25.4
Social security receipts	4.2	4.3	4.3	4.4	4.5	4.4
Miscellaneous	3.5	3.4	3.4	3.4	3.4	3.3
Current expenditure, Of *which:*	26.6	27.4	28.2	28.9	29.1	30.4
Interest payments	2.0	1.5	1.4	1.3	1.2	1.3
Goods and services	5.2	5.3	5.8	6.1	6.1	6.1
Compensation of employees	8.0	8.5	8.6	8.8	8.7	9.0
Current transfers	10.7	11.3	11.7	11.9	12.2	13.0
Depreciation	0.7	0.8	0.8	0.8	0.9	1.0
Current expenditure, excluding interest	24.6	25.9	26.8	27.6	27.9	29.1
Capital balance	-3.6	-4.4	-3.9	-3.7	-3.3	-3.8
Capital receipts (excluding taxes on capital)	1.1	1.0	1.1	1.1	1.1	1.0
Gross capital formation	3.7	4.3	4.2	3.9	3.6	3.9
Capital transfers	1.1	1.1	0.8	0.9	0.8	0.9
General government balance	4.4	0.9	-0.4	0.2	1.3	-1.0
Primary balance	6.4	2.4	1.0	1.5	2.5	0.3
Memorandum items:						
Structural (as a percent of potential GDP)						
Government balance (including one-off factors)	2.4	-0.5	-1.2	0.6	1.6	-1.0
Revenue 1/	35.6	33.7	32.8	33.9	34.8	34.2
Expenditure	33.2	34.2	34.0	33.3	33.2	35.2
Government balance (excluding one-off factors)	2.4	-0.5	-1.2	0.2	0.7	-0.5
Primary balance	4.4	1.0	0.1	1.9	2.8	0.3
General government gross debt (as percent of GDP)	38.3	35.9	32.7	32.1	29.6	29.6
Growth in nominal GDP	15.2	12.0	10.9	5.3	8.5	8.4

Sources: Department of Finance and Fund staff estimates.

1/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010
				(Staff Projections)				
Total revenue	33.9	34.8	34.2	33.8	33.7	33.7	33.7	33.7
Taxes and social security contributions	29.4	30.3	29.9	29.6	29.6	29.6	29.6	29.6
Other revenue	4.5	4.5	4.3	4.2	4.1	4.1	4.1	4.1
Contingency provision			0	0	0.0	0.0	0.0	0.0
Total expenditure	33.7	33.5	35.2	34.3	34.2	34.2	34.2	34.2
Primary expenditure, of which:	32.4	32.3	33.9	33.0	33.0	33.0	33.0	33.0
Gross fixed investment	3.9	3.6	3.9	3.8	3.8	3.8	3.8	3.8
Government consumption	15.7	15.7	16.1	15.9	15.9	15.9	15.9	15.9
Current transfers	11.9	12.2	13.0	12.3	12.3	12.3	12.3	12.3
Capital transfers	0.9	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Interest payments	1.3	1.2	1.3	1.3	1.2	1.2	1.2	1.2
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Budget balance	0.2	1.3	-1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Nominal GDP growth in percent	5.3	8.5	8.4	8.0	7.4	6.9	6.8	6.7
Gross debt	32.1	29.6	29.6	29.2	29.0	29.0	29.0	29.0
Structural budget balance, including one-offs 2/	0.6	1.6	-1.0	-0.7	-0.7	-0.5	-0.5	-0.5
Structural budget balance, excluding one-offs 2/	0.2	0.7	-0.5	-0.8	-0.8	-0.5	-0.5	-0.5
Output gap	-0.8	-0.5	0.0	0.7	0.4	0.0	0.0	0.0
				(Stability Program December 2004 Update)				
Total revenue	34.4	35.2	34.2	33.8	33.2	...	...	...
Total expenditure	34.3	34.3	35.0	34.5	33.8	...	...	...
Of which:								
Collective consumption	5.6	5.6	5.7	5.6	5.6	...	...	...
Individual consumption	10.3	10.4	10.5	10.4	10.2	...	...	...
Social transfers in kind	9.1	9.2	9.1	8.9	...	...	...	...
Social transfers other than in kind	9.0	9.5	9.4	9.3	9.2	...	...	...
Gross fixed investment	3.9	3.5	3.9	3.9	3.7	...	...	...
Interest payments	1.3	1.2	1.3	1.2	1.3	...	...	...
Subsidies	0.6	0.6	0.6	0.6	0.6	...	...	...
Other	3.7	3.6	3.6	3.4	3.2	...	...	...
General government balance	0.1	0.9	-0.8	-0.6	-0.6	...	...	...
Of which: due to contingency	...	...	...	0.4	0.8	...	...	...
Memorandum items:								
Nominal GDP growth in percent	5.3	8.3	8.5	8.1	8.1	...	...	...
Gross debt	32.1	30.5	30.1	30.1	30.0	...	...	...
Structural budget balance 2/	0.1	1.4	0.0	0.4	0.3	...	...	...
Output gap	-0.1	-1.1	-1.9	-2.4	-2.1	...	...	...

Sources: Fund staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2006–07, but are adjusted for the difference between the government's and staff's growth assumptions. From 2008 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2004 are based on the latest available official information, whereas projections for 2005–07 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Program.

2/ As a percent of potential GDP.

Table 6. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004
External indicators						
Exports (annual percent change, value in U.S. dollars)	12.2	10.1	9.6	10.8	13.0	14.5
Imports (annual percent change, value in U.S. dollars)	9.3	12.7	7.4	7.6	12.0	13.2
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5	-3.9
Current account balance	0.6	-0.1	-0.6	-1.3	-1.4	-0.4
Capital and financial account balance,	-1.8	9.3	0.3	0.9	2.2	3.3
Of which:						
Inward portfolio investment	71.2	81.4	86.0	58.3	69.2	74.8
Inward foreign direct investment	19.1	27.1	9.3	24.1	17.7	7.7
Other investment liabilities (net)	-1.1	-8.8	16.5	14.7	21.7	15.0
Total external debt 1/	2.8	2.0	1.8	0.6	0.0	0.0
Of which:						
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0	0.0
U.S. dollar per euro (period average)	1.1	0.9	0.9	0.9	1.1	1.2
U.K. £ per euro (period average)	0.7	0.6	0.6	0.6	0.7	0.7
Financial markets indicators						
General government debt	48.7	38.3	35.9	32.7	32.1	29.6
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3	3.7
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6	1.9
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2	26.0
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5	3.5
Financial sector risk indicators						
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9	26.6
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9	14.1
Personal lending as a share of total loans (excluding financial intermediation and government)	53.7	52.1	52.2	55.3	55.6	55.8
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	44.4	44.9
Other housing finance	0.9	1.0	0.9	0.8	0.4	0.3
Other personal lending	13.0	12.2	12.5	12.0	10.8	10.6
Annual mortgage credit growth rates	22.4	24.3	17.8	23.1	25.5	26.5
Commercial property lending as a percent of total loans (excluding financial intermediation) 2/	12.4	15.0	16.4	17.0	19.7	21.2
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5	29.4
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2	32.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7	662.0
Non-performing loans (in percent of total loans) 4/	1.0	1.0	1.0	1.0	0.9	0.8
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9	0.7
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9	12.6
Bank return on assets	1.3	1.2	0.9	1.0	0.9	...
Bank return on equity	23.0	22.0	16.0	18.0	17.8	...
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6	33.0
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2	40.0
Deposits to M3 ratio 5/ 6/	1.0	1.0	1.0	1.0	1.5	1.4
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 7/	1.3	1.4	1.4	1.4	1.5	1.6
vis-à-vis total 2/ 7/	1.5	1.5	1.6	1.5	1.6	1.7
Concentration ratios in the banking sector						
No. of banks accounting for 25 percent of total assets	3.0	3.0	3.0	3.0	2.0	2.0
No. of banks accounting for 75 percent of total assets	23.0	23.0	21.0	19.0	18.0	17.0
Share of state-owned banks in total assets	3.0	2.0	1.0	0.0	0.0	0.0
Share of foreign-owned banks in total assets	37.0	39.0	42.0	29.0	31.0	34.0

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and Fund staff estimates.
1/ Represents non-euro debt of the government sector.
2/ Includes lending for construction and real estate activities.
3/ Credit equivalent values.
4/ Owing to differences in classification, international comparisons of nonperforming loans are indicative only.
5/ Non-government deposits vis-à-vis Irish and nonresidents to M3 ratio.
6/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.
7/ Nongovernment loans/nongovernment deposits ratio.

Ireland: Fund Relations
(As of April 30, 2005)

I. **Membership Status**: Joined 8/08/57; Article VIII

II. **General Resources Account:**	**SDR Million**	**% Quota**
Quota	838.40	100.00
Fund holdings of currency	578.05	68.95
Reserve position in Fund	260.36	31.05
Holdings Exchange Rate		

III. **SDR Department:**	**SDR Million**	**% Allocation**
Net cumulative allocation	87.26	100.00
Holdings	58.45	66.99

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/Interest	0.53	0.72	0.72	0.73	0.72
Total	0.53	0.72	0.72	0.73	0.72

VII. **Exchange Arrangement**

As of January 1, 1999, the euro became the currency of Ireland and the irrevocably fixed conversion rate between the euro and the Irish pound is 0.787564. Ireland maintains an exchange system free of restrictions, other than those in accordance with UN Security Council resolutions and EU regulations. Those restrictions have been notified to the Fund under Decision 144—(52/51).

VIII. **Article IV Consultations**
The discussions for the last Article IV consultation were conducted in Dublin during July 8–20, 2004. The staff report (Country Report No. 04/348) was considered by the Executive Board on October 29, 2004 (EBM/04/102). Article IV consultations with Ireland are currently on the standard 12–month cycle.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Ireland: Statistical Issues

Data provision is adequate for surveillance. Ireland is subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank. It has also subscribed to the Fund's Special Data Dissemination Standard (SDDS).

1. The consumer price index is published monthly. The weights of the current index, December 2001=100, are based on the 1999–2000 Household Budget Survey and prices updated to December 2001. The weights are updated every 5 years. National accounts are based on constant 1995 prices, though there are plans to introduce chain-linking in 2005. Quarterly national accounts are currently published within 3 months of the reference period. Data on employment, earnings, unit wage costs, and national income and expenditure are available with a 3–7 month lag, but some non-SDDS series—such as household disposable income—are published with longer lags. There are plans to introduce sectoral balance sheet data in 2005. Ireland does not have an overall earnings index, but there are plans to extend the scope and consistency of earnings data.

2. There are plans to start publishing a quarterly general government balance in 2005.

3. Quarterly balance of payments data are in line with the *Balance of Payments Manual*, 5th edition (BPM5), although the historical data start only in 1998. Some discrepancies exist between exports and imports data from the national accounts and the balance of payments. Data are compiled by the Central Statistics Office and are based on statistical surveys combined with administrative data. These data are closely integrated with the compilation of national accounts. An integrated computer data processing system was introduced in late 2001. The system provides a powerful prepublication analytical tool.

Ireland: Table of Common Indicators Required for Surveillance
(as of June 6, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	6/6/05	6/6/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2005	5/31/05	M	M	M
Reserve/Base Money	Apr 2005	5/31/05	M	M	M
Broad Money	Apr 2005	5/31/05	M	M	M
Central Bank Balance Sheet	Apr 2005	5/31/05	M	M	M
Consolidated Balance Sheet of the Banking System	Apr 2005	5/31/05	M	M	M
Interest Rates[2]	6/6/05	6/6/05	D	D	D
Consumer Price Index	Apr 2005	5/12/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	3/3/2005	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	May 2005	6/2/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2005 Q1	5/4/2005	Q	Q	Q
External Current Account Balance	Q4, 2004	3/24/05	Q	Q	Q
Exports and Imports of Goods and Services	Q4, 2004	3/24/05	Q	Q	Q
GDP/GNP	Q4, 2004	3/31/05	Q	Q	Q
Gross External Debt	Q4 2004	3/31/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

INTERNATIONAL MONETARY FUND

IRELAND

Staff Report for the 2005 Article IV Consultation

Supplementary Information

Prepared by the European Department

Approved by Alessandro Leipold and Michael Hadjimichael

September 30, 2005

1. This supplement reports on recent developments since the staff report was issued.[1] These developments support the thrust of the staff appraisal. In particular, with the economy now in the neighborhood of full employment, continued rapid growth of domestic demand could give rise to wage pressures and further erode competitiveness. Against this background, the key policy priorities remain fiscal restraint, to help relieve potential overheating and to build a cushion in the event that downside risks materialize; wage moderation, to keep wage growth in line with productivity growth; and continued efforts to maintain financial stability.

2. **Revisions to national accounts data for 1995–2004 do not alter the general pattern of economic growth in recent years**. The new data incorporate two methodological improvements: chain-linked deflators and a better measure of financial intermediation services. Average annual real GDP and real GNP growth rates over the period as a whole are virtually unchanged, though growth was slightly weaker during the late 1990s boom and slightly stronger during the downturn of 2001–03. Real GDP growth in 2004 was revised down to 4½ percent, reflecting a lower contribution from net exports, and a reduction in net factor income cut real GNP growth to 4 percent.

3. **Domestic demand growth was very strong in the first half of 2005, as anticipated in the staff report**. Private consumption grew by about 5 percent year-on-year, supported by rapid employment and income growth, and machinery and equipment investment increased by over 25 percent, reflecting in part purchases of aircraft. However, net exports subtracted about 2 percentage points from GDP growth, reflecting in part a slowdown in partner-country growth. House price increases continued to slow, consistent with a soft landing for the housing market, though private sector credit growth remained very high. Employment and the labor force grew by about 5 percent year-on-year in the second quarter, reflecting

[1] The attachment contains updated staff report tables and background section of the PIN.

increases in the working age population—due in part to large net immigration—and in labor force participation, and the unemployment rate fell slightly over the year to 4¼ percent. Despite higher oil prices, HICP inflation was steady at about 2 percent, in line with the euro area average.

4. **While the short-term growth forecast has been revised down, the economic outlook remains strong.** The real GNP growth projection for 2005 has been marked down by 0.6 percentage points to 4½ percent, reflecting mainly the soft patch in exports in the first half. Going forward, higher oil prices are expected to dampen household disposable incomes and corporate profitability, though the strength of consumption and business investment in the first half of the year have resulted in an upward revision to domestic demand for the year as a whole. The staff's new forecast is somewhat below the Department of Finance's projection of 5 percent. In 2006, domestic demand is expected to ease slightly, reflecting in part higher oil prices, and the contribution from net exports to rise slightly, as export growth returns to trend.

5. **Recent fiscal developments are consistent with a projected general government deficit of about 1 percent of GDP in 2005.** As expected, revenue has continued to exceed the budget profile, reflecting in particular VAT and excise receipts, stamp duties, and collections from revenue investigations. Though expenditure has been slightly lower than projected, staff assume that it will be in line with the budget for the year as a whole. Staff's projection is similar to the Department of Finance's revised forecast, published in September.

Table 1. Ireland: Selected Economic Indicators
(Annual change unless otherwise stated)

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
National accounts (constant prices) 1/						
GNP	3.9	2.7	5.1	4.0	4.5	4.9
GDP	6.2	6.1	4.4	4.5	4.5	4.9
Domestic demand	3.9	4.3	4.6	4.3	5.7	4.7
Private consumption	5.6	3.5	3.4	3.8	4.8	5.6
Public consumption	10.6	7.4	3.5	2.4	4.1	2.9
Gross fixed investment	-0.2	3.7	5.6	8.0	8.4	3.7
Net exports (contribution to GDP growth)	2.6	2.2	1.7	0.8	-0.3	0.8
Exports of goods and services	9.3	4.0	0.8	7.0	2.5	5.1
Imports of goods and services	7.3	1.8	-1.4	7.6	3.5	5.0
Prices, wages and employment						
Harmonized Index of Consumer Prices (annual average)	4.0	4.7	4.0	2.3	2.3	2.5
Average hourly earnings , manufacturing	10.3	8.6	4.7	4.5	...	...
Output, manufacturing 2/	10.0	7.6	4.6	0.4	...	...
Unit wage costs (manufacturing) 2/	-2.6	-8.2	-4.1	0.2	...	...
GNP/employment	0.8	0.9	3.2	1.0	1.8	3.2
Employment	3.1	1.8	1.9	3.0	2.6	1.7
Unemployment rate (in percent)	3.9	4.4	4.7	4.5	4.2	4.0
Money and credit (end-period)						
M3 3/ 4/	17.2	9.3	...	22.5	17.7	...
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7	...
Financial and asset markets (end-period)						
Three-month treasury bill 4/	3.3	2.9	2.1	2.2	2.1	...
10-year government bond 4/	5.1	4.3	4.3	3.7	3.2	...
ISEQ index 4/	-0.3	-30.0	23.2	26.0	26.3	...
House prices (permanent tsb index/ESRI) 4/	4.4	13.3	13.7	8.6	6.2	...
Public finance (In percent of GDP)						
General government balance 6/	0.8	-0.4	0.2	1.4	-1.1	-0.7
Primary balance 6/	2.3	0.9	1.4	2.6	0.1	0.6
General government debt	35.4	32.1	31.1	29.0	29.4	29.3
External trade and balance of payments						
Balance of goods and services (Percent of GDP)	14.7	16.6	15.5	14.9	13.5	13.2
Current account (Percent of GDP)	-0.6	-1.0	0.0	-0.8	-1.9	-2.2
Official reserves (In billions of SDRs, end-period.) 4/	4.5	4.0	2.8	1.9	1.8	...
Effective exchange rates (1995=100, annual average)						
Nominal 7/	89.2	90.7	96.7	99.7	96.8	...
Real (CPI based) 7/	94.4	98.9	106.8	110.2	106.8	...
Memorandum items for 2004:						
Area	70.3 thousand square kilometers					
Population (in million)	4.0					
GDP per capita (in SDRs)	31,728					

Sources: Department of Finance; Central Bank of Ireland; IMF, International Financial Statistics; and Fund staff calculations.

1/ Based on National Income and Expenditure, compiled in accordance with the new European System of National Accounts (ESA 95).
2/ Underlying productivity growth data may be overstated because of problems related to the measurement of output produced by multinational companies operating in Ireland.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.
4/ As of July 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank international financial companies and valuation effects arising from exchange rate movements.
6/ Excludes allocations for financing of future pensions liabilities and one-off expenditures.
7/ As of June 2005.

Table 2. Ireland: Contributions to GDP Growth, 2001-06
(In percent) 1/

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
Domestic demand	3.4	3.7	3.9	3.6	4.8	4.0
Private consumption	2.7	1.7	1.6	1.8	2.2	2.6
Public consumption	1.4	1.0	0.5	0.3	0.5	0.4
Fixed investment	-0.1	0.9	1.3	1.8	2.0	0.9
Structures	0.8	0.9	1.3	1.5	0.9	0.2
Residential investment	0.6	0.5	1.3	1.3	0.3	-0.2
Equipment	-0.6	0.1	0.1	0.3	1.1	0.7
Change in stocks	-0.6	0.1	0.5	-0.3	0.0	0.1
Net exports	2.6	2.2	1.7	0.8	-0.3	0.8
Exports	8.0	3.6	0.7	5.9	2.2	4.3
Imports	-5.4	-1.4	1.0	-5.1	-2.4	-3.4
Statistical discrepancy	0.2	0.2	-1.1	0.1	0.0	0.0
GDP (annual percent change)	6.2	6.1	4.4	4.5	4.5	4.9
GNP (annual percent change)	3.9	2.7	5.1	4.0	4.5	4.9
Memorandum item						
Current account (as a percent of GDP)	-0.6	-1.0	0.0	-0.8	-1.9	-2.2

Source: Fund staff estimates.

1/ Rounding may effect totals.

Table 3. Ireland: Summary of Balance of Payments 2001-06

	2001	2002	2003	2004	Proj. 2005	Proj. 2006
			(In billions of euro)			
Current account balance	-0.8	-1.3	0.0	-1.2	-3.1	-3.7
Balance of goods and services	17.2	21.7	21.5	22.1	21.6	22.8
Goods balance	30.5	35.4	32.6	31.8	32.2	34.6
Exports of goods	86.7	89.5	78.3	80.2	85.7	92.1
Imports of goods	-56.2	-54.1	-45.7	-48.4	-53.5	-57.4
Services balance	-13.3	-13.8	-11.1	-9.7	-10.6	-11.8
Credit	28.6	31.6	37.1	42.2	45.1	48.0
Debit	-41.8	-45.4	-48.2	-51.9	-55.7	-59.8
Of which: Royalties						
Credit	0.2	0.3	0.2	0.2	...	...
Debit	-10.6	-11.7	-14.3	-14.3	...	...
Income balance	-18.3	-23.7	-21.9	-23.6	-25.2	-27.1
Credit	32.2	28.8	30.1	33.8	...	...
Debit	-50.5	-52.4	-52.1	-57.4	...	...
Current transfers (net)	0.3	0.7	0.4	0.3	0.6	0.6
Capital and financial account balance	0.4	1.6	-1.3	4.7	...	...
Capital account balance	0.7	0.5	0.1	0.4	...	...
Financial account	-0.3	1.1	-1.4	4.3	...	...
Direct investment	6.2	19.4	15.3	-3.6	...	...
Portfolio investment	-25.2	-38.0	-40.0	-7.0	...	...
Other investment	19.0	19.3	21.6	13.7	...	...
Reserve assets	-0.4	0.3	1.8	1.2	...	...
Net errors and omissions	-0.4	0.3	-1.3	3.5	...	...
			(In percent of GDP)			
Memorandum items						
Current account balance	-0.6	-1.0	0.0	-0.8	-1.9	-2.2
Balance on goods and services	14.7	16.6	15.5	14.9	13.5	13.2
Goods balance	26.0	27.2	23.4	21.4	20.2	20.1
Services balance	-11.3	-10.6	-8.0	-6.5	-6.7	-6.9
Income balance	-15.6	-18.1	-15.8	-15.9	-15.8	-15.8
Current transfers	0.3	0.5	0.3	0.2	0.4	0.4
Capital and financial account balance	0.3	1.2	-0.9	3.2	...	...
Of which:						
Direct Investment	5.3	14.9	11.0	-2.4	...	...
Portfolio Investment	-21.5	-29.1	-28.7	-4.7	...	...
Other Investment	16.3	14.8	15.5	9.2	...	...

Sources: The Central Statistics Office; and Fund staff estimates.

Table 4. Ireland: General Government Finances
(In percent of GDP)

	2000	2001	2002	2003	2004	2005 Proj.
Current balance	7.9	5.1	3.4	3.7	4.7	2.8
Current revenue, *of which:*	34.2	32.3	31.1	31.7	33.1	32.9
Tax revenue (including taxes on capital)	26.6	24.6	23.6	24.2	25.4	25.2
Social security receipts	4.2	4.3	4.2	4.2	4.4	4.4
Miscellaneous	3.4	3.4	3.3	3.3	3.3	3.3
Current expenditure, *of which:*	26.3	27.2	27.7	28.0	28.5	30.1
Interest payments	2.0	1.5	1.3	1.2	1.2	1.3
Goods and services	5.1	5.2	5.4	5.3	5.9	5.9
Compensation of employees	7.9	8.4	8.6	9.0	8.7	9.1
Current transfers	10.6	11.3	11.6	11.8	12.0	12.9
Depreciation	0.7	0.7	0.8	0.8	0.8	0.9
Current expenditure, excluding interest	24.3	25.7	26.4	26.8	27.3	28.8
Capital balance	-3.6	-4.4	-3.8	-3.6	-3.2	-3.9
Capital receipts (excluding taxes on capital)	1.1	1.0	1.1	1.1	1.1	1.1
Gross capital formation	3.6	4.2	4.2	3.8	3.6	3.9
Capital transfers	1.1	1.2	0.8	0.9	0.8	1.1
General government balance	4.3	0.8	-0.4	0.2	1.4	-1.1
Primary balance	6.3	2.3	0.9	1.4	2.6	0.1
Memorandum items						
Structural (as a percent of potential GDP)						
Government balance (including one-off factors)	2.6	-0.5	-1.2	0.4	1.7	-1.1
Revenue 1/	35.2	33.2	32.2	32.9	34.3	34.0
Expenditure	32.6	33.7	33.4	32.5	32.6	35.1
Government balance (excluding one-off factors)	2.6	-0.5	-1.2	0.0	0.8	-0.6
Primary balance	4.6	1.0	0.2	1.6	2.9	0.2
General government gross debt (as percent of GDP)	37.8	35.4	32.1	31.1	29.0	29.4
Growth in nominal GDP	15.2	12.2	11.4	6.6	6.8	7.5

Sources: Department of Finance and staff estimates.

1/ Revenues in 2002 exclude UMTS receipts of 0.2 percent of GDP.

Table 5. Ireland: Medium-Term General Government Finances 1/
(As a percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010
				(Staff Projections)				
Total revenue	32.9	34.3	34.0	33.6	33.4	33.4	33.4	33.4
Taxes and social security contributions	28.5	29.8	29.6	29.4	29.3	29.3	29.3	29.4
Other revenue	4.4	4.5	4.3	4.2	4.0	4.0	4.0	4.0
Contingency provision			0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	32.7	32.9	35.1	34.3	34.2	34.2	34.2	34.2
Primary expenditure, of which:	31.5	31.7	33.8	33.0	33.0	33.0	33.0	33.0
Gross fixed investment	3.8	3.6	3.9	3.8	3.8	3.8	3.8	3.8
Government consumption	15.0	15.3	15.9	15.8	15.8	15.8	15.8	15.8
Current transfers	11.8	12.0	12.9	12.3	12.2	12.2	12.2	12.2
Capital transfers	0.9	0.8	1.1	1.1	1.1	1.1	1.1	1.1
Interest payments	1.2	1.2	1.3	1.3	1.2	1.2	1.2	1.2
Budget balance	0.2	1.4	-1.1	-0.7	-0.8	-0.8	-0.8	-0.8
Memorandum items								
Nominal GDP growth in percent	6.6	6.8	7.5	7.7	7.4	7.2	7.0	6.9
Gross debt	31.1	29.0	29.4	29.3	29.4	29.6	29.7	29.9
Structural budget balance, including one-offs 2/	0.4	1.7	-1.1	-0.8	-0.9	-0.8	-0.8	-0.8
Structural budget balance, excluding one-offs 2/	0.0	0.8	-0.6	-0.9	-1.0	-0.8	-0.8	-0.8
Output gap	-0.3	-0.5	0.0	0.4	0.2	0.0	0.0	0.0
				(Stability Program December 2004 Update)				
Total revenue	34.4	35.2	34.2	33.8	33.2	...	...	...
Total expenditure	34.3	34.3	35.0	34.5	33.8	...	...	...
of which:								
Collective consumption	5.6	5.6	5.7	5.6	5.6	...	...	...
Individual consumption	10.3	10.4	10.5	10.4	10.2	...	...	...
Social transfers other than in kind	9.0	9.5	9.4	9.3	9.2	...	...	...
Gross fixed investment	3.9	3.5	3.9	3.9	3.7	...	...	...
Interest payments	1.3	1.2	1.3	1.2	1.3	...	...	...
Subsidies	0.6	0.6	0.6	0.6	0.6	...	...	...
Other	3.7	3.6	3.6	3.4	3.2	...	...	...
General government balance	0.1	0.9	-0.8	-0.6	-0.6	...	...	...
of which due to contingency	...	...		0.4	0.8	...	...	...
Memorandum:								
Nominal GDP growth in percent	5.3	8.3	8.5	8.1	8.1	...	...	...
Gross debt	32.1	30.5	30.1	30.1	30.0	...	...	...
Structural budget balance 2/	0.1	1.4	0.0	0.4	0.3	...	...	...
Output gap	-0.1	-1.1	-1.9	-2.4	-2.1	...	...	...

Sources: Staff estimates and Department of Finance

1/ Based on current policies. The staff estimates assume that tax revenues will perform according to the latest SP projections in 2006–07, but are adjusted for the difference between the government's and staff's growth assumptions. From 2008 onwards, tax revenues (excluding indirect taxes) are projected using the OECD's estimates of tax elasticities. Expenditure estimates for 2005 are based on the latest available official information, whereas projections for 2006–07 assume expenditure to increase at the pace envisaged in the SP (except for interest rate expenditure). Due to different accounting conventions, the staff's estimates of total revenue and expenditure ratios differ from the Stability Programme.
2/ As a percent of potential GDP.

Table 6. Ireland: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004
External indicators						
Exports (annual percent change, value in U.S. dollars)	12.5	10.5	10.1	10.5	14.3	16.7
Imports (annual percent change, value in U.S. dollars)	9.7	13.0	7.9	6.7	13.3	17.5
Terms of trade (goods, annual percent change)	-2.5	-3.1	2.0	2.0	-0.5	-1.4
Current account balance	0.2	-0.4	-0.6	-1.0	0.0	-0.8
Capital and financial account balance,	-1.8	9.2	0.3	1.2	-0.9	3.2
Of which:						
Inward portfolio investment	70.3	80.4	84.8	57.6	75.3	85.6
Inward foreign direct investment	18.9	26.8	9.2	23.9	14.5	6.2
Other investment liabilities (net)	-1.1	-8.7	16.3	14.8	15.5	9.2
Total external debt 1/	2.8	2.0	1.8	0.6	0.0	0.0
Of which:						
External debt to exports ratio	4.0	2.6	2.4	0.8	0.0	0.0
External interest payments to exports (in percent)	0.3	0.2	0.1	0.2	0.0	0.0
U.S. dollar per euro (period average)	1.07	0.92	0.89	0.94	1.13	1.24
U.K. £ per euro (period average)	0.66	0.61	0.62	0.63	0.69	0.68
Financial markets indicators						
General government debt	48.1	37.8	35.4	32.1	31.1	29.0
Government bond yield (10-year, end-period)	5.6	5.1	5.1	4.3	4.3	3.7
Spread of government bond yield with Germany (end of period)	0.6	0.2	0.6	0.2	0.3	0.3
Real government bond yield (10-year, period average, based on national CPI)	3.1	-0.1	0.1	0.3	0.6	1.9
Annual change in ISEQ index (in percent, end of period)	0.4	14.1	-0.3	-30.0	23.2	26.0
Personal lending interest rate	10.5	11.8	10.6	10.4	9.9	9.9
Variable mortgage interest rate	4.2	6.0	4.6	4.2	3.5	3.5
Financial sector risk indicators						
Annual credit growth rates (to private sector)	21.3	21.3	15.1	15.0	17.9	26.6
Annual deposit growth rates	8.1	15.6	15.6	9.6	11.9	14.1
Personal lending as a share of total loans	53.7	52.1	52.2	55.3	55.6	55.8
(excluding financial intermediation and government)						
Of which:						
House mortgage finance	39.7	39.0	38.8	42.4	44.4	44.9
Other housing finance	0.9	1.0	0.9	0.8	0.4	0.3
Other personal lending	13.0	12.2	12.5	12.0	10.8	10.6
Annual mortgage credit growth rates	22.4	24.3	17.8	23.1	25.5	26.5
Commercial property lending as a percent of total loans						
(excluding financial intermediation) 2/	12.4	15.0	16.4	17.0	19.7	21.2
Foreign-currency denominated assets (in percent of total assets)	41.0	41.5	44.6	40.1	32.5	29.4
Foreign-currency denominated liabilities (in percent of total liabilities)	42.8	44.4	47.4	42.9	34.2	32.2
Contingent and off-balance sheet accounts (in percent of total assets) 3/	400.5	465.1	591.8	505.2	537.7	662
Non-performing loans (in percent of total loans) 4/	0.98	1.03	1.03	0.97	0.93	0.82
Total provisions for loan losses (in percent of total loans)	1.1	1.1	1.1	1.1	0.9	0.7
Risk-weighted capital/asset ratios of domestic banks (in percent)	10.8	10.7	10.6	12.3	13.9	12.6
Bank return on assets	1.3	1.2	0.9	1.0	0.9	1.0
Bank return on equity	23.0	22.0	16.0	18.0	17.8	20.7
Liquid assets of all banks to total assets (liquid asset ratio)	32.0	32.0	30.0	30.0	33.6	33.0
Liquid assets of all banks to short-term liabilities (in percent)	39.0	44.0	37.0	34.0	41.2	40.0
Deposits to M3 ratio 5/ 6/	1.03	1.03	1.02	1.02	1.46	1.36
Loan-to-deposit ratio vis-à-vis Irish residents 2/ 7/	1.29	1.36	1.44	1.43	1.46	1.61
vis-à-vis total 2/ 7/	1.47	1.54	1.59	1.51	1.56	1.70
Concentration ratios in the banking sector						
No. of banks accounting for 25 percent of total assets	3	3	3	3	2	2
No. of banks accounting for 75 percent of total assets	23	23	21	19	18	17
Share of state-owned banks in total assets	3	2	1	0	0	0
Share of foreign-owned banks in total assets	37	39	42	29	31	34

Sources: Data provided by the authorities; Central Bank of Ireland; International Financial Statistics; Bloomberg; and Fund staff estimates.

1/ Represents non-euro debt of the government sector.

2/ Includes lending for construction and real estate activities.

3/ Credit equivalent values.

4/ Owing to differences in classification, international comparisons of nonperforming loans are indicative only.

5/ Non-government deposits vis-à-vis Irish and nonresidents to M3 ratio.

6/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.

7/ Nongovernment loans/nongovernment deposits ratio.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Ireland

On October 5, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Ireland.[1]

Background

Macroeconomic performance in Ireland was extraordinary during the 1990s and has remained impressive in recent years, due in significant measure to good policies. Real GNP growth averaged 4½ percent in 2003–04, reflecting strong domestic demand and healthy net exports. Rapid employment growth was supported by sizable immigration. With the appreciation of the euro since 2002, HICP inflation has fallen to about 2¼ percent. House price appreciation has continued to slow gradually, but house prices remain high on various measures.

Ireland's public finances are strong, but fiscal policy has been procyclical in recent years. Gross public debt is about 30 percent of GDP, among the lowest in the EU; taxes on labor and business income are relatively low; and the general government fiscal position has been either close to balance or in surplus since 1996. However, fiscal policy was expansionary during 2001–02, when economic activity was somewhat higher than potential, and contractionary during 2003–04, when the output gap was negative. The 2005 budget implies considerable fiscal stimulus, at a time when the economy is widely regarded as being close to full employment.

Labor market flexibility is Ireland is good, as reflected in rapid employment growth and low unemployment. This is largely due to reforms of the tax and benefit systems, which has produced one of the lowest tax wedges among industrial countries. However, labor costs are

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

high compared to euro area partners. National wage agreements and public sector benchmarking exercises play important roles in the wage setting process.

Banking system profitability and capitalization are strong, and nonperforming loans are low. However, vulnerabilities exist: credit growth—while slowing—remains high, property-related lending accounts for more than half of the stock of bank lending, and net interest margins have declined as reliance on more expensive wholesale funding has increased. Household debt has risen sharply and amounted to 120 percent of disposable income at end-2004.

The elderly dependency ratio in Ireland will rise considerably over the coming half century, though the increase is back-loaded compared to the rest of the euro area. Incentives to keep older people in the workforce are relatively strong, so that the effective retirement age is one of the highest among industrial countries. The state-funded old-age pension provides a flat share of average earnings, which helps the elderly avoid poverty but provides only a low replacement rate for the majority of workers.

Executive Board Assessment

The Executive Directors commended Ireland's continued impressive economic performance, the result of sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and wage moderation. Directors welcomed the authorities' intention to keep these policies in place, allowing Ireland to maintain its competitiveness and sustain its remarkable performance going forward.

Directors expected economic growth to be strong in the short term, driven by an acceleration of consumption and continued robust business investment, though—with the gradual cooling of the housing market—residential investment will likely decline modestly starting next year. The main risks to the outlook are a further rise in oil prices, an abrupt slowdown in global growth, and a sharp decline in the housing market. While acknowledging uncertainties about supply potential, Directors viewed the economy as now being close to full employment. With inflation projected to rise next year, rapid growth of aggregate demand could give rise to wage pressures, which would undermine external competitiveness, especially as labor costs are already high.

Directors welcomed Ireland's low level of public debt and generally prudent fiscal policy. However, they noted that the 2005 budget is imparting considerable fiscal stimulus, adding to cyclical pressures. With euro area monetary policy very accommodative from Ireland's perspective, fiscal policy needs to help relieve potential overheating. Directors called for prudent budget execution and saving any revenue windfalls in the remainder of 2005, and for underlying fiscal tightening in 2006, in line with the authorities' medium-term fiscal objective of close to balance or surplus. In addition, Directors underscored the importance of building a fiscal cushion in good times, such as now, in the event that downside risks materialize. If aggregate demand were to weaken abruptly, Directors agreed that automatic stabilizers should be allowed to operate fully and that specific measures to prop up the housing market should be avoided.

Regarding the composition of fiscal adjustment, Directors recommended that the growth of current spending be restrained and that the tax base be broadened. Moderating the steep escalation in current spending would limit the risk of inefficiencies. The tax base could be broadened by limiting property-related capital allowances, preserving the nominal ceiling on mortgage interest tax relief, and introducing a property tax.

Directors supported the authorities' objective of improving value for money in the delivery of public services. They suggested that five-year envelopes could be introduced for current spending, that fiscal projections could be extended to five years, that government procurement practices could be strengthened further, and that a focus on quantified performance targets could help motivate efficiency gains. Separately, Directors noted that—to improve fiscal neutrality and reduce the risk of procyclical fiscal policy—it could be desirable to introduce automatic indexation of tax credits and bands, excise duties, and social welfare payments to developments in consumer prices.

While the conduct of fiscal policy in Ireland has been laudable over the years, Directors shared the authorities' view that it would be useful to deepen public understanding of fiscal issues. As pressures to raise spending are longstanding and could increase, an enhanced public debate could help clarify both short- and longer term constraints and requirements. However, many Directors did not see a case in Ireland's circumstances for the creation of a fiscal council to provide third-party assessments.

Directors commended the openness and flexibility of Ireland's labor market, and the low labor tax wedge, which have enabled Ireland to benefit from enhanced intra-EU labor mobility and contributed to faster growth and low unemployment. They underscored that keeping wages in line with productivity is essential to maintaining competitiveness, noting that wages are high relative to those in the euro area. With the slowdown in productivity growth and the entrenchment of low and stable inflation, Directors recommended that wage increases under the forthcoming national wage agreement and the next public sector benchmarking exercise be moderate. In addition, Directors noted that the wage agreement needs to preserve flexibility, given differential productivity developments across firms, and that the next benchmarking exercise should be as transparent as possible, continue to promote verifiable modernization in the public sector, and avoid putting upward pressure on wages elsewhere in the economy.

While recognizing the banking system's strong profitability and capitalization, Directors noted that vulnerabilities exist and therefore welcomed the authorities' efforts to increase awareness of risks. They highlighted, in particular, the need to monitor carefully trends in the housing market, given the high exposure of banks to this market. Directors underscored that continued supervisory efforts are essential to limit excessive risk-taking by lenders and borrowers: stress-testing could be enhanced and conducted more frequently, credit standards could be strengthened, and interim updates to the *Financial Stability Report* could be prepared. Directors welcomed the FSAP update planned for 2006.

Directors considered Ireland well placed to cope with the fiscal impact of population ageing, given the low debt ratio and the accumulation of reserves in the National Pensions Reserve Fund. Nevertheless, they shared the concern that households are on the whole not saving enough for retirement, and welcomed the authorities' consideration of further policy responses. Directors noted that Ireland's effective retirement age is one of the highest among industrialized countries, and concurred that encouraging longer active participation in the labor force is important. Beyond that, the appropriate role of government in addressing inadequate household saving depends crucially on the tradeoff between the risk of forcing some people to save more than they wish and the risk of some people not saving enough and falling back on the government in the future. In general terms, the solution should be clearly sustainable over the long run and provide the right incentives to work and save.

Directors agreed that strengthening competition in the domestic economy is crucial to maintaining strong productivity growth and external competitiveness. In the banking system, codes of conduct to promote competition could usefully be extended, with the eventual objective of removing the regulation of certain fees. In the non-life insurance sector, greater disclosure of aggregate information on claims histories would be desirable. Better regulation is also needed in retail and professional services to stimulate competition and reduce prices.

Directors encouraged the authorities to continue their efforts to improve the timeliness and reliability of statistics.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Ireland: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
Real Economy (change in percent)					
Real GDP	6.2	6.1	4.4	4.5	4.5
Real GNP	3.9	2.7	5.1	4.0	4.5
Domestic demand	3.9	4.3	4.6	4.3	5.7
Exports of goods and services	9.3	4.0	0.8	7.0	2.5
Imports of goods and services	7.3	1.8	-1.4	7.6	3.5
HICP	4.0	4.7	4.0	2.3	2.3
Unemployment rate (in percent)	3.9	4.4	4.7	4.5	4.2
Public Finances (percent of GDP)					
General government balance	0.8	-0.4	0.2	1.4	-1.1
Structural balance 2/	-0.5	-1.2	0.4	1.7	-1.1
General government debt	35.4	32.1	31.1	29.0	29.4
Money and Credit (end-period, percent change)					
M3 3/ 4/	17.2	9.3	...	22.5	17.7
Private sector credit 4/ 5/	15.1	15.0	17.9	26.6	26.7
Interest rates (end-period)					
Three-month 4/	3.3	2.9	2.1	2.2	2.1
10-year government bond yield 4/	5.1	4.3	4.3	3.7	3.2
Balance of Payments (percent of GDP)					
Trade balance (goods and services)	14.7	16.6	15.5	14.9	13.5
Current account	-0.6	-1.0	0.0	-0.8	-1.9
Reserves (gold valued at SDR 35 per ounce) end of period, in billions of SDRs) 4/	4.5	4.0	2.8	1.9	1.8
Exchange Rate					
Exchange rate regime			Member of euro area		
Present rate (September 8, 2005)			US$ per euro 1.2418		
Nominal effective rate (1995=100) 6/	89.2	90.7	96.7	99.7	96.8
Real effective rate (1995=100, CPI based) 6/	94.4	98.9	106.8	110.2	106.8

Sources: Central Statistics Office; Department of Finance, Datastream and IMF International Financial Statistics.
1/ Staff projections, except where noted.
2/ In percent of potential GDP.
3/ The methodology used to compile M3 has been amended in line with Eurosystem requirements. Therefore, there is a break in the series.
4/ As of July 2005.
5/ Adjusted change, which includes the effects of transactions between credit institutions and non-bank internatioanl financial companies and valuation effects arising from exchange rate movements.
6/ As of June 2005.

Strengthening surveillance and crisis prevention

CHAPTER • 4

During the financial year, the IMF made progress with a range of reforms that followed up on the 2004 Biennial Surveillance Review.[1] It sharpened the focus of surveillance, deepened its coverage of exchange rate and financial sector issues, improved its analysis of debt sustainability and balance sheet vulnerabilities, paid greater attention to the possibility of regional and global spillovers (see Chapter 3), and enhanced surveillance in low-income countries (Chapter 6). Many of these steps were given added impetus by the Fund's Medium-Term Strategy (Chapter 2), which was discussed by the International Monetary and Financial Committee (IMFC) at its April 2006 meeting. In its communiqué of April 22, 2006, the IMFC reiterated the importance of making IMF surveillance more effective (see Appendix IV for the full text of the communiqué).

The Fund took steps to improve the effectiveness and organizational structure of its financial sector work:

- An external working group reviewed the Fund's financial and capital markets work. Based on the working group's report, the Managing Director initiated a major operational reorganization aimed at putting financial issues at the center of the Fund's work and at ensuring that such financial expertise better serves its 184 members (Box 4.1).
- Additional resources were devoted to monitoring financial systems, especially in supporting the compilation of financial soundness indicators (Box 4.2).
- The Board considered a report by the Independent Evaluation Office on the Financial Sector Assessment Program (FSAP).
- All of the Fund's anti-money-laundering and combating-the-financing-of-terrorism (AML/CFT) work was unified in its Legal Department. This is expected to strengthen work in this area.

With many countries facing important fiscal challenges, the Fund continued to advance its analysis of, and policy advice on, public investment and fiscal policy and related issues. In a pilot project, a new framework for looking at public investment issues was applied in eight countries; experience with the pilot has helped define directions for further work, which will be coordinated with the World Bank. Another staff study focused on the contingent liabilities created by government guarantees and reviewed related disclosure and fiscal accounting issues. The Board discussed several of these issues in May and November 2005.

As oil prices rose during the year, Fund advice focused partly on the need for improved data quality and transparency in the oil sector. The Fund encouraged Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS) participants to provide more information on oil and gas activities and to improve the quality and transparency of oil market data. In this connection, the Fund's *Guide to Resource Revenue Transparency* was finalized. In addition, the Board carried out major reviews of the Fund's work on standards and codes, including data standards.

The IMF continued to work closely with standard-setting bodies such as the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Organization of Securities Commissions, the Committee on Payments and Settlement Systems, the International Accounting Standards Board, and the Financial Action Task Force on Money Laundering. IMF staff participated in public commentary on proposals for a new capital adequacy framework for banks issued by the Basel Committee in 2004, and the Board discussed the implications of the framework for the Fund's work in October 2005.

In the area of crisis prevention, the Fund participates in the Financial Stability Forum (FSF), reporting regularly on various issues related to financial stability. In FY2006, the IMF contributed to the FSF agenda on a range of issues related to risk transfer and global asset allocation in financial systems, as well as on strategies (such as business continuity planning) to mitigate risks from a possible avian flu pandemic, the robustness of international standard-setting processes, and financial institutions' funding liquidity risk management practices. The IMF's Board also discussed a report by the IEO on the Fund's approach to capital account liberalization, and Fund staff applied balance sheet analysis in their surveillance work.

[1]The review and the Public Information Notice summarizing the Board's discussion of the review can be found at *www.imf.org/external/np/pdr/surv/2004/082404.htm.*

Box 4.1 Reorganizing the Fund's financial sector work

In a globalized world where capital moves almost instantaneously across borders, the distinction between domestic and international financial markets is increasingly blurred. In recognition of this, the IMF is shifting the emphasis in its surveillance from real to financial developments and their interactions, with a greater focus on balance sheet linkages and the sources of financing.

To improve its financial sector surveillance, in June 2005, the IMF commissioned a study by an external working group chaired by William J. McDonough, U.S. Public Company Accounting Oversight Board Chairman.[1] Based on the group's recommendations, the IMF decided to strengthen the Fund's financial and capital markets work by creating a new department in early FY2007 to serve as the center of all aspects of financial, capital markets, and monetary work in the IMF.[2] The new department merges the functions and staff of the former International Capital Markets Department (ICM) and the Monetary and Financial Systems Department (MFD).

A new Financial Sector Steering Committee chaired by the Managing Director is overseeing the merger and will be responsible for coordinating financial sector work and ensuring the close involvement of Fund management in financial sector issues. A task force assisted by outside experts and policymakers has been set up to upgrade the analytical framework for covering financial sector issues in the IMF's surveillance over individual member countries' policies ("Article IV consultations").

[1]See Press Release No. 05/132, at *www.imf.org/external/np/sec/pr/2005/pr05132.htm.*

[2]See Press Release No. 06/21, at *www.imf.org/external/np/sec/pr/2006/pr0621.htm.*

Financial sector surveillance

During the year, the IMF completed 16 assessments[2] under the FSAP, of which 4 were updates (another 43, of which 16 are updates, are either under way or agreed and being planned). Work continued on the Offshore Financial Centers and AML/CFT programs (Boxes 4.3 and 4.4).

Implications of Basel II for the Fund

In June 2004, the Basel Committee on Banking Supervision issued a new capital adequacy framework for banks, *International Convergence of Capital Measurement and Capital Standards—A Revised Framework* ("Basel II"), for implementation in the Group of Ten countries[3] beginning in January 2007. This new framework, which is far more complex than the 1988 Accord ("Basel I"), consists of three pillars. Pillar 1 introduces a menu of options for assessing the capital adequacy of banks; Pillar 2 requires an upgrading of supervisory practices to review banks' international capital adequacy assessments; and Pillar 3 requires public disclosure of more information on banks' risk profile and risk-management systems.

In October 2005, the IMF's Executive Board met to discuss the implications for the IMF of the new framework,[4] which Directors considered an important step toward addressing weaknesses in the existing Basel I framework, especially in improving risk management in financial institutions. For many countries, however, the new framework—in particular, Pillar 1—might be too complex and resource-intensive to become an immediate priority. Some countries have not yet fully implemented Basel I. The Board emphasized that premature adoption of Basel II in countries with limited capacity could divert resources from more urgent needs.

Under these circumstances, Directors generally considered that many countries might benefit more in the short term from a strengthening of supervisory practices as set out under Pillar 2 and from an enhancement of banks' disclosure practices under Pillar 3 to facilitate the exercise of market discipline. Countries should give priority to developing their financial sector infrastructure and, over time, move toward Basel II implementation. Directors stressed that road maps for Basel II implementation should be comprehensive and realistic and give appropriate attention to necessary preconditions, such as adequate credit data systems. In countries where banks implement the advanced approaches under Basel II, financial sector surveillance should include an assessment of the adequacy of Basel II implementation.

Directors cautioned that Fund staff should avoid conveying the impression that countries would be criticized for not moving to adopt the Basel II framework. They urged staff to be completely candid when asked to assess countries' readiness to move to Basel II and to indicate clearly the risks of moving too quickly and too ambitiously.

Directors voiced concerns that increased risk sensitivity would result in higher capital requirements for loans to emerging market and developing countries as well as higher risk-related capital charges, resulting in reduced capital flows

[2]These numbers refer to financial sector assessments discussed by the Board during FY2006.

[3]The Group of Ten (G-10) refers to the group of countries that have agreed to participate in the IMF's General Arrangements to Borrow, a supplementary borrowing arrangement established in 1962 that can be invoked if the IMF's resources are estimated to be below members' needs.

[4]See Public Information Notice No. 05/154, "IMF Executive Board Discusses Implications of the New Basel Capital Adequacy Framework for Banks," *www.imf.org/external/np/sec/pn/2005/pn05154.htm.*

to these countries. Also, bank lending to these countries during an economic downturn would become more costly, resulting in reduced bank lending and increased procyclicality. On the other hand, it was noted that bank lending rates to emerging market and developing countries may already incorporate the risk premium, and that the greater risk sensitivity under Basel II could mitigate "herd behavior" by banks, which makes this outcome less likely.

Many Directors considered it appropriate for Fund staff, together with other relevant institutions, to develop guidance materials to support assessments of countries choosing to adopt Basel II, taking into account each country's specific circumstances. Technical assistance should focus on putting in place the prerequisites for countries seeking to adopt the Basel II framework—namely, strengthening financial sector infrastructure, core supervisory functions, and the conditions allowing for the exercise of market discipline. Directors called for a clear division of labor between the IMF and the World Bank, with the Fund bearing primary responsibility for financial stability issues and the supervisory framework and practices, and the Bank for financial sector infrastructure and institutional development.

To conduct financial sector surveillance effectively in the Basel II environment, the Fund will need to build its expertise, although resources will be scarce in the coming years. The Fund will need to use external funding where possible and to recruit outside experts for both the short and the long terms.

Box 4.2 Financial soundness indicators

The IMF, in consultation with the international community, has developed indicators to monitor the soundness of the financial sector. Financial soundness indicators (FSIs) have also been developed for the markets in which the financial institutions operate, for the corporate and household sectors, and for real estate markets. The new methodology is contained in the IMF's *Compilation Guide on Financial Soundness Indicators*.[1]

As part of its efforts to enhance financial system surveillance, in 2004 the IMF launched a coordinated compilation exercise for FSIs. The terms of reference required that the 62 participating countries compile and submit to the IMF end-2005 data for at least the core set of 12 indicators, along with detailed metadata. Countries were also encouraged to compile and submit data and metadata for any of 28 encouraged FSIs (see Table 2.1 in the IMF's *2004 Annual Report)*. These data and metadata will be made public by the IMF by end-2006. Participating countries are encouraged to follow the IMF *Compilation Guide's* recommendations to the extent possible to foster comparability of data across countries.

To support the compilation of FSIs, the IMF conducted four regional meetings during May–July 2005 (in Brasilia, Frankfurt, Singapore, and Vienna), which were attended both by representatives from the participating countries and by observers from international and regional agencies. The meetings provided an opportunity to discuss the methodology of the *Compilation Guide* and the implications of evolving supervisory and accounting standards, and to consult with countries on their FSI compilation issues, as well as on their first draft FSI metadata.

Later in the year, participating countries provided a second draft of FSI metadata to IMF staff. In December 2005, representatives from eight international and regional agencies that are members of a reference group for the exercise met in Washington, D.C., to receive updates on the progress made on the exercise and to discuss remaining issues.[2]

[1] Available at *www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm*.

[2] "Progress on the Financial Soundness Indicators Work Program" is available at *www.imf.org/external/np/sta/fsi/eng/2005/061405.htm*.

IEO report on the Financial Sector Assessment Program

The Financial Sector Assessment Program (FSAP) was introduced in May 1999 by the IMF and the World Bank to strengthen the monitoring of member countries' financial systems. It is designed to help countries prevent and increase their resilience to crises and cross-border contagion and to foster sustainable growth by promoting financial system soundness and financial sector diversity. Assessments of financial systems undertaken under the FSAP

- identify the strengths, risks, and vulnerabilities in the financial system and the two-way linkages between financial sector performance and the macroeconomy;
- ascertain the financial sector's development needs; and
- help country authorities design appropriate policy responses.

The comprehensive nature of financial sector assessments requires a wide range of analytical tools and techniques. These include financial stability analysis, stress testing and scenario analysis, and assessments of countries' observance of relevant international financial sector standards, codes, and good practices. In implementing the FSAP, the IMF and the World Bank draw on feedback received from the Executive Boards of both institutions, from countries that have participated in the program, and from various international groups. They also draw on the knowledge of experts from a range of cooperating central banks, supervisory agencies, standard-setting bodies, and other international institutions, and outside experts augment the expertise in the IMF and the World Bank. In September 2005, the institutions jointly published a *Financial Sector Assessment Handbook*.[5]

Executive Directors met in January 2006 to discuss the IEO's evaluation of the FSAP.[6] They agreed with the key IEO conclusion that the FSAP represented a distinct improvement in the Fund's ability to conduct financial sector surveillance and to understand linkages between financial sector vulnerabilities and macroeconomic stability. Directors were encouraged by the IEO's assessment that FSAPs and FSAP updates contributed to the articulation of policy recommendations, prompted better discussions with authorities, and supported policy and institutional changes.

At the same time, Directors considered that the IEO report provided a balanced and candid assessment of areas for improvement—in particular, making financial stability assessments an integral part of the Fund's bilateral and multilateral surveillance and ensuring participation by countries most in need of stronger financial sector surveillance. Directors recognized that any adjustments and improvements would need to take into account possible resource implications for the Fund.

Most Directors agreed that incentives to participate in FSAP assessments and updates were critical for maintaining the program's effectiveness. They were concerned that some countries that are systemically important or that might have vulnerable financial systems had not yet volunteered for initial assessments and that some countries had been reluctant to volunteer for updates, but most Directors considered that the voluntary nature of the FSAP should be maintained.

Directors welcomed the discussion in the IEO report on whether the criteria for prioritizing FSAPs and FSAP updates were adequate (Recommendation 1). While a few Directors considered that the IEO report did not provide sufficient evidence that current mechanisms are inadequate, many Directors agreed on the need for clearer guidance.

To align FSAP coverage better with the needs of surveillance, most Directors agreed with the IEO proposal that management should indicate to the Board which countries it considered the highest priorities for FSAP assessments and updates (Recommendation 2). Most Directors considered that Article IV staff reports should explicitly recommend an initial FSAP or FSAP update in priority cases but should be mindful of potential market sensitivities. A number of Directors also pointed to the report's finding that the burden of FSAPs on the authorities is high and stressed that reducing this burden through better planning and focus is critical for achieving increased participation.

Many Directors saw merit in the IEO proposal that staff develop country-specific plans for financial sector surveillance. It was noted, however, that this proposal goes to fundamental questions as to how the Fund should conduct financial sector surveillance. Directors agreed that the proposal, as well as possible adjustments to resource allocation and other modalities (including the frequency of FSAPs), would be considered in the broader context of the ongoing discussion on enhancing the effectiveness of Fund financial sector surveillance.

Box 4.3 Monitoring offshore financial centers

The offshore financial center (OFC) assessment program was initiated in 2000 and reviewed by the Executive Board in 2003. At that time, the Executive Board agreed that the monitoring of OFCs, to ensure their compliance with supervisory and integrity standards, should become a standard component of the Fund's financial sector work. In February 2006, the staff issued a progress report to the Executive Board.[1] Forty-two assessments were completed under the first phase of the program. In the second phase, as of April 30, 2006, six jurisdictions had been assessed. Assessments are being conducted in accordance with the four– to five-year cycle envisaged by the Executive Board.

Progress has also been made on the information dissemination and monitoring initiative that was undertaken (1) to provide the IMF with information for its ongoing monitoring of financial developments in these centers and (2) to help improve the transparency of activities in international and offshore financial centers. As of end-April 2006, 18 jurisdictions had provided the IMF with data as part of this initiative. The IMF continues to provide technical assistance, generally to small, lower-income jurisdictions, mainly on banking supervision and anti-money-laundering and combating-the-financing-of-terrorism measures.

In November 2005, the IMF held the third roundtable for onshore and offshore supervisors and standard setters. The roundtable highlighted the need for continued attention to cooperation and information sharing, risk-based supervision, and appropriate sequencing of standards implementation as the means to address increasingly complex cross-border issues. Participants agreed that supervisors and standard setters should consider disseminating good practices on information sharing, providing Web site guides to jurisdictions' information-sharing arrangements, and assigning priority and resources to information exchange issues.

[1]The report is available at *www.imf.org/external/np/pp/eng/2006/020806.pdf*

[5]The Handbook is available online at *www.imf.org/external/pubs/ft/fsa/eng/index.htm.*

[6]The IEO's "Report on the Evaluation of the Financial Sector Assessment Program" is available at *www.imf.org/external/np/ieo/2006/fsap/eng/index.htm;* the summary of the Board's discussion can be found at *www.imf.org/external/np/ieo/2006/fsap/eng/pdf/sumup.pdf.*

Box 4.4 Update on AML/CFT

In September 2005, the IMF's Executive Board endorsed an adjustment of the IMF's anti-money-laundering/combating-the-financing-of-terrorism (AML/CFT) program to focus more on tackling the challenges faced by countries implementing standards and regimes. The IMF's Board also endorsed Special Recommendation IX of the Financial Action Task Force (FATF) concerning measures to deter cross-border movements of currency and monetary instruments related to the financing of terrorism and money laundering. These decisions were based on a review of the Fund's and the Bank's work programs following a call by their Boards in March 2004 to make AML/CFT a regular part of the work of both institutions.[1]

Although AML/CFT regimes have been strengthened in the member countries of the Fund and the Bank in recent years, the review indicated that the revision of the FATF standard in June 2003 significantly raised the bar for countries' legal, regulatory, and institutional frameworks. Comparing assessments carried out before and after the revision, the review showed that all countries faced difficulties in achieving compliance with the revised standard. Given the complexity of the revised standard, the higher costs of implementation, and the competing demands on national resources, the review advised focusing on practical considerations, vulnerabilities, priorities, and sequencing in putting AML/CFT regimes in place.

The IMF and the World Bank, in collaboration with other donors, have greatly intensified the delivery of technical assistance to respond to countries' needs. Nearly 1,000 officials from 111 countries have been trained in AML/CFT, including legal, financial intelligence unit, and supervisory issues, and 37 countries have adopted or are in the process of enacting AML/CFT legislation, while a number of others are at earlier stages in the process. However, in light of the Fund's and the Bank's limited resources, the review urged the donor community to commit additional resources to helping countries implement the revised standard.

Going forward, the Fund and the Bank will focus on conducting assessments of members' AML/CFT regimes, technical assistance delivery, and broader regulatory and economic policy issues; increasing outreach to raise awareness among parliamentarians and key decision makers on AML/CFT; and working with the donor community to commit additional resources in support of countries' needs for technical assistance.

[1]The review is available at *www.imf.org/external/np/pp/eng/2005/083105.htm.*

Directors concurred with the IEO recommendation to strengthen links between FSAPs and surveillance (Recommendation 3). To facilitate this, Financial Sector Stability Assessments (FSSAs) should contain candid summaries of the main findings of FSAPs with relevance for the macroeconomy and potential macroeconomic implications of key financial sector risks. Directors stressed that financial stability issues judged to be of high importance—including those with potential global repercussions—should be a major focus of Article IV consultations and of the Board discussions of them.

Directors encouraged the staff to follow up on IEO recommendations to improve further the quality of FSAPs and strengthen their impact (Recommendation 4). Staff recommendations should be clearly prioritized and the potential consequences of not addressing key weaknesses candidly discussed. Directors emphasized the importance of treating financial sector and cross-border linkages more systematically in FSAP analysis in light of the growing importance of regional and global spillover effects. To improve the quality and clarity of stress-testing analysis, the reports needed to contain more informative and candid discussions on methodological and data limitations, and the staff should not refrain from carrying out analysis of politically sensitive shocks.

Directors discussed the implications of the publication policy of FSSAs for the effectiveness of FSAPs. While some Directors considered that a move to presumed publication of the FSSA would enhance the impact of FSAPs on country authorities, donors, and market participants, many other Directors argued that such a move would not be consistent with the voluntary nature of the program.

Many Directors welcomed the IEO's recommendation to introduce changes in the organization of IMF mission activities to utilize scarce financial sector expertise more effectively in the surveillance process (Recommendation 5).

While the view was expressed that the Fund should take the lead on all FSAPs, most Directors were in broad agreement with the report's recommendations regarding Bank-Fund collaboration (Recommendation 6). They concurred that the current joint approach, including the central role for the Bank-Fund Financial Sector Liaison Committee, should be maintained. At the same time, further efforts should be made to take full advantage of the distinctive contributions that the two institutions can make—with the Fund focusing on stability issues and the Bank on financial sector development and institution building.

Directors concurred that there was room to improve the coordination of FSAP-related technical assistance activities, based on the country's own action plans (Recommendation 7). They noted that steps had been taken in this direction—such as follow-up meetings on technical assistance of the authorities with IMF staff and, sometimes, donors. At the same time, Directors cautioned against overburdening the FSAP with additional expectations regarding the assessment and planning of technical assistance needs and taking excessively formal approaches to follow-up that could overtax already stretched Fund resources and discourage ownership by the authorities.

Fiscal analysis and policy advice

Many countries with IMF-supported programs must undertake fiscal adjustment to stabilize their economies, address their balance of payments problems, and improve their longer-term growth performance.[7] How can countries undertake fiscal adjustment without neglecting their infrastructure needs? The Board first discussed this issue at an informal seminar in April 2004, based on two papers prepared by IMF staff.[8] Following up on that discussion, the IMF staff carried out a study in eight pilot countries in Africa, Asia, Latin America, and the Middle East. Another staff study focused on the contingent liabilities created by government guarantees and reviewed related disclosure and fiscal accounting issues. The findings were summarized in three papers discussed by the Board in May 2005.[9]

Public investment and fiscal policy

At their discussion, Directors generally supported the staff's conclusions. They reiterated the importance of public infrastructure investment for economic growth, while acknowledging the lack of hard evidence in the pilot countries on the precise relationship between the two, and emphasized the relative importance of complementary factors such as macroeconomic stability and the investment climate. Public infrastructure investment and rehabilitation needs remained sizable, especially in low-income countries. Directors noted the possible causes and consequences of the decline in public investment observed in several of the pilot countries. Among the possible causes are fiscal consolidation, including in the context of Fund-supported programs; a fall in public saving; completion of major public infrastructure projects; preference for a smaller public sector; and private sector development. Directors encouraged the staff to investigate further how the quality and composition of public expenditure affect growth and to improve debt sustainability analyses by taking account of robust estimates of the growth implications of public investment. However, they emphasized that the World Bank should take the lead in exploring the growth implications of specific public investment projects.

Directors supported the focus on the overall fiscal balance and on complementary indicators, such as the current fiscal balance, when assessing the scope for increasing public investment and the quality of a country's fiscal policy. The scope for increasing public investment by relaxing overall fiscal targets remained quite limited in most countries, particularly in those that had a high debt burden and were vulnerable to macroeconomic shocks. Directors stressed the overarching importance of ensuring that borrowing to finance public investment was consistent with macroeconomic stability and debt sustainability. Where this outcome was not assured, increases in public investment would need to be matched by increases in public saving through better prioritization of expenditure and, in many countries, sustained efforts to mobilize additional revenue. More policy options were available to countries with relatively low debt burdens and to countries with access to concessional financing on a sustained basis. Directors also emphasized the need to improve the quality of new investment by strengthening the institutional capacity for project appraisal, selection, and implementation, which remain the responsibility of the multilateral development banks; in this regard, they saw an important role for technical assistance from the latter.

A key conclusion that emerged from the studies was that additional room for public infrastructure spending could not be created by changes in fiscal accounting. Countries with different levels of economic and institutional development could well have different "optimal" ratios of public investment to GDP. An assessment of the scope for increasing public investment in any given country would require, in particular, careful analysis of macroeconomic conditions; debt sustainability; the quality of the proposed projects; and the trade-offs among taxes, public infrastructure spending, and other types of expenditure. Directors also emphasized the need to address noninfrastructure bottlenecks to economic development, in particular, the policy and institutional environment for private investment, including especially the tax and regulatory frameworks and governance.

Directors generally saw merit in the staff's call for comprehensive coverage of public enterprises in fiscal statistics, in line with the IMF's *Government Finance Statistics Manual 2001* (GFSM 2001) framework, but recognized that this would be a difficult task achievable only over time because of data problems. Most Directors endorsed the approach proposed by the staff for moving forward in this area by progressively integrating public enterprise operations into

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[7] The IMF issued updated guidelines for fiscal adjustment in January 2006, reflecting not only the significant changes that have taken place in the world economy since the previous guidelines were published in 1995 but also changes in the IMF's approach to fiscal adjustment. The new guidelines can be found at *www.imf.org/external/np/pp/eng/2006/012706a.pdf.*

[8] See Public Information Notice No. 04/45, "IMF Executive Board Holds Informal Seminar on Public Investment and Fiscal Policy," *www.imf.org/external/np/sec/pn/2004/pn0445.htm;* "Public Investment and Fiscal Policy," *www.imf.org/external/np/fad/2004/pifp/eng/index.htm;* and "Public-Private Partnerships," *www.imf.org/external/np/fad/2004/pifp/eng/031204.htm.*

[9] See Public Information Notice No. 05/68, "IMF Executive Board Holds Follow Up Meeting on Public Investment and Fiscal Policy," *www.imf.org/external/np/sec/pn/2005/pn0568.htm;* "Public Investment and Fiscal Policy—Lessons from the Pilot Country Studies," *www.imf.org/external/np/pp/eng/2005/040105a.htm;* "Public Investment and Fiscal Policy—Summaries of the Pilot Country Studies," *www.imf.org/external/np/pp/eng/2005/040105b.htm;* and "Government Guarantees and Fiscal Risk," *www.imf.org/external/np/pp/eng/2005/040105c.htm.*

countries' fiscal accounts, thereby ensuring greater uniformity of reporting across the membership over time. With regard to the treatment of public enterprises in fiscal indicators, Directors noted that hardly any public enterprises met the criteria for commercial orientation proposed in the staff paper considered by the Board in April 2004. They broadly endorsed the proposed revised approach, which focused more on the fiscal risks posed by the operations of public enterprises. Most Directors also agreed that testing the revised criteria in a sample of upcoming Article IV consultations could inform the design of a strategy. A few Directors felt that it would not be appropriate to allow for greater case-by-case flexibility in making decisions on integrating public enterprises in fiscal indicators and targets in a Fund-supported program context and noted the difficulties of assessing fiscal risks posed by individual enterprises. These Directors called for the development of a more standardized approach.

Public-private partnerships (PPPs) offer a potential avenue to increase infrastructure investment, provided they are appropriately structured and the institutional framework is well developed. Directors agreed with the view that PPPs should be undertaken with the goal of increasing efficiency by attracting private capital. Directors strongly cautioned against pursuing PPPs because of a desire to move investment spending off budget. Furthermore, the government should ensure that the risk associated with PPPs was appropriately shared with the private sector, with the risk borne by the government reflected in the fiscal accounts. Directors endorsed the view that high priority should be given to strengthening the institutional framework for PPPs—including the establishment of a sound legal framework and the preparation of a public sector comparator—and called on the multilateral development banks to take the lead on these issues.

Directors saw the lack of an internationally accepted accounting and reporting standard for PPPs as a possible obstacle to the development of efficient PPPs and endorsed continued staff work with the relevant accounting bodies to promote the preparation of such a standard. In the meantime, they generally endorsed the proposed disclosure and reporting requirements for PPPs, noting the importance of valuing the contingent liabilities associated with guarantees. They saw merit in the staff's proposed approach to incorporating PPPs in debt sustainability analysis, which involves counting committed payments by the government under PPP contracts and expected payments arising from the calling of guarantees as future primary spending. A few Directors called for caution in factoring implicit contingent liabilities related to PPPs into debt sustainability analyses. Most Directors agreed that the issue of setting caps on expected costs arising from PPPs, including in Fund program design, should be determined on a case-by-case

Ireland

Ireland's economy has performed impressively over the past decade. Real GNP growth averaged about 7 percent a year during 1995–2004, bringing income per capita up to the average of the EU-15; the unemployment rate declined sharply and is now one of the lowest in the industrial countries; and inflation stabilized close to the euro area average. This remarkable performance owed much to sound economic policies, including prudent fiscal policy, low taxes on labor and business income, and social partnership agreements that contributed to wage moderation.

Economic performance continues to be strong. In 2005, real GNP growth reached $5^1/_2$ percent, driven by domestic demand; unemployment was close to the natural rate; and the general government recorded a surplus of 1 percent of GDP. Labor force growth, fueled by increased participation and immigration, has helped dampen wage pressures. House price appreciation, which had eased through mid-2005, has picked up again against the backdrop of rapid credit growth. In response to a reported relaxation of lending standards, the authorities have increased the risk weighting on residential mortgages.

In March 2006, an IMF team visited Dublin to update the 2000 Financial Sector Assessment Program (FSAP). The team found that Ireland's financial system remained robust but recommended some improvements to the supervisory framework, including upgrading stress testing, strengthening on-site supervision of insurers, and enhancing public disclosure requirements for insurers.

Ireland-IMF activities during FY2006

May 2005	Discussions on 2005 Article IV consultation
October 2005	Completion of 2005 Article IV consultation
March 2006	Mission to update the 2000 FSAP

basis, with a focus on cases where these costs contribute to, or limit the capacity to respond to, debt sustainability problems.

Directors noted the staff's assessment that further work along the lines being proposed may require significant additional staff resources, which will be quantifiable only over the longer term, depending on the pace at which national authorities can move to include public enterprises in the fiscal accounts, and on the results of the testing in a sample of Article IV consultations of the revised criteria for assessing the fiscal risks posed by public enterprises. The issue of resource cost, as well as the balance of costs and benefits that emerges moving forward, will therefore need to be kept under close review.

Statistical frameworks for strengthening fiscal analysis in the Fund

As a follow-up to the Executive Board May 20, 2005, meeting on public investment and fiscal policy, Directors held a seminar in November at which they discussed a staff paper on using the *Government Finance Statistics Manual 2001* (GFSM 2001)[10] statistical framework to strengthen fiscal analysis in the Fund. They considered that the GFSM 2001 provided a comprehensive analytical framework that would strengthen fiscal policy analysis and reporting in Fund surveillance and program work through three summary fiscal tables—the operating statement, the balance sheet, and the cash statement—and the core indicators that are derived from these tables.

Use of the GFSM 2001 framework, which enhances the ability to record noncash transactions in a coherent and consistent manner, leads to greater transparency and consistency in the presentation of country fiscal data in staff reports. Directors acknowledged that GFSM 2001 was an appropriate framework for handling new and complex fiscal operations that could pose challenges to fiscal reporting and analysis.

Directors were encouraged that the actions recommended by the staff could be accomplished in three phases: data presentation (short term), country reporting (medium term), and full implementation of accrual reporting and the associated underlying systems (long term). Noting that the GFSM 2001 framework had not been tested across the Fund's membership, most Directors supported the staff's proposal to conduct pilot studies for volunteer countries over two years and within the Fund's existing budgetary envelope to map out more fully the process involved in shifting to the GFSM 2001 framework. The staff will report back to the Board on the pilot studies, together with proposals for full implementation of the GFSM 2001 methodology. Proposals would need to take account of countries' different capacities and legal constraints and of the costs to the Fund and to national authorities.

Directors were supportive of the technical assistance work being done by the Fund staff, including provision of guidance to country compilers in reporting operational data to the Fund using the GFSM 2001 framework. They emphasized the importance of this technical assistance work to strengthen the underlying accounting and classification systems.

Standards and codes, and data provision to the Fund

The Standards and Codes Initiative and Data Standards Initiatives have been important adjuncts to the Fund's surveillance and capacity-building activities. In FY2006, the IMF's Executive Board carried out its third review of the Standards and Codes Initiative and its sixth review of the Data Standards Initiatives, the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS). Of the Fund's 184 members, 146 subscribe to the SDDS or participate in the GDDS (Box 4.5).

Standards and Codes Initiative

In July 2005, the IMF's Executive Board considered a joint IMF–World Bank staff paper on the Standards and Codes Initiative, which was launched in 1999 as part of efforts to strengthen the international financial architecture.[11] The initiative was designed to promote greater financial stability at both the domestic and the international levels through the development, dissemination, adoption, and implementation of international standards and codes in 12 areas—data quality, monetary and financial policy transparency, fiscal transparency, banking supervision, securities, insurance, payments systems, anti-money-laundering provisions, corporate governance, accounting, auditing, and insolvency and creditor rights. The IMF and the Bank evaluate member countries' policies against international standards and codes that serve as benchmarks of good practice in these areas and

[10] The staff paper, "Using the GFSM 2001 Statistical Framework to Strengthen Fiscal Analysis in the Fund," can be found at *www.imf.org/external/np/pp/eng/2005/102505.pdf.* The manual is available at *www.imf.org/external/pubs/ft/gfs/manual/index.htm.* For a summary of the Board discussion, see Public Information Notice No. 05/167, *www.imf.org/external/np/sec/pn/2005/pn05167.htm.*

[11] For a summary of the Board discussion, see Public Information Notice No. 05/106, at *www.imf.org/external/np/sec/pn/2005/pn05106.htm.* The paper discussed by the Board, "The Standards and Codes Initiative—Is It Effective? And How Can It Be Improved?" is available at *www.imf.org/external/np/pp/eng/2005/070105a.htm.*

Box 4.5 ROSCs and Data Standards Initiatives

Reports on the Observance of Standards and Codes (ROSCs). A ROSC is an assessment of a country's observance of standards in one of 12 areas useful for the operational work of the Fund and the World Bank. The reports—about 74 percent of which have subsequently been published—examine three broad areas: (1) transparent government operations and policymaking (data dissemination, fiscal transparency, monetary and financial policy transparency); (2) financial sector standards (banking supervision, payments systems, securities regulation, insurance supervision, and efforts to combat money laundering and the financing of terrorism (AML/CFT)); and (3) market integrity standards for the corporate sector (corporate governance, accounting, auditing, insolvency, and creditor rights). Participation in the Standards and Codes Initiative continues to grow. As of end-April 2006, 725 ROSC modules had been completed for 130 countries, or 71 percent of the Fund's membership, and most systemically important countries had volunteered for assessments. More than 340 of the ROSCs were on financial sector standards. Of these, about one-third were related to banking supervision, and the others were fairly evenly distributed across the other standards and codes.

Special Data Dissemination Standard (SDDS). Created in 1996, the SDDS is a voluntary standard whose subscribers—countries with access to international financial markets or seeking it—commit to meeting internationally accepted norms of data coverage, frequency, and timeliness. Subscribers also agree to issue calendars on data releases and follow good practice with respect to the integrity and quality of the data and access by the public. SDDS subscribers provide information about their data compilation and dissemination practices (metadata) for posting on the IMF's Dissemination Standards Bulletin Board (DSBB).[1] Subscribers are also required to maintain a Web site electronically linked to the DSBB that contains the actual data. SDDS subscribers began disseminating prescribed data on external debt in September 2003; data for 54 countries are published in the World Bank's *Quarterly External Debt Statistics* (QEDS). Romania and Morocco became subscribers in FY2006, raising the number of SDDS subscribers to 62 as of April 30, 2006.

General Data Dissemination System (GDDS). The GDDS framework was established in 1997 to help Fund member countries improve their statistical systems. Voluntary participation allows countries to set their own pace but provides a detailed framework that promotes the use of internationally accepted methodological principles, the adoption of rigorous compilation practices, and ways in which the professionalism of national statistical agencies can be enhanced.

[1]The Web site address is *dsbb.imf.org/Applications/web/dsbbhome.*

The 83 participants in the GDDS at end-April 2006 provide metadata describing their data compilation and dissemination practices as well as detailed plans for improvement for posting on the IMF's Dissemination Standards Bulletin Board. Between the fifth review of the Data Standards Initiatives in July 2003 and April 30, 2006, 30 countries and territories began participating in the GDDS. Of the 89 countries and territories participating in the GDDS since it was introduced, 6 have graduated to the SDDS, 5 since the fifth review.

In addition, the Fund staff has been developing the **Statistical Data and Metadata Exchange (SDMX)** standard, in collaboration with other international organizations. The SDMX aims to facilitate efficient electronic exchange and management of statistical information among national and international entities by providing standard practices, coherent protocols, and other infrastructural blueprints for reporting, exchanging, and posting data on Web sites.

Data Quality Assessment Framework (DQAF). The DQAF is an assessment methodology that was integrated into the structure of the data module of ROSCs following the fourth review of the Data Standards Initiatives in 2001. The DQAF's broader application in providing guidance for improving data quality has been integrated into the Data Quality Program as well as more prominently into Article IV consultations.

issue Reports on the Observance of Standards and Codes (ROSCs), which are intended to help countries strengthen their economic institutions, to inform the work of the Fund and the Bank, and to inform market participants.[12]

The Fund and the Bank Boards previously reviewed the implementation of the initiative in 2001 and 2003. A key focus of the second review[13] was on how to handle growing demand for assessments. Directors saw greater prioritization as key to focusing scarce resources on areas where reforms were most needed. The 2005 review sought to assess the initiative's effectiveness, including by surveying the views of stakeholders, such as country authorities and market participants.

At their discussion, Directors noted that the number of completed assessments had grown substantially in the past two years, although at a somewhat slower pace than earlier, reflecting a reduction of the number of financial sector standards assessed under the streamlined FSAP and the completion of initial assessments for a substantial portion of the IMF's membership. Most systemically important countries had participated in the initiative. There had been some important exceptions, however, and regional participation had remained uneven.

Directors were broadly satisfied with the initiative's effectiveness to date, although some objectives had been met more successfully than others—for example, the identification of vulnerabilities and establishment of priorities for

[12]The Board has not yet endorsed a standard for insolvency and creditor rights.
[13]See Public Information Notice No. 03/43 at *www.imf.org/external/np/sec/pn/2003/pn0343.htm.*

strengthening domestic institutions. Although the initiative had not yet had a large impact on the implementation of reforms, it was still relatively new, considering the long time frame of institutional reforms, and more of its benefits should materialize as time passes. The initiative had helped the Fund prioritize technical assistance needs and increasingly led to follow-up technical assistance. In part of the membership—including many emerging market economies—the initiative had contributed significantly to surveillance, even though, overall, its contribution to surveillance across the membership had been modest. Directors expressed disappointment that the use of ROSCs by market participants remained low.

The Board saw merit in maintaining the initiative, stressing that it had already delivered substantial results in some dimensions and that it was expected to yield further benefits, particularly in helping members implement institutional reforms. Directors generally concurred with stakeholders that the scope of the initiative and its key governance features should be left unchanged but recommended a number of other changes. Although they continued to support the voluntary nature of the initiative, Directors called for stronger efforts to encourage country participation and, in particular, to ensure that countries that chose to participate in the initiative were those most likely to benefit from it. To encourage further participation, many Directors supported the proposal to include consistently in Article IV consultations staff's views on priority areas for standards assessments.

Directors noted that frequent updating of ROSCs would be too costly. They supported a more flexible approach similar to that agreed for the FSAP, which featured an average update frequency of five years, to allow for country-specific circumstances. Priority would be given to updates for countries in which significant gaps had been identified in previous assessments and that would contribute the most to national or systemic stability.

Directors supported measures to strengthen the integration of the initiative with Fund surveillance and technical assistance through greater coordination between and within departments. In line with the conclusions of the 2004 Biennial Review of Surveillance, Directors stressed the need to reflect ROSCs' macro-relevant findings in Article IV reports, while cautioning against the mechanistic inclusion of detailed ROSC recommendations.

Directors favored steps to enhance the clarity of ROSC findings. Each ROSC should include (1) an executive summary providing a clear assessment, while avoiding a rating or "pass or fail" report; (2) a principle-by-principle summary of the observance of the standard; and (3) a prioritized list of key recommendations. These changes, while falling short of meeting market participants' suggestions, would promote greater use of ROSCs, although the objective of informing market participants would likely remain challenging. Directors agreed that the practice of sharing draft ROSCs with the authorities, the current policy of voluntary publication of ROSCs, and outreach activities should continue.

Directors noted that, after extensive consultations, the Organization for Economic Cooperation and Development (OECD) had revised the *Principles of Corporate Governance*. The main revisions related to governance, shareholder rights, disclosure and transparency, and insolvency and creditor rights. Directors agreed to recognize the revised principles for use in the initiative.

Sixth review of Data Standards Initiatives

The Fund's Data Standards Initiatives, the SDDS and GDDS, aim to increase the comprehensiveness and timeliness of statistical information available to markets and the public, thus contributing to member countries' pursuit of sound macroeconomic policies and the improved functioning of financial markets.

In November 2005, Executive Directors concluded discussions on the sixth review of the Data Standards Initiatives.[14] They commended the member country authorities for their efforts to promote adherence to the initiatives. Since the last review, which was concluded in July 2003, the number of SDDS subscribers and GDDS participants had increased. Further progress in these initiatives continued to be important for the efficient operation of markets, and for effective surveillance and crisis prevention. Directors broadly agreed that adherence to international transparency standards—and to the SDDS in particular—could be an important factor in improving a country's access to international capital markets. In this vein, Directors recommended moving forward with the Fund's voluntary and cooperative strategy for assisting members to participate in the initiatives.

Directors welcomed the graduation of a number of countries from the GDDS to the SDDS since the last review and supported continuing the Fund staff's integrated outreach and technical assistance efforts in building countries' statistical capacities to levels that meet SDDS requirements.

Directors also supported continued efforts to promote the dissemination and exchange of statistical information on the Internet among international organizations and their member countries using a common data transmission and dissemination standard. Among these efforts was the

[14]For a summary of the Board discussion, see Public Information Notice No. 05/155, *www.imf.org/external/np/sec/pn/2005/pn05155.htm*. The review can be found at *www.imf.org/external/np/pp/eng/2005/070105s.pdf*.

Box 4.6 External debt Web site

In March 2006, the IMF, the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), and the World Bank launched a new Web site—the Joint External Debt Hub (JEDH)—to provide a one-stop source of comprehensive external debt statistics compiled from national and creditor/market sources.[1]

The JEDH brings together national external debt data provided by 54 subscribers to the IMF's Special Data Dissemination Standard (SDDS), creditor/market-sourced data on external debt and data on selected foreign assets for 175 countries, and associated metadata for the two sets of statistics. The national external debt data are sourced from the World Bank's *Quarterly External Debt Statistics* (QEDS) database, and the creditor/market data are sourced from the four agencies. The JEDH replaces the tables currently at *www.oecd.org/statistics/jointdebt* and expands the available range of information.

The new Web site provides timely access to quarterly external debt statistics, thereby greatly facilitating macroeconomic analysis and cross-country and data source comparisons. For each of the 54 SDDS subscribers, data are provided on loans and deposits, debt securities, and trade credits, and the national and the creditor/market viewpoints, when available, are compared.

The Web site builds on initiatives started in the late 1990s by the Inter-Agency Task Force on Finance Statistics[2] to improve the availability of comprehensive and consistent external debt statistics. Major milestones include the quarterly publication of market/creditor data from 1999; the publication of the *External Debt Statistics: Guide for Compilers and Users*[3] in 2003; the dissemination since September 2003 of national data on the quarterly external debt position with a one-quarter lag by SDDS subscribers, with redissemination of these data for most subscribers on the World Bank's QEDS Web site[4] from 2004; and the recent development by the IMF of the data quality assessment framework for external debt statistics.

The JEDH uses Statistical Data and Metadata Exchange (SDMX) standards established by the BIS, the European Central Bank, Eurostat, the IMF, the OECD, the United Nations, and the World Bank.

[1]The new Web site is located at *www.jedh.org*.

[2]The agency's members are the IMF, the Commonwealth Secretariat, the European Central Bank, Eurostat, the Paris Club Secretariat, and the United Nations Conference on Trade and Development.

[3]The Guide is available at *www.imf.org/external/pubs/ft/eds/Eng/Guide/index.htm.*

[4]At *www.worldbank.org/data/working/QEDS/sdds_main.html.*

development of data and metadata transmission standards under the Statistical Data and Metadata Exchange Initiative (SDMX) of seven international organizations, including the IMF.[15]

Directors welcomed the generally positive experience with implementing new data categories. In particular, nearly all SDDS subscribers now met the data dissemination requirements for external debt data, and a majority of GDDS participants disseminated metadata on their external debt (Box 4.6). No member had availed itself of the opportunity to report inflation-targeting indicators, however, and incorporation of Millennium Development Goals indicators into the metadata of the GDDS had also been slow. Looking ahead, Directors agreed to consider at the next review of the Fund's Data Standards Initiatives whether a core set of Financial Soundness Indicators (FSIs) should be incorporated into the SDDS.

Directors broadly supported requiring subscribers to use standardized electronic reporting procedures to allow more effective monitoring of their observance of the SDDS. They encouraged the staff to work with subscribing countries in designing the system so as to minimize the reporting burden and cost of observance while maximizing the efficiency of monitoring.

Directors noted the staff's intention of posting annual assessments of subscribing countries' observance of their SDDS undertakings on the Dissemination Standards Bulletin Board (DSBB), beginning in early 2007, stressing that these reports should distinguish between major and minor deviations from SDDS requirements. They encouraged the staff to continue to raise SDDS observance issues with country authorities.

Many Directors considered that countries' commitment to improving data transparency and their statistical systems should be a factor in allocating technical assistance. However, they observed that a country's decision not to participate could be a function of limited resources and capacity constraints and thus felt that the criteria for access to Fund technical assistance should remain flexible. Directors recognized the central role played by Fund area departments in developing a technical assistance strategic framework and supported further collaboration with the World Bank and other institutions and donors in helping GDDS participants become SDDS subscribers. In addition, they supported the integration of the GDDS in Poverty Reduction Strategy Papers (PRSPs).

Most Directors endorsed the suggestion that SDDS subscribers and GDDS participants be encouraged to provide

[15]The SDMX consortium comprises, in addition to the IMF, the Bank for International Settlements, the European Central Bank, Eurostat, the Organization for Economic Cooperation and Development, the United Nations, and the World Bank.

Uruguay

In June 2005, the IMF's Executive Board approved a three-year Stand-By Arrangement for Uruguay. Since then, the economy has continued to perform strongly, with sound macroeconomic policies and a supportive external environment contributing to strong growth and low inflation, enabling the government to make progress on its social agenda.

Real GDP growth in 2005 reached 6.6 percent, driven by strong exports and private consumption. The public sector primary surplus moved close to the government's medium-term target of 4 percent of GDP, and in December 2005 the government adopted a five-year budget consistent with its key objective of ensuring debt sustainability. This was accompanied by prudent monetary policy, and annual inflation was 6.5 percent in March 2006, well within the central bank's target range.

The government has made significant progress on an ambitious structural agenda and expects to complete important reforms in 2006, including tax reform, financial sector restructuring, central bank independence, and improvement of debt management and the investment climate. The implementation of these reforms should further reduce vulnerabilities and help sustain high growth over the medium term.

Market confidence in Uruguay's policies and favorable external conditions have also contributed to a significant reduction in the country's sovereign spreads and improved market access. Moreover, strong exports and private capital inflows have allowed Uruguay to strengthen its reserve position significantly. In March 2006, Uruguay advanced its planned issuance of global bonds, enabling it to repay, ahead of schedule, $625 million in obligations coming due to the IMF in 2006.

Uruguay-IMF activities in FY2006

June 2005	IMF Executive Board approves a new three-year Stand-By Arrangement for Uruguay
September 2005	Completion of first review of Uruguay's performance under Stand-By Arrangement
January 2006	Completion of second review of performance under Stand-By Arrangement
March 2006	Completion of third review of performance under Stand-By Arrangement
March 2006	Visit of Deputy Managing Director Agustín Carstens

additional metadata on oil and gas activities and products. They noted that this would promote public knowledge and understanding of how countries incorporate oil market information when compiling macroeconomic indicators.

Directors generally endorsed the further integration of the SDDS and the GDDS into the Fund's Data Quality Program by reformatting countries' SDDS/GDDS metadata according to the Data Quality Assessment Framework (DQAF). Using a common metadata structure would increase both the effectiveness and the efficiency of the staff's work on the SDDS, the GDDS, the data ROSC, and statistical technical assistance, without imposing an additional burden on participating countries.

Guide on Resource Revenue Transparency

In December 2004, the IMF disseminated for public comment a draft *Guide on Resource Revenue Transparency.* The Guide[16] was finalized in June 2005, following a period of comment by the Executive Board and the general public. Given the potentially substantial costs of nontransparent practices in the management of natural resource revenues, institutional strengthening to improve transparency in resource-rich countries can provide ample payoff for a relatively modest investment.

The Guide applies the principles of the *Code of Good Practices on Fiscal Transparency*[17] to the unique set of problems faced by countries that derive a significant share of revenues from natural resources (the focus of the Guide is on hydrocarbon and mineral resources). It complements the *Manual on Fiscal Transparency*[18] by providing a framework that covers the resource-specific issues to be considered in assessing fiscal transparency—for example, as part of a fiscal ROSC. It also includes a summary overview of generally recognized good or best practices for transparency of resource-revenue management that can be used by member countries, the IMF, the World Bank, and others providing technical support.

Crisis prevention

Surveillance is one of the IMF's main tools in the prevention of financial crises. Although the crises of the 1990s have been followed by several years of relative calm, the IMF continues to refine its tools for identifying vulnerabilities and weaknesses in its member countries and in the international financial system so that they can be addressed before a crisis erupts.

[16]Available at *www.imf.org/external/pubs/ft/grrt/eng/060705.pdf.*
[17]The Code can be found at *www.imf.org/external/np/fad/trans/code.htm.*
[18]Available at *www.imf.org/external/np/fad/trans/manual/index.htm.*

In September 2005, the IMF sponsored a high-level conference at its Washington, D.C., headquarters that addressed key financial stability issues. Participants in the conference—central bank and supervisory officials from 40 of the IMF's member countries—examined the risks stemming from rapid credit growth and asset price bubbles in financial and housing markets, possible monetary and prudential policy responses for addressing these risks, the institutional aspects of implementing the financial stability mandate, and issues related to supervisory gaps and preconditions.

Another key issue for financial stability is the dramatic increase in capital mobility. Despite its considerable potential benefits, capital mobility can put countries at risk of a crisis if investors suddenly lose confidence and withdraw their capital. The Fund has therefore sought to build up its expertise on the issues surrounding capital account liberalization and to strengthen its policy advice in this area. The importance of this issue was highlighted in both the Medium-Term Strategy and the IEO's "Report on the IMF's Approach to Capital Account Liberalization."[19]

IEO report on IMF's approach to capital account liberalization

At their May 2005 discussion of the IEO's report on the IMF's approach to capital account liberalization, Executive Directors noted that financial integration can confer benefits to the global economy by promoting an efficient allocation of savings and a diversification of risks. Stressing the increasing significance of capital account issues in IMF surveillance and of fully addressing the difficulties and complexities the Fund faces in providing advice in this area, they welcomed the opportunity to explore how the Fund's effectiveness could be further advanced.

Directors appreciated the IEO's efforts in evaluating the IMF's experience since the early 1990s with a large sample of representative countries. They noted that the report offered a broadly accurate account of the evolution of Fund thinking and practice on the issues surrounding capital account liberalization and capital flow management. Directors welcomed the IEO's confirmation that the Fund did not apply an inappropriate "one-size-fits-all" approach to capital account liberalization in individual countries and concurred with the report's finding that the IMF did not pressure members to liberalize their capital accounts sooner than desired by the authorities and generally did not challenge the use of temporary capital controls. The Fund's approach to capital account liberalization should continue to be flexible and take account of countries' specific circumstances and preferences. At the same time, Directors recognized that the risks of an open capital account had not always been sufficiently highlighted in the Fund's past operational policy advice and that little policy advice had been offered in the context of multilateral surveillance. Substantial strides have been made in recent years, however, based on experience and supported by the Fund staff's extensive analytical work on capital account issues and financial system stability.

Directors expressed a variety of views on the importance of factors motivating capital account liberalization, such as free trade agreements and bilateral investment treaties. It was acknowledged that such agreements are negotiated voluntarily by country authorities when considered to be in the national interest. At the same time, many Directors saw a key role for Fund involvement in policy advice on capital account issues as a means of promoting orderly and nondiscriminatory capital account liberalization.

Directors also commented on the two main recommendations of the IEO report. With respect to the first recommendation—the need for more clarity on the IMF's approach to capital account issues—Directors stressed that the Fund had long attached importance to capital account issues and vulnerabilities. The Fund had provided country-specific guidance to member countries on strengthening domestic policies and practices to manage risks related to capital account liberalization. Furthermore, regional and global surveillance had increasingly focused on global financial market linkages, demand and supply factors, and the implied costs and benefits of capital account liberalization. Directors agreed that the IMF had a responsibility to its members to analyze the benefits and risks in a world of open capital markets and to provide them with practical, sound, and appropriate policy advice on those issues. On the broader aspects of the Fund's role in capital account liberalization, most Directors did not wish to explore further at that time the possibility of giving the Fund jurisdiction over capital movements. However, a number of Directors felt that the Fund should be prepared to return to this issue at an appropriate time. Directors also noted that additional work on capital account issues was contemplated in the context of the Fund's Medium-Term Strategy.

Directors saw scope for sharpening the IMF's advice on capital account issues. They emphasized that Fund staff should continue to draw upon all available research in its policy advice to members, and that further research and study were needed to fully understand how best to obtain the benefits and manage the risks of capital account liberalization, including sequencing issues. Directors urged the staff to base policy advice on solid analysis of individual country situations. Directors also encouraged the staff to

[19] The report and the summary of the Board's discussion are available at *www.imf.org/external/np/ieo/2005/cal/eng/index.htm.*

further strengthen its technical expertise on capital account issues.

With respect to the second recommendation—that the IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and to what can be done to minimize the volatility of capital movements—Directors welcomed the various initiatives under way in the Fund to strengthen research, analysis, and surveillance of the supply of capital flows. They agreed with the IEO's view that considerable progress had already been made in this area. A number of recent staff studies had examined the supply-side features of capital flows, and Directors noted that recent issues of the *Global Financial Stability Report* had examined the determinants and volatility of capital flows to emerging market countries. Directors further pointed to the Capital Markets Consultative Group, which served as an informal forum for dialogue between participants in international capital markets and Fund management,[20] as well as to the visibility given to supply-side issues by staff at the Financial Stability Forum (FSF) and the Basel Committee on Banking Supervision.

Directors encouraged the staff to continue to deepen its understanding of supply-side factors and their operational and policy implications. In particular, they suggested that more attention be devoted to the spillover effects from regional developments and from policies in systemically important advanced and developing countries. Directors cautioned that any expanded work on supply-side issues should not entail Fund involvement in the regulation of the sources of capital, noting that the Fund should instead coordinate with the FSF and other forums that have the necessary expertise and mandate in the setting of standards.

Directors agreed that the IMF's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping to ensure that controls are not used as a substitute for adjustment. The aim would be to build on existing Fund expertise in this area and to ensure that policy advice on capital account issues was fully incorporated in bilateral and multilateral surveillance. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's Medium-Term Strategy.

[20]The Capital Markets Consultative Group (CMCG) was established in July 2000 by Horst Köhler, the IMF's Managing Director at that time, to provide a forum for informal dialogue between participants in international capital markets and the IMF. The CMCG is chaired by the IMF's Managing Director. In March 2006, Rodrigo de Rato, the IMF's current Managing Director, participated in a meeting of the Capital Markets Consultative Group in Mexico City.

Balance sheet analysis

In line with the increased emphasis on key balance sheet risks and financial vulnerabilities, the *World Economic Outlook* reports and two issues of the *Global Financial Stability Report* published in FY2006 applied balance sheet analysis to their coverage of mortgage markets and the U.S. household sector, respectively, as did Germany's Article IV consultation with respect to long-term public sector issues (see Chapter 3). A staff paper on debt-related vulnerabilities and financial crises examined developments in Argentina, Brazil, Lebanon, Peru, Turkey, and Uruguay.[21] The IMF staff refined its modeling tools and developed its databases to support the analysis of global imbalances and other multilateral policy issues. In addition, the analytical framework for the balance sheet approach was extended by use of a contingent claims approach.

Global economic and financial impact of an avian flu pandemic

In its present form, the virus that causes avian flu cannot transmit efficiently from human to human, but a mutation allowing such transmission could cause a pandemic. To help raise awareness about the potential economic and financial risks of an avian flu pandemic, the Fund has published a paper, "The Global Economic and Financial Impact of an Avian Flu Pandemic and the Role of the IMF," with an attachment outlining the elements emerging as good practices in business continuity planning in the financial sector in the event of a pandemic.[22]

Although predictions are subject to a high degree of uncertainty, a severe pandemic would likely have a significant economic impact. A high level of illness and absenteeism could lead to a sharp, albeit temporary, decline in global economic activity because it would pose a negative shock to both supply and demand. Demand could contract sharply, with consumer spending falling and investment being put on hold, while trade and tourism flows could be interrupted in some countries. The fiscal challenges associated with an avian flu pandemic, as fiscal deficits widen, could be significant, especially for low-income countries, and some countries could face overall balance of payments pressures.[23]

[21]Published as Christoph B. Rosenberg and others, 2005, *Debt-Related Vulnerabilities and Financial Crises*, IMF Occasional Paper No. 240; see *www.imf.org/external/Pubs/NFT/Op/240/op240.pdf.*

[22]Available at *www.imf.org/external/pubs/ft/afp/2006/eng/022806.htm;* see also "Progress Report to the International Monetary and Financial Committee on Fund Initiatives to Promote Avian Flu Preparedness," *www.imf.org/external/np/pp/eng/2006/041806.pdf.*

[23]The economic and financial impact of a pandemic are discussed in the *World Economic Outlook, April 2006,* and the *Global Financial Stability Report, April 2006.*

High absenteeism could also disrupt critical functions and services of the financial system, including payments, clearing and settlement, and trading. Such disruptions could spill over into other jurisdictions. As regards financial markets, some increase in risk aversion is highly likely, leading to a greater demand for liquidity and for low-risk assets. While the "flight to quality" should be temporary, asset price declines could put the balance sheets of some financial institutions under stress. There could be a period in which net capital flows to some emerging markets decline or are even reversed.

Preparations to limit the impact of the avian flu outbreak are rapidly moving to the forefront of policy priorities in many countries and international organizations. At the International Pledging Conference on Avian and Human Influenza, held in Beijing in January 2006, $1.9 billion was pledged to support efforts at all levels to help fight avian flu and prepare for a possible pandemic. The World Bank, the World Health Organization (WHO), the Food and Agriculture Organization (FAO), and the Organization for Animal Health (OIE) are taking the lead in preparing a global coordinated response strategy to the possibility of an avian flu crisis and helping members improve surveillance and control capacity and develop national action plans.

The Fund is encouraging countries to prepare for a possible pandemic and facilitating cooperation across countries in preparing contingency plans, particularly in the financial sector. It would be willing to help organize technical assistance for members preparing to deal with a pandemic, if requested to do so.

The level of preparedness in the financial sector for a pandemic varies significantly across the Fund's membership. Some countries, particularly those affected by the 2003 SARS (Severe Acute Respiratory Syndrome) outbreak, are well advanced, while others appear to be only starting to develop a comprehensive approach. Cross-country coordination is being supported by efforts of the Financial Stability Forum, the Fund, and the Joint Forum.[24]

To facilitate sharing of knowledge and experience in business continuity planning in the financial sector, the Fund is organizing regional seminars bringing central banks and supervisory authorities together with health experts and business continuity planners from private financial institutions to share their knowledge on key issues related to avian flu pandemic preparedness. Five such seminars were conducted by early May 2006, including four hosted at the Fund's facilities in Singapore, Tunis, Vienna, and Washington, D.C., and one hosted by the Reserve Bank of South Africa in Pretoria. Additional seminars will be offered in 2006 to ensure that all members have an opportunity to participate.

Should a pandemic occur, the Fund will advise members on appropriate macroeconomic policies and help support them with balance of payments financing if needed.

[24]The Joint Forum consists of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Joint Forum organized a meeting in Hong Kong SAR on February 22, 2006, to discuss business continuity planning. The Financial Stability Forum met on March 16–17, 2006, in Australia and discussed, among other things, pandemic avian flu preparedness.

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IRELAND'S HOUSING BOOM: WHAT HAS DRIVEN IT AND HAVE PRICES OVERSHOT?

ECONOMICS DEPARTMENT WORKING PAPER No. 492

By
David Rae and Paul van den Noord

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Abstract

Ireland's housing boom: what has driven it and have prices overshot?

The Irish housing market is very buoyant. The housing boom is driven by strong economic growth, dynamic demographics and low interest rates. However, large tax advantages and relatively lenient credit policies by banks have also played their part, and prices may have become overvalued. To the extent that high house prices reflect favourable tax treatment, they may lead to economic inefficiencies by drawing excessive resources into residential construction. While a soft landing appears the most likely prospect, a disorderly correction of house prices would pose risks for macroeconomic and possibly financial stability. In this context, one policy lever available to the government would be a phased removal of the tax advantages associated with housing. In addition, banks should remain cautious in their lending and provisioning policies.

This paper relates to the 2006 Economic Survey of Ireland (www.oecd.org/eco/surveys/ireland).

JEL classification: E2; R21; R31.

Key words: House prices; housing market; residential construction; property tax.

* * * * *

Résumé

L'envolée du marché irlandais du logement

Le marché de l'immobilier est très dynamique en Irlande. L'essor du logement s'explique par la forte croissance économique, la dynamique démographique et la faiblesse des taux d'intérêt. Cependant, les importants avantages fiscaux et les politiques de crédit relativement libérales des banques ont aussi joué leur rôle et les prix sont désormais peut-être surévalués. Dans la mesure où les prix élevés de l'immobilier reflètent un régime fiscal favorable, ils peuvent conduire à des inefficiences économiques en attirant des ressources excessives dans la construction résidentielle. Tandis qu'un atterrissage en douceur apparaît très probable, une correction désordonnée de ces prix ferait peser des risques sur la stabilité macroéconomique, voire financière. Dans ce contexte, un des leviers d'action à la disposition des autorités serait une suppression graduée des avantages fiscaux associés au logement. En outre, les banques devraient être incitées à faire preuve de prudence dans leurs politiques de prêt et de provisionnement.

Ce document de travail se rapporte à l'Étude économique de l'Irlande 2006 (www.oecd.org/eco/études/irlande).

Classification JEL : E2 ; R21 ; R31.

Mots clés : Immobilier ; marché du logement ; construction résidentielle ; taxe foncière.

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Ireland's housing boom: what has driven it and have prices overshot?

by David Rae and Paul van den Noord[1]

House prices across the industrialised world have surged since the mid-1990s – with the notable exceptions of Germany and Japan which are both still grappling with the aftermath of real estate busts in the early 1990s. In many countries, housing demand is underpinned by an easy monetary stance (Otrok and Terrones, 2005), while over a longer period tight zoning regulations have exacerbated the upward movement in property prices in and around growth centres (Glaeser *et al.*, 2005). Yet Ireland stands out by its extraordinarily strong increase in house prices over the past decade. It is important to understand what has been driving this increase in order to judge the likelihood, timing and size of any fall. A sharp decline in house prices would be a concern for homeowners and could have serious consequences for macroeconomic and financial stability. Meanwhile, the booming market combined with the tax treatment of housing may be impacting on the economy's productive potential by diverting a large amount of resources into residential construction. It may also be acting as a brake on labour supply by making it more expensive for people to immigrate and settle in the country.

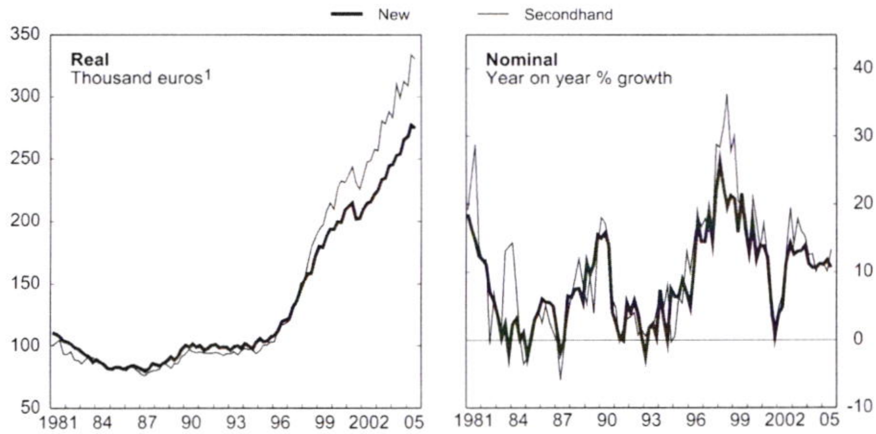
This paper argues that *most* of the increase in Irish house prices is justified by the economic and demographic driving forces. It should be remembered that in 1993 the average Irish house cost a mere € 75 000, which was extraordinarily low for a European country. Since then, remarkable growth in incomes, low interest rates, strong population growth, especially among the younger house-forming age groups, a surge in immigration and changing living patterns have all contributed to the boom. However, prices have probably over-shot to some extent, and taxation may have contributed to fuelling the speculative boom. Looking ahead, the most likely scenario is that prices stabilise and the housing market stays flat for some years. But there is some risk that house prices will fall, and the market is certainly exposed should the economy be hit by a negative shock. This chapter looks at the past and the future of the housing market and discusses the role that policy can play going forward.

Forces driving the housing market

Ireland's house prices have risen dramatically since the mid-1990s. From 1995 to 2005 the price of second-hand houses more than tripled in real terms (Figure 1, left panel). House price inflation eased temporarily in 2001 but it has reignited since. Compared with other countries, the Irish housing boom has been extraordinarily vigorous: both in real and nominal terms the increase in house prices since the mid-1990s has been the highest in the OECD, with the United Kingdom and Spain ranking second and third respectively.

1. This paper was originally prepared for the *OECD Economic Survey of Ireland* published in March 2006 on the responsibility of the Economic and Development Review Committee. The authors are grateful to colleagues in the OECD for their helpful comments, especially Boris Cournède, Peter Hoeller, Andrew Dean and Val Koromzay. Special thanks go to Desney Erb for her technical assistance. The authors can be contacted at david.rae@oecd.org and paul.vandennoord@oecd.org.

Figure 1. House price growth remains high



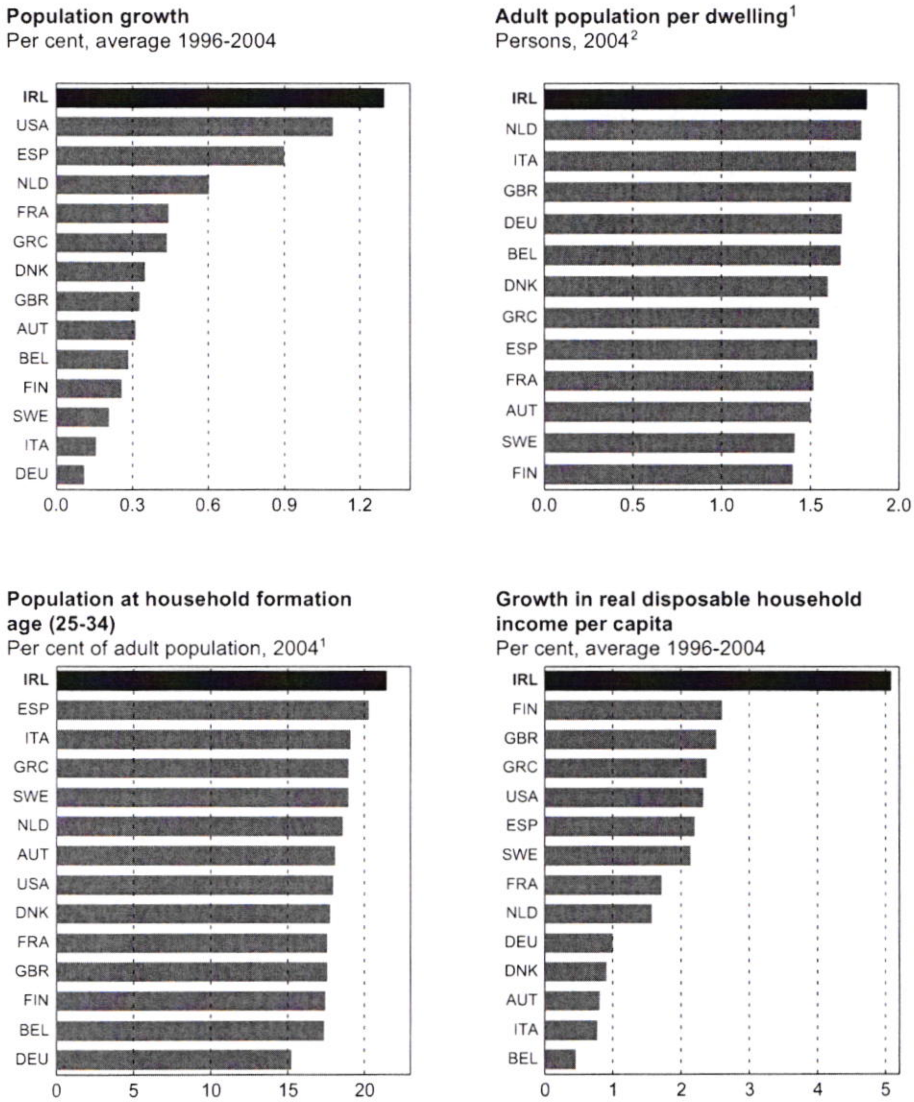
1. Nominal prices deflated using the harmonised consumer price index (base 2005).

Source: Department of the Environment, Heritage and Local Government, *Quarterly Housing Statistics* and OECD, Main Economic Indicators database, May 2006.

More favourable demand factors in comparison with developments elsewhere have surely played a role in shaping the buoyant price developments in Ireland. Growth in real disposable income since the mid-1990s has been stronger than in any other industrial country and real interest rates were among the lowest (Figure 2). The decline in inflation has also contributed by front-loading mortgage repayments. Furthermore, demographic trends were particularly favourable to housing demand in the 1990s, including strong population growth, a sharp fall in household size from a high level, a rapid acceleration in the growth of population in the household formation cohort and sizeable net immigration. Other demographic developments include the increase in the number of double income households and higher divorce rates. Another factor is the number of baby boomers investing in the buy-to-let market because of increasing worries about inadequate pension provisions for retirement.

In addition, the tax treatment of housing in Ireland has been more favourable for home ownership than in most other EU countries (van den Noord, 2005). This is reflected in a low user cost of capital. The user cost for homeowners is analogous to the cost of rental accommodation for tenants. It includes the after-tax mortgage interest rate net of capital gains, the opportunity cost associated with equity financing (usually the after-tax deposit rate), property tax (if any) and depreciation. There have been extended periods when the user cost has been negative, in particular in the late-1970s and from the mid-1990s onwards, implying a strong incentive to invest in housing.[1] The main driving factor keeping the user cost negative has been the untaxed capital gains (on owner-occupied homes), whereas the importance of income tax deductions has diminished with the gradual decline in marginal income tax rates and a series of other tax reforms (Box 1). Since taxation of capital gains has an important negative influence on the user cost, its absence could have acted as a catalyst for the upward spiral in house prices.

Figure 2. Forces shaping house prices



1. Adult population covers persons from age 20 onwards.
2. 2003 for Austria, Finland, France, Greece and Italy.

Source: OECD (2005), Labour Force Statistics and Economic Outlook 78 databases; European Mortgage Federation (2005), *Hypostat 2004*.

Box 1. Tax breaks for housing and policy flip-flops

Ireland has some of the most generous tax provisions for owner-occupied housing, largely because it is the only OECD country that allows households a tax deduction for mortgage interest payments at the same time as *not* taxing property values, capital gains or imputed rent (Barham, 2004 and van den Noord, 2005).[1] The following provisions are the most important ones:

- Ireland introduced a residential property tax in April 1983. The rate was 1½ per cent for properties above a certain value and where the owner's income exceeded a certain rate. The 1994 Budget adjusted these price and income thresholds, but those measures were scrapped in the following budget, with a return to the previous system. The property tax was abolished altogether two years later. A private residence of up to one acre is exempt from capital gains tax, which is large enough to cover virtually all houses.

- Mortgage interest can be deducted against income tax. Prior to 1974 there was no limit as the full cost of mortgage interest could be deducted at the marginal tax rate. A ceiling was introduced in 1974 and increased on two occasions, in 1993 and 2003. Both these increases followed prolonged periods in which interest repayments normally exceeded the ceiling. Mortgage interest relief was phased in at the standard rate of tax (as opposed to the marginal rate) in 1994. This saw a reduction in the benefit accruing to homeowners with the deductibility rate falling from 48% in 1993 to 26% in 1997. Meanwhile, the imputed rental income is not taxed, unlike rental income to a third party.

- A package of tax measures was introduced in 1998 in an attempt to deflate what appeared to be a housing bubble. Stamp duty on new houses that were not owner-occupied was increased, while stamp duty on second-hand houses was reduced; capital gains tax on disposals of qualified residential land was reduced; and tax breaks for rental income were removed. These were successful in stopping house price inflation – possibly too successful, as they were reversed in the 2002 Budget. Meanwhile, another package of measures was introduced in 2000 in order to discourage investors from buying rental property. This included a 9% stamp duty on the purchase of property for rent. That also worked but had the predictable side effect of driving up rents, so it was abolished just a year later. Stamp duty was changed again in the 2005 Budget, this time lowering the tax for first-time buyers.

1. Finland, Portugal and Spain are the only other countries which, like Ireland, give a tax deduction for mortgage interest payments but do not tax imputed rent or capital gains on the principal owner-occupied dwelling. However, all three have municipal taxes on property values ranging from 0.4% to 1%. The size of the tax bias in Ireland has been reduced over time as the ceiling on mortgage interest deductibility has not kept pace with the increase in house prices. Updating the estimates by van den Noord (2005) shows an overall tax wedge of –0.57% for the first seven years and –0.36% thereafter, giving Ireland the fifth-largest tax bias in the EU15.

Access to mortgage finance is also less restrictive in Ireland than elsewhere, especially compared with continental Europe (Table 1). Financial market liberalisation during the 1980s and 1990s has supported demand by allowing a rapid expansion in credit. The full effects of liberalisation were beginning to be felt in the mid-1990s, just at the time when housing demand was growing fast. Loan-to-value ratios have risen from an average level of 60% in the 1980s to around 80% at present. The trend towards securitisation of bank loans is another factor. In general, securitisation makes interest rates on new borrowing more responsive to financial market developments. It also enhances competition, which lowers the costs of taking out a mortgage and makes it easier for households to access their capital through housing equity withdrawals (Catte *et al.*, 2004). The adoption of the euro has been another important influence in helping to increase the elasticity of supply of mortgages. The exchange rate risk disappeared, removing one of the obstacles to the freer flow of funds within the euro area. This means that the domestically-based Irish banks have a hugely expanded pool of funds available. The removal of the exchange rate risk premium, by lowering interest rates, has also acted to stimulate demand for mortgages. Finally, most mortgages in Ireland are variable rate loans, so the reduction in short-term interest rates (until recently) has further boosted demand.

Table 1. Mortgage and housing market indicators

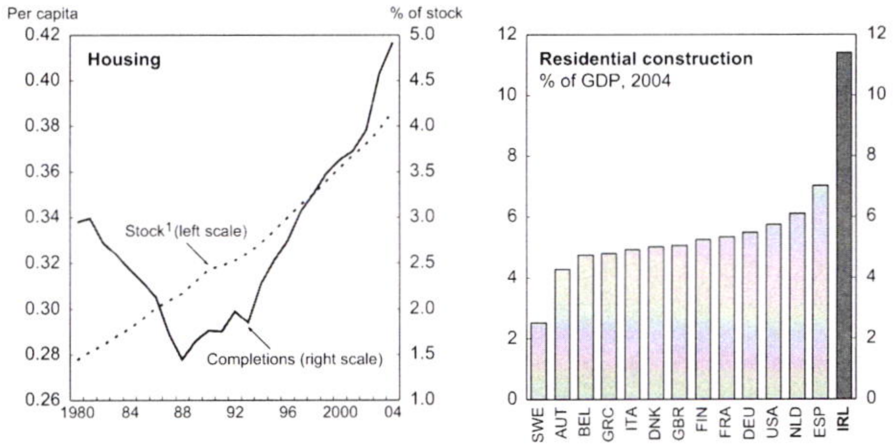
	Residential mortgage debt (% of disposable income, 2003)[1]	Typical loan-to-value ratios of new loans (%)	Typical loan term (years)	Variable interest rates (% of all loans, 2002)[2]	Securitisation of mortgages	Home ownership rate (%, 2002)[2]
Ireland	**106**	**70-100**	**20**	**85**	**Limited**	**77**
Australia	120	90-100	25	73	Yes	70
Austria	..	..	20-30	..	..	56
Canada	77	70-80	25	25	Yes	66
Denmark	188	80	30	15	Yes	51
Finland	71	75-80	15-18	97	Limited	58
France	40	80	15	20	Limited	55
Germany	83	70-80	25-30	72	Limited	42
Italy	20	50	15	56	No	80
Japan	58	80	25-30	..	No	60
Netherlands	208	87	30	15	Yes	53
New Zealand	129	..	..	..	..	65
Norway	24	70	15-20	..	No	77
Portugal	33	..	15	..	..	64
Spain	67	..	15	75	Yes	85
Sweden	98	80-90	<30	38	Limited	61
United Kingdom	105	75	25	72	Yes	69
United States	78	80	30	33	Yes	68

1. 2002 for Norway and Portugal, 2005 estimate for Ireland.
2. Or latest year available.

Source: OECD (2005), *OECD Economic Outlook*, No. 78, Paris; OECD (2004), *OECD Economic Outlook*, No. 75, Paris, June; Tsatsaronis, K. and H. Zhu (2004), "What Drives Housing Price Dynamics: Cross Country Evidence", *BIS Quarterly Review*, Bank for International Settlements, Basel, March; Ahearne, A.G. *et al.* (2005), "House Prices and Monetary Policy: A Cross-Country Study", *International Finance Discussion Papers*, No. 841, Board of Governors of the Federal Reserve System, September; Central Bank and Financial Services Authority of Ireland.

The rise in housing demand triggered a strong response in supply, which again is unprecedented by international standards (Figure 3). House construction and residential permits per capita are among the highest in the OECD. Around a third of the housing stock is younger than ten years old. Half of the stock is detached houses, with apartments accounting for just 6%. The enormous increase in housing supply was accompanied by significant increases in real construction costs and land prices. The significant cost increases did not deter the supply of housing, which was aided by more relaxed zoning rules. Yet, despite the massive increase in the housing stock, it will almost certainly increase further in the medium term (even ignoring the effect of population growth) given that in Ireland there are significantly more adults per dwelling than in other OECD countries. If preferences in Ireland were similar to those in other EU countries, this would, *ceteris paribus,* lead to falling numbers of (adult) persons per dwelling. This gap has undoubtedly been a factor in the buoyant demand for housing and a driving force behind the escalation of house prices, and is likely to act for several more years. Indeed, the high cost of accommodation in Ireland may be discouraging people from forming an independent household (Fitz Gerald, 2005).

Figure 3. Residential construction is booming



1. OECD estimate of stock of permanent dwellings, end of year.

Source: Department of the Environment, Heritage and Local Government (2005), *Annual Housing Statistics, Bulletin 2004*, The Stationery Office, Dublin and OECD (2005), Economic Outlook 78 database.

Are house prices overvalued?

The question of whether the fundamentals can fully explain the Irish housing boom can be addressed by different methods. One approach is to use an econometric model and see if house prices deviate from their long-term equilibrium level. Another is to treat housing as an asset that reflects the discounted present value of its future earnings. However, these indicators need to be complemented by other evidence such as price-to-rent ratios, measures of affordability and benchmarking against other countries. A range of evidence is discussed below.

An econometric model of house prices

Econometric models can be used to estimate the "fundamental" price, as determined by demand factors, such as real disposable income and real interest rates, and supply factors. A price level in excess of the fundamental price could be a sign that prices are inconsistent with demand and supply conditions and instead may be driven by irrational expectations of future capital gains. In such a house price bubble, home buyers consider that a house that would normally be too expensive for them (or much more expensive than renting) is worth buying because they will be compensated by significant further price increases (Meen, 2000 and Case and Shiller, 2003).

After tracking each other closely for many years, the prices of new and second-hand houses began to diverge in the mid-1990s. Since 1995, average second-hand house prices have risen by around 340%, compared with 240% for new houses. The different trajectories are not surprising as the two types of housing are not perfect substitutes (for example, the average new house is smaller and further from the city centre) and the supply of new houses can expand more rapidly than existing dwellings, the supply of which is less elastic. Because the markets are so closely related but are not perfect substitutes, the prices of new and second-hand houses are modelled together in a joint estimation framework based on a cointegration error-correction approach. Long-run or equilibrium prices are assumed to depend on real per capita disposable income, y, the real after-mortgage interest rate, r, and the stock of each type of dwelling, H. The basic estimation framework is shown below:

$$p_t^{sh} / p_t^c = \alpha_1 + \beta_1 y_t - \gamma_1 r_t - \theta_1 \left(h_t^{sh} - pop_t^{25-44}\right) + \lambda_1 \left(pop_t^{25-44} / pop_t\right).$$

$$p_t^{new} / p_t^c = \alpha_2 + \beta_2 y_t - \gamma_2 r_t - \theta_2 \left(h_t^{new} - pop_t^{25-44}\right) + \lambda_2 \left(pop_t^{25-44} / pop_t\right).$$

where lower case letters denote natural logarithms, p^n is the price of new houses, p^{sh} is the price of second-hand houses and p^c stands for consumer prices, here measured by the core harmonised consumer price index (HICP; excluding food and energy). The housing stock, h_t, is based on a cumulation of housing completions net of depreciation (see Box 2 for a more precise description of the variables). In the estimation described below, the stock of new dwellings was not found to be a statistically significant determinant of the price of new dwellings, and therefore was dropped from the estimation. To some extent this is not surprising as supply is fairly elastic. The demographic variable (the share of the population that is around the household-formation age) is included to capture the hypothesis that a younger population is likely to put extra pressure on the housing market.

The two equations are estimated on quarterly data from 1977 to 2004 using the Seemingly Unrelated Regressions (SUR) estimator. Short-run error correction models are then estimated, again using SUR. The final results from the system are:

Second-hand house prices: long run

$$p_t^{sh} / p_t^c = \underset{(3.88)}{6.811} + \underset{(48.4)}{1.6883}\, y_t - \underset{(9.16)}{1.9289}\, r_t - \underset{(6.63)}{1.6785}\left(h_t^{sh} - pop_t^{25-44}\right) + \underset{(6.36)}{2.9862}\left(pop_t^{25-44} / pop_t\right)$$

New prices: long run

$$p_t^n / p_t^c = \underset{(10.4)}{-2.6130} + \underset{(57.6)}{1.5279}\, y_t - \underset{(14.8)}{2.0471}\, r_t$$

Second-hand prices: short run

$$\Delta\left(p_t^{sh} / p_t^c\right) = \underset{(0.16)}{0.0119}\Delta\left(p_t^{sh} / p_t^c\right)_{t-1} + \underset{(1.58)}{0.1127}\Delta\left(p_t^{sh} / p_t^c\right)_{t-2} + \underset{(3.47)}{0.2517}\Delta\left(p_t^{sh} / p_t^c\right)_{t-3}$$

$$+ \underset{(5.76)}{0.9916}\Delta y_t + \underset{(2.13)}{0.4052}\Delta y_{t-4}$$

$$- \underset{(6.405)}{0.4817} ECM_{t-1} + \underset{(4.37)}{0.3382} ECM_{t-1}^{new\ prices} + \underset{(3.35)}{0.0403} DUM$$

$$R^2 = 0.5127; \quad s.e. = 0.0238; \quad DW = 1.75$$

New prices: short run

$$\Delta(p_t^n / p_t^c) = \underset{(2.21)}{0.1584}\Delta(p_t^n / p_t^c)_{t-3} + \underset{(2.56)}{0.1939}\Delta(p_t^n / p_t^c)_{t-6} + \underset{(5.57)}{0.7948}\Delta y_t + \underset{(2.74)}{0.4171}\Delta y_{t-4}$$

$$- \underset{(2.82)}{0.1708} ECM_{t-1}^{negative} - \underset{(1.03)}{0.0598} ECM_{t-1}^{pos} - \underset{(1.11)}{0.00326} + \underset{(4.14)}{0.0408} DUM$$

$$R^2 = 0.4927; \quad s.e. = 0.0199; \quad DW = 1.81$$

The main findings are that:

- The long-run income elasticity is estimated to be 1.5 for new houses and 1.7 for second-hand houses. Both estimates are higher than the ones estimated by Fitz Gerald *et al.* (2003) and IMF (2004), which are 1.07 (for new houses) and 1.20 (for a weighted-average of new and second-hand houses) respectively. The demographic variable affects second-hand house prices in the expected way, but is not significant in the equation for new houses.
- The interest rate semi-elasticity is around –2.0 in both cases. This also is larger than estimates in other recent studies.
- The per capita housing stock has a significant negative impact on the price of second-hand houses.
- The short-run income elasticities are high in both equations, meaning that prices respond quickly to changes in household incomes.
- For new house prices, the error-correction coefficient is asymmetric. It implies that house prices rise more easily than they fall. More precisely, negative disequilibria (prices below fundamentals) tend to be corrected by a subsequent increase in prices. In contrast, if prices are above fundamentals they tend not to drop but to "wait for fundamentals to catch up" (see O'Donovan and Rae, 1997, for evidence of a similar effect in New Zealand).
- The error-correction coefficient for new house prices enters the equation for second-hand house prices with a positive sign. This means that disequilibrium in the market for new houses spills over into the market for second-hand houses.
- A dummy variable (DUM) was included to capture a confidence crisis in 2001 associated with the announced (but rapidly withdrawn) introduction of a flat-rate 9% stamp duty (to replace the existing progressive rate schedule with a top rate of 9%) and a 2% anti-speculative property tax. The coefficient implies that the policy change led to a temporary fall in house price inflation by around 10 percentage points, although it may also be picking up other factors such as the hit to confidence coming from the bursting of the high-tech bubble.
- In terms of the statistical properties of the equations: *a)* the fit is relatively good for such a volatile variable, with a standard error around 2% in both equations; *b)* the error-correction coefficients are relatively large and statistically significant, implying that the long run equations are cointegrated (this is confirmed by a direct ADF test of the residuals from the long-run equations); *c)* there are no signs of mis-specification from residual tests of autocorrelation, heteroscedasticity and non-normality; and *d)* the coefficient estimates are relatively stable over time.

Box 2. Description of the data

House prices are average sales prices recorded by the Department of Heritage and Local Government. They are not adjusted for quality or composition (an alternative quality adjusted index is constructed by TSB Permanent Bank but this starts only in 1996). They are deflated by the core HICP (HICP excluding food and energy). Series for the stock of dwellings and pre-tax mortgage interest rates have been provided by the Economic and Social Research Institute (ESRI). The total dwelling stock is based on summing up dwelling completion figures, adjusting for depreciation and benchmarking to census estimates in 1991, 1996 and 2002. This is split between new and second-hand houses as follows. The stock of new houses is estimated by summing completions (less depreciation) and assuming that 15% of new houses "fall" from the new to the second-hand market each year. That is, the half-life of a new house before it becomes part of the "established" or second-hand stock is approximately 4-5 years. The stock of second-hand houses is equal to the total stock (as estimated by ESRI) minus the new stock. The after-tax mortgage interest rate has been computed as the pre-tax mortgage interest rate multiplied by one minus the relevant marginal income tax rates as published in Barham (2004). The real after-tax rate is the nominal after-tax rate minus the core HICP inflation rate. Real disposable household income is taken from the OECD Economic Outlook database. Demographic variables (population by age) are from the Central Statistics Office.

An extended three-equation model was also tested. This had an additional equation for dwelling investment because the housing stock is likely to be an endogenous variable, and in particular to be a function of house prices. The additional equation did not materially alter the estimates in the house price equations so the results are not reported here (available on request from the authors).

Actual and fitted values are shown in Figure 4. The long-run equation can be used to estimate the fundamental price levels. The result, shown in Figure 5, suggests that house prices have been above their fundamental level since early 2003. By the end of 2004, given interest rates prevailing at that time, second-hand house prices were around 10% overvalued and new house prices around 20% higher than their fundamental level. If long-term interest rates were to return to a more reasonable estimate of their long run level (*i.e.* 2 percentage points higher than at the end of 2004) then the overvaluation would be 16% and 26% respectively.

In sum, the model and similar econometric estimates suggest that prices have overshot their fundamental value. It is worth noting, however, that around 80 to 90% of the increase in house prices since 1995 is justified by the fundamentals – rising incomes, lower interest rates, demographic factors, etc. The remainder appears to be speculative froth. All econometric models are subject to considerable uncertainty, due to modelling error, omitted variable bias and so forth, but the estimate from this model is broadly consistent with a similar analysis conducted by the IMF (2004). Some alternative econometric models presented in the Irish Central Bank's *Financial Stability Report 2005* show an estimated over-valuation ranging from essentially zero to more than 70%, highlighting that it is necessary to look at more than one indicator and to make judgements about which indicators may be more reliable than others. Alternative evidence is discussed below.

Figure 4. Actual and fitted house price growth

Per cent, annualised rate

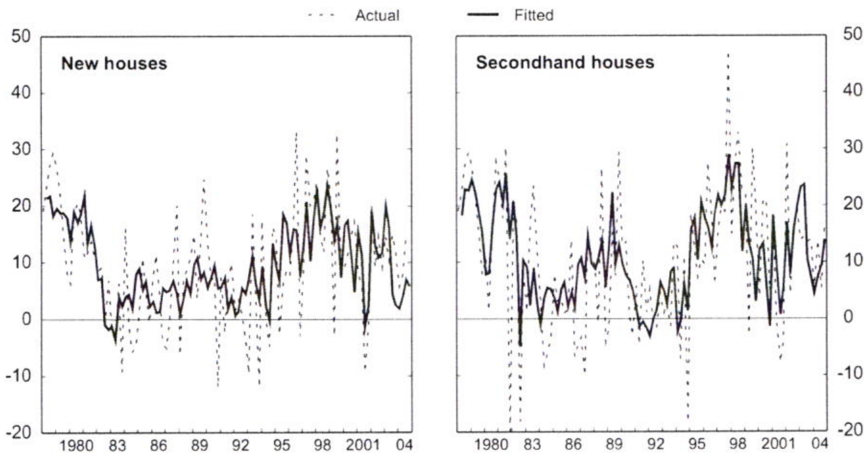
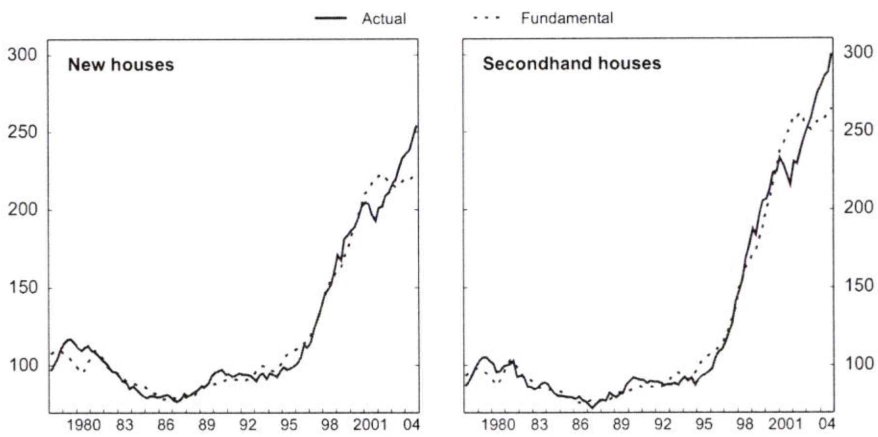


Figure 5. Actual and fundamental house prices

In thousand euros, real prices[1]

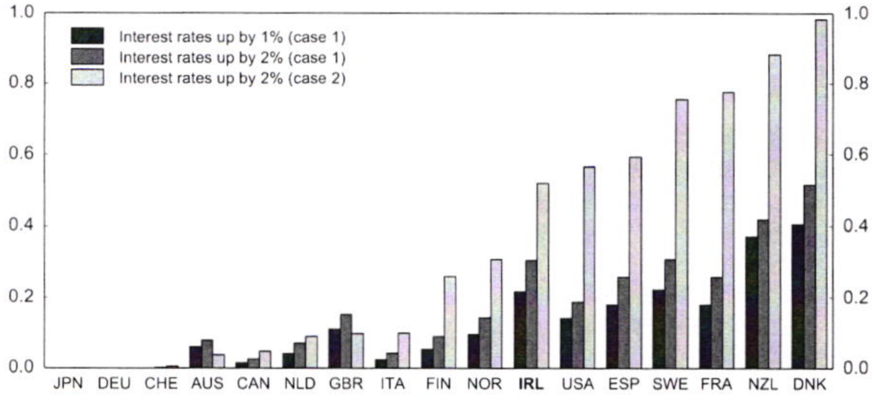


1. Nominal prices deflated using the harmonised consumer price index.

The probability that house prices are approaching a peak

Another way to look at the issue is to build a model that tries to predict house price peaks. Van den Noord (2006) constructs a cross-country probit model for 17 OECD countries in which the probability that real house prices are at a peak depends on past price increases, a measure of the deviation of prices from their trend, and real long-term interest rates. Historically, this model has performed reasonably well at predicting peaks. House prices have been moving up strongly in real terms since the mid-1990s in the majority of OECD countries, not just Ireland, and the current upswing is the longest of its kind in the OECD area since the 1970s. In the current cycle, real house prices have peaked in only two countries so far (Finland in 2000 and Australia in 2004), while they have slowed considerably in two other countries (the United Kingdom and the Netherlands). In most other countries, including Ireland, real house prices have

Figure 6. The probability that real house prices are nearing a peak[1]



1. Case 1 refers to a 100 basis point increase in interest rates from mid-2006 levels, at current real house prices. Case 2 assumes that real house prices continue to increase (or decrease) for another year at the pace observed in 2005 before the interest rate shock is applied. To call a peak it is required that real prices fall over a period of at least six quarters after having risen by at least 15% cumulatively over a period of six quarters.

Source: van den Noord, P. (2006), "Are House Prices Nearing a Peak? A Probit Analysis for 17 OECD Countries", *Economics Department Working Papers*, OECD, Paris, forthcoming.

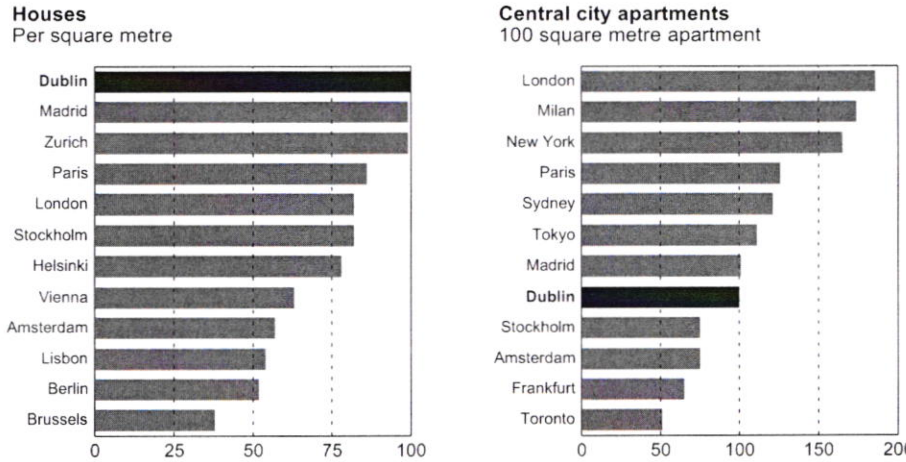
kept growing at a rapid pace or even accelerated. Simulations with the probit model suggest that housing markets in most countries would be resilient against a 1 or 2 percentage points hike in long-term interest rates if it kicked in at current real house price levels, the main exceptions being Denmark and New Zealand (Figure 6). However, the picture changes considerably if real prices are assumed to increase for another year at their observed 2005 pace in each country. In that situation, an increase in interest rates would raise the probabilities of a peak nearing to 50% or more also in Ireland, the United States, France, Spain and Sweden.

International comparisons

It is difficult to compare prices across countries because the size, quality, location and amenities of houses can differ substantially. Comparisons are a little easier if they are restricted to the major cities, but this does not solve the problem entirely. Bearing this in mind, the available evidence suggests that average prices in Dublin are higher than in comparable cities. In a comparison of average sale prices in 2004 across a dozen European cities, the price per square metre was higher in Dublin that everywhere else (Figure 7, left panel). Some further evidence comes from cost-of-living comparisons conducted by various private-sector consultancies. These usually focus on prices or rents of inner-city apartments typically bought or rented by business executives. Here Dublin does not stand out so dramatically (Figure 7, right panel).[2] This may be because rents are not especially high in Ireland but it may also reflect urban sprawl. Anecdotally at least, there is not a great deal of diversity in the housing stock. The centres of the main cities have not been taken over by apartment complexes and there is relatively little high-density in-fill housing. If preferences change and Irish people become more comfortable living in downtown apartments or in higher-density housing with no garden, then the distribution of prices may become more uneven: house prices in the central city may rise significantly relative to prices in the suburbs and city fringes. There is some evidence this may be happening already (Policy Exchange, 2005).

Figure 7. Average house prices

Dublin = 100, 2004



Source: OECD calculations based on data from ERA Immobilier (left panel) and The Economist Intelligence Unit (right panel).

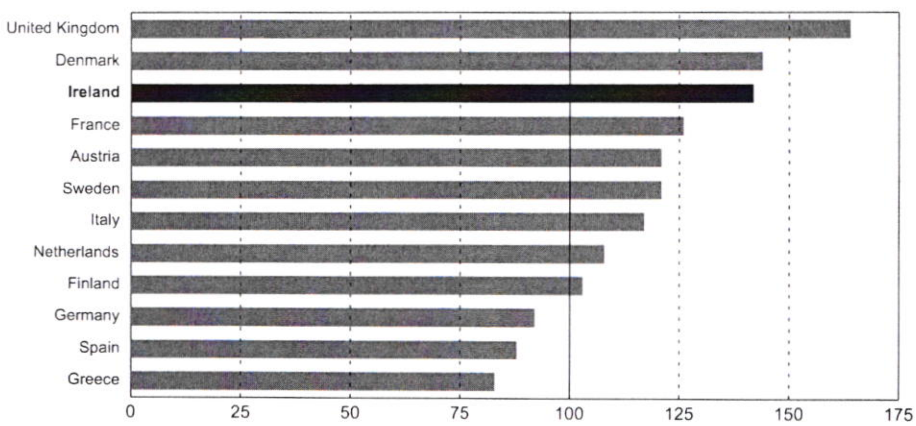
Another way to compare across countries is to look at broadly defined housing costs across countries. Figure 8 shows relative housing costs for several European countries, including house prices and rents as well as household operation and maintenance costs such as water, electricity and gas. In 1995, Ireland was less expensive than the United Kingdom but almost tied for second place with Denmark.

Owning versus renting and the "great ratios"

In a majority of countries, the ratios of prices to rents and prices to disposable income do not have strong trends when considered over long periods of time. The ratios may rise sharply during housing booms, but they usually fall back again through a combination of falling real house prices (*i.e.* a lower numerator) and rising rents or incomes (the denominator rising to catch up). In Ireland's case, the increase

Figure 8. Housing costs are high by international standards

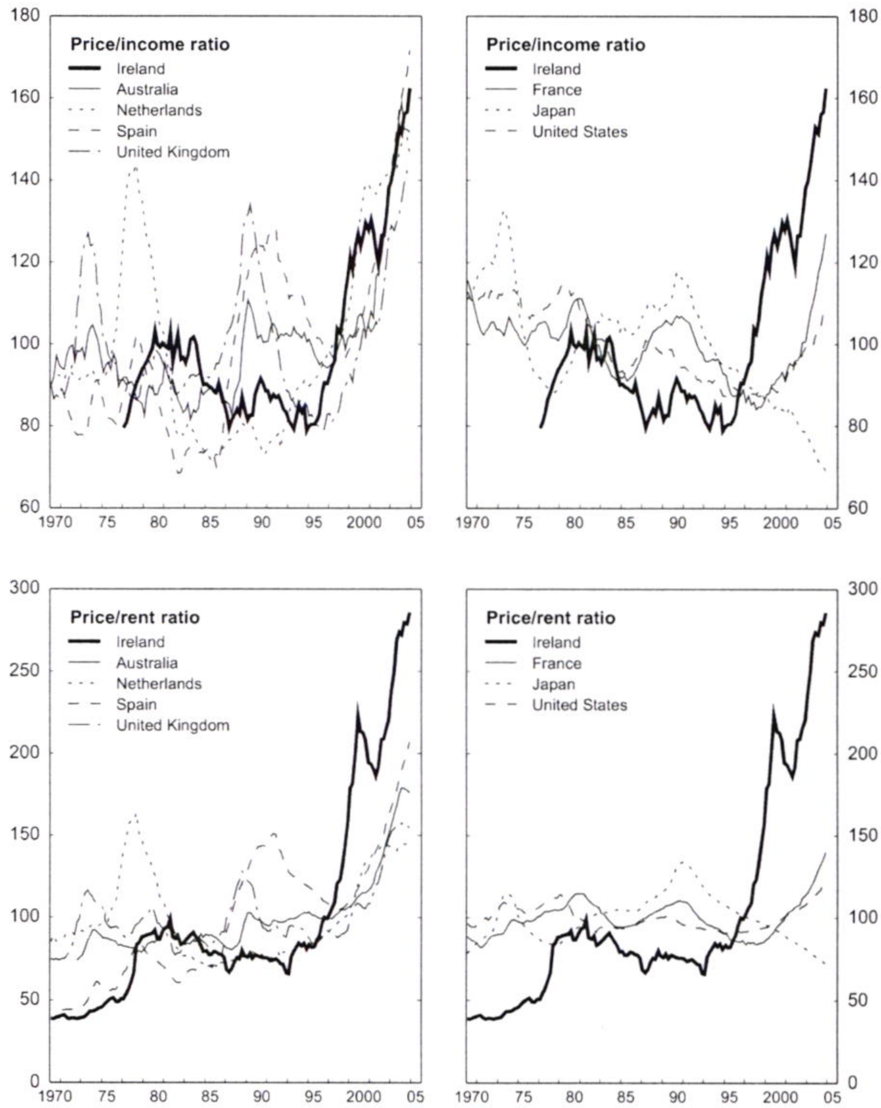
Housing costs including household maintenance, index Belgium = 100



Source: Eurostat.

Figure 9. House prices are generally high relative to rents and income

Sample average = 100



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

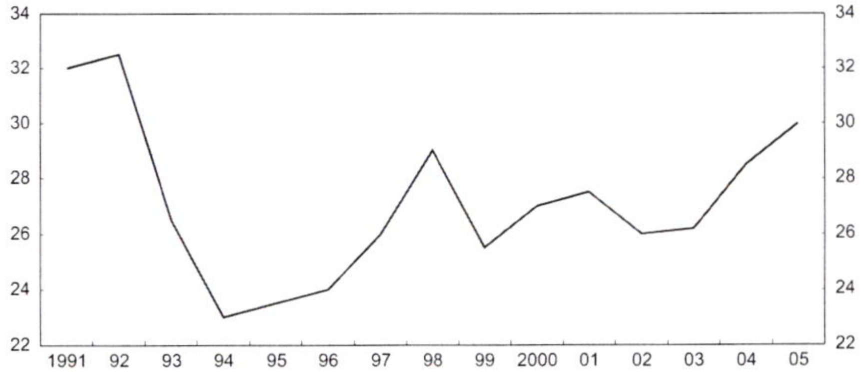
in these two ratios far outstrips the cycles that have been seen in other countries before the most recent global housing boom (Figure 9), although the increase in the price-to-income ratio is in line with some other countries that have also enjoyed booming house prices in the last five years.

The forward-looking present value approach

In theory, permanently lower interest rates should lead to permanently higher price-to-rent and price-to-income ratios. Therefore, *some* increase in these ratios, as identified in the previous paragraph, is justified by the decline in Irish real interest rates. Whether the run-up is *fully* justified can be assessed using the forward-looking present value approach. It determines the fundamental house price as the present

Figure 10. Mortgage repayment burden for a first-time buyer

Mortgage repayments as a proportion of disposable income



Source: Irish Central Bank.

discounted value of expected future rental income from the property and has the advantage over econometric models that it relates the fundamental price to expectations of the future rather than comparing it to past developments. Real incomes have now converged to the euro area average but house prices have substantially overshot the European average. This would imply that people expect growth in Irish incomes to remain above the euro area average for some time to come, and this is probably a fair assumption. If the annual rental income on private housing remains at € 13 000 and assuming a discount rate of 2%, the present value model would give a fundamental house price that is close to current levels. That is, this model concludes that current prices can be justified so long as interest rates remain at their current low level. However, assuming a more reasonable discount rate that reflects long-term expectations of interest rates of around 4%, the present value model yields a 20% overvaluation.

Affordability

The concept of housing "affordability" is popular in public discussions and with the real estate industry, perhaps because of its simplicity. While it is not particularly useful for assessing house price over-valuation, it is a useful measure of cash flow pressures. In 2005, the average mortgage repayment burden for a first time buyer was estimated to be 30% of disposable income (Central Bank, 2005), which is higher than in 1994/95, but is actually slightly lower than it was in 1991, when interest rates were much higher (Figure 10). Thus, the repayment burden is not out of line with past levels – provided, of course, that interest rates remain low.

Other evidence

The effects of increased housing wealth and equity withdrawal on household saving have never been strong in Ireland. The savings rate has been fluctuating around 9% throughout the housing boom. However, this does not imply that no housing equity is released, but rather that it may be recycled back into the housing market. This shows up especially in the buy-to-let market and in the rapid growth in the number of secondary or otherwise mostly vacant homes. This suggests that demand is driven, at least in part, by expectations of capital gains, which may confirm the impression of over valuation emerging from some of the quantitative indicators.

The buy-to-let market is small but has been growing fast.[3] New buy-to-let mortgages constituted 20% of all mortgage transactions in 2004 while 30% of second-hand dwellings sold during the first half of 2004 were previously held as investment properties. The buy-to-let market is dominated by small, mostly inexperienced investors, whose primary objective is to provide for retirement. With property investors taking such an active part in the market, the question is to what extent they have driven up house prices. Attracted by the substantial capital gains and small carrying costs, many investors have entered the buy-to-let market, possibly displacing first time buyers and contributing significantly to housing demand and house prices. The main concern – and another indication of overshooting prices – is the growing divergence between property prices and rental income. Indeed, rents actually fell from 2002 to early 2005. The position of those in the buy-to-let segment of the market will continue to be sustainable only if interest rates stay low. However, if mortgage rates were to rise many of these investment positions would be loss making.

Demand for second homes appears to be another important factor in the housing market. Although housing supply has risen tremendously in recent years, a surprisingly large proportion of it appears to be satisfying demand for second-home properties (in 2005, around 15% of homeowners aged 35-54 owned a second home). As in the case of the buy-to-let market, some properties may have been acquired with the expectation that house prices would continue to grow at a fast pace for the indefinite future. More generally, an important element of the boom over the last decade has been the growth in the number of dwellings that are vacant, for whatever reasons, for most of the year. Fitz Gerald *et al.* (2003) calculated that the number of vacant dwellings in Ireland had increased by 80 000 from 2000 to 2003, which is equivalent to half the houses constructed over that period. On the basis of modelling work in that paper it was estimated that this additional demand would have added between 15 and 20% to house prices over the same period, which roughly corresponds to the overvaluation estimated in the econometric model above.

Key policy issues

Risks to financial stability

An over-valued housing market may have implications for financial stability, but that depends on many factors. The first point to note is that an overvaluation does not imply that prices will drop, at least if the degree of overvaluation is moderate. The housing market is unlike other asset markets in that house price dynamics are not symmetric. Prices rise quickly during booms, but in a market slump most people prefer to take their house off the market rather than sell at a loss. Hence, a *small* fall in prices followed by several years of a flat market is more likely than a sharp drop in house values. Put another way, the price level may remain fairly high as the market waits for the underlying fundamentals to catch up. Another factor working in favour of this benign scenario is that, in the past, house price slumps have usually been triggered by a hike in interest rates, and while interest rates in the euro area are back on an upward path, the increase is likely to be relatively mild – a hike in rates has usually been the trigger for price slumps in the past. But even if they are not overvalued, concerns about stability still arise. If the fundamental drivers were themselves subject to severe negative shocks – such as a slowdown in the expected growth rate of disposable income – then house prices could still fall substantially. This would be particularly difficult for households that are highly leveraged in the buy-to-let and secondary home markets. The sensitivity of these markets to changes in financial conditions may be illustrated by the hit to confidence and the subsequent halt in real house price growth in 2001-02 when the budget announced an increase in the stamp duty and the introduction of an anti-speculative property tax (Box 1). The potential magnitude of the problem is difficult to gauge. Average debt levels are high and are growing rapidly (Table 1), but there is little up-to-date information on how this is distributed across households. The current level of rents is not adequate to cover debt service costs for new or very recent investors (*i.e.* those with a loan-to-value ratio of at least 80%), so their financial position will be squeezed if prices do not rise as fast as they had hoped. Even if house prices level off, there is a potential macroeconomic and financial stability issue that could arise from decline in residential construction. As noted in Chapter 1, the rate of house building will need to fall to some extent to return to its sustainable long-run level. International experience shows that this process is seldom smooth: when the investment rate turns down, it usually falls sharply (Box 3).

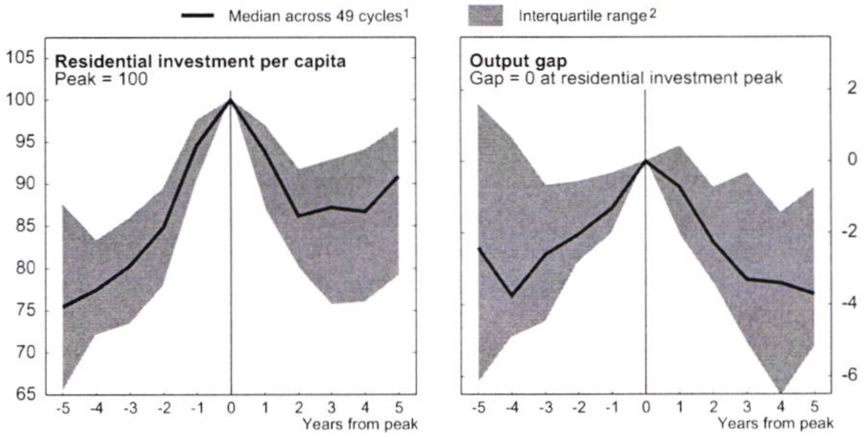
Box 3. Has residential construction ever had a soft landing?

Residential investment is characterised by a pronounced boom-bust cycle. This box looks at how often a construction boom has been followed not by a slump but by a soft landing.

Between 1960 and 2004, 49 residential construction booms have occurred in 23 countries for which data is available. A boom is defined (rather generously) as a rise in the level of real per capita residential investment of at least 15% over a five-year period. In order to avoid identifying false peaks and data blips, a peak is defined as the highest point in a window of the preceding four years and the subsequent three years. By construction, the latest peak that can be identified is 2002; the analysis therefore omits the housing booms that are currently underway. In the cycles that have been identified, the average increase in real per capita residential investment from trough to peak is around 40%. The largest occurred in Korea from 1973 to 1978 (where investment rose by 160%). The trough-to-peak increase has exceeded 50% in 16 cases.

The downturn that follows is usually rapid. On average in the first year after the peak, 40% of the increase during the trough-to-peak upswing is reversed, with another 40% lost in the second year (Figure 11). Investment stabilises at that level for two years, before beginning to recover about five years after the peak.

Figure 11. Has there ever been a soft landing?



1. In each cycle, real per capita residential investment is scaled so that the peak equals 100.
2. The shaded area shows the middle two quartiles (*i.e.* half the countries fall in this range).

Source: OECD (2005), Economic Outlook 78 database.

How common are soft landings? If a soft landing is defined as a relatively small reduction in the investment rate, they are not especially common. There have been only four cases where the decline in per capita residential investment has been smaller than one-third of the increase that occurred during the boom years (these are the Netherlands after 1978, Belgium after 1990, the United Kingdom after 1998 and Finland after 2000). Soft landings are more common if they are defined as *gradual* declines, *i.e.* where it takes at least three years to hit the trough. There have been around 20 examples of these. But all of these were comparatively deep declines. If a soft landing is defined as something that is *both mild and gradual*, there has not been a single case out of the 49 boom-bust cycles.

It is also revealing to look at the behaviour of monetary policy before and after the construction peaks. Of the 34 booms for which there is also data on short-term interest rates, monetary policy tightened before the investment peak in only a little over half of all cases. Thus, there appear to be factors other than a tightening of monetary policy that have been responsible for many of the downturns.

Stress testing by the central bank suggests that the banking system has adequate capacity to absorb a modest fall in residential construction and house prices. However, it is more exposed to a negative shock that reduces residential and commercial property prices simultaneously as more than half of the banking sector's loan book relates to property. Hence, it would be worthwhile for banks to err on the side of caution. Loan provisions are currently in line with international norms, despite Ireland's financial risks possibly being higher than in other countries.[4]

Longer-term economic efficiency

Aside from the question of whether house prices are currently overvalued, there are also issues of longer-term welfare related to the housing market. Given the high price level, the share of the average household budget that is spent on housing is high by international standards. This suggests there may be over-investment in housing and a corresponding under-investment in more productive assets.

The scarcity of accommodation in Ireland is partly a matter of misallocation of resources. To the extent that the increased stock of dwellings is absorbed as secondary or vacant dwellings, there are fewer dwellings available to meet the rise in the number of households driven by the changing age structure of the population. This has also put pressure on the resources of the building industry. Moreover, as noted by Fitz Gerald (2005) the high demand for secondary homes makes it more expensive for individuals to live and run businesses in the regions. The provision of the necessary infrastructure for new dwellings, such as sewerage and water connections, is very expensive, especially in urban areas. Where such dwellings are held vacant for investment purposes,[5] there is not an occupier to generate tax revenues to help defray the costs. Moreover, the government's social housing policy may be putting undue pressure on property prices (Box 4).

Box 4. Housing support may not be provided in the most cost-effective way

The government has substantially increased expenditure on housing support for people on low incomes. In 2004, public social expenditure on housing was more than 1½ per cent of national income – around four times the OECD average. It is unclear whether this money is well spent. There are around 15 different schemes but the government appears to have a strong preference for encouraging home ownership rather than providing rent assistance (Fahey, 2004). In 2004, only 16% of total expenditure went towards rent subsidies (housing benefits); approximately two-thirds went to capital expenditure, especially the construction and maintenance of local authority housing. Local authorities rent out 107 000 units at an average rent of just € 32 per week, so it is no surprise that there is a long waiting list for such housing. Expenditure on social and affordable housing schemes in 2004 amounted to € 1.88 billion and benefited 12 145 households. This subsidy is therefore equivalent to € 155 000 per household. Instead of building new houses for these families, that sum could cover all their rent for 10 to 15 years depending on the type and location of the rental accommodation. In its latest attempt to encourage home ownership, the government announced in 2005 that a further 10 000 houses would be built under its Affordable Housing scheme. People who would otherwise have to spend more than 35% of their net disposable income on a mortgage can apply to buy one of 10 000 new houses at up to a third off market value. The scheme is income tested, and is available to households earning up to around 130% of the average wage. This is in addition to the tenant purchase scheme under which social housing tenants can buy their properties at a considerable discount.

Policy needs to shift to a more tenure-neutral stance. The private rental sector, which currently is small by European standards, could expand if the government shifted more resources towards rent assistance instead of constructing houses and selling them or renting them and controlling the system through queues. Constructing houses and selling them at a low price seems especially ineffective as government assistance only takes into account a household's current, but not permanent income. It has aspects of a lottery, and its irreversibility makes it impossible to adapt to changes in situation or to households' often transitory needs. It is also a high-cost measure, so that less is available for lower cost, but more effective measures. Subsidising low-rent housing, while not suffering from irreversibility to the same extent, still often does not cater to the poorest households as it can be difficult to dislodge renters whose incomes have risen above the threshold for being placed in a low-rent flat. In addition, the owners of social housing parks usually have little incentive to maintain the property. Providing assistance by a housing benefit or housing vouchers would be entirely tenure neutral if households were free to use their means-tested benefits to cover rent or a mortgage. Means-tested housing benefits necessarily increase marginal effective tax rates on low-income earners but Ireland has relatively low marginal rates (at least on first earners) and therefore has more scope than most countries to deliver its housing policy through the income support system and let households make their own choices about whether to own or rent from the private or social sectors.

Furthermore, the level of house prices could reduce the growth potential of the economy by discouraging potential migrants, shifting the balance of labour market growth from employment to wages, with a consequent deterioration in competitiveness. Rises in house prices lead to unambiguous welfare gains for current home owners while immigrants, first time buyers and those with lower labour market skills miss out.

Tax policy issues

Some landowners are reaping large capital gains as a result of the major investment in infrastructure by the state and the rezoning of land for development. It would be appropriate for part of this windfall to be siphoned off by taxation to partly fund the infrastructure investment that creates the gain in the first place. The higher development levies that have been implemented go some way in this direction but they do not affect existing home owners. In contrast, the state is intervening in a number of different ways to encourage demand for housing, thereby pushing up the price. The tax relief on mortgage payments and the under-pricing of infrastructure encourage higher demand and higher prices, especially for land. Restrictive zoning, while popular with existing suburban residents, fuels an artificial shortage and encourages urban sprawl. Hence there is a strong argument for a property tax. But this has so far proved unacceptable to the public. As a softer alternative, some have advocated a property tax on vacant or second dwellings only (Fitz Gerald, 2005). This would help defray infrastructure costs, reduce demand and therefore reduce price pressures, thereby enhancing the productive potential of the wider economy. A very important side effect is that it would reduce the share of this potentially most volatile element in the housing stock.

Box 5. Summary of recommendations

- Phase out the strong bias towards housing that is embedded in the tax system. For example, mortgage interest should not be tax deductible unless a tax on imputed rental incomes or a broader capital gains tax is introduced.
- Introduce a property tax in order to fund local infrastructure and services, and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.
- Encourage banks to be sufficiently prudent in their lending and loan-loss provisioning practices.
- Social housing policy should become more tenure-neutral by scaling back house building and providing more by way of income support and/or housing vouchers.

Notes

1. For Ireland, the user cost is computed by Barham (2004) following the method of Poterba (1984).

2. The figures in the right-hand panel come from the Economist Intelligence Unit and are based on a 100 m^2 apartment close to the city centre. They are highly correlated with the Union Bank of Switzerland's cost of living comparison in different cities (correlation coefficient of 0.78).

3. In 2004, around 8% of the housing stock was for private rental.

4. Loan loss provisions fell from 1.4% of loans in 2000 to 0.7% in the second quarter of 2005 (Central Bank, 2005). This level is in line with other European countries (Hoeller *et al.*, 2004).

5. There was a strange tax loophole until 2002 which meant that it could be worthwhile for a landlord who owned multiple properties to buy an additional property and keep it vacant.

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WORKING PAPERS

The full series of Economics Department Working Papers can be consulted at www.oecd.org/eco/Working_Papers/

491. *Boosting Competition in Ireland*
(June 2006) Dave Rae, Line Vogt and Michael Wise

490. *Factors Behind Low Long-Term Interest Rates*
(June 2006) Rudiger Ahrend, Pietro Catte and Robert Price

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(June 2006) Stéphanie Guichard and Willi Leibfritz

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(June 2006) Paul van den Noord

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(May 2006) Rudiger Ahrend and William Tompson

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(May 2006) Nick Vanston

482. *Revised OECD methods for supply-side and medium-term assessment: a capital services approach*
(Forthcoming in June) Pierre-Olivier Beffy, Patrice Ollivaud, Pete Richardson and Frank Sédillot

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(February 2006) Benoît Bellone and Alexandra Bibbee

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(November 2005) Florence Jaumotte and Nigel Pain

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Batch 8 – List the external expert advice (non-legal) sought or obtained by the Department of Finance on the banking sector and the macroeconomic view during the period 2001 to 2010. If necessary and if not otherwise identified in existing documents, please create a document containing this information. Please also include dates when advice was sought and the contact details for the relevant organisations.

Majority of records held are responses to public consultations on the implementation of EU legislative measures, there are a no of Fitch XX reports – no other external advice sought

Advice	Date advice sought	Contact details
Informal Consultation on the Implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements: response from Euroclear UK & Ireland Ltd	27 August 2010	Susann Altkemper Euroclear UK & Ireland Ltd
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from An Post	July 2009	Hugh O'Reilly, Company Solicitor, An Post
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from Chambers Ireland	July 2009	Sean Murphy Chambers Ireland Merrion Square
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from Chasepaymentech	July 2009	Shane Fitzpatrick Managing Director Europe
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from Irish League of Credit Unions (ILCU)	July 2009	Breege-Anne Murphy
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from IPSO	July 2009	
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from VISA Europe	July 2009	
Consultation on transposition of Directive 2007/64/EC on payment services in the internal market : Response from Matheson Ormsby Prentice on behalf of Western Union	July 2009	
Consultation on PSD National Discretions: Response from An Post	Feb 2008	John Daly
Consultation on PSD National Discretions: Response from ILCU	Feb 2008	Charles McLaughlin Head of IT
Consultation on PSD National Discretions: Response from IPSO	Feb 2008	Pat McLoughlin CEO, IPSO

Consultation on PSD National Discretions: Response from Financial Services Ombudsman	Feb 2008	Joe Meade
Consultation on PSD National Discretions: Response from Mastercard Europe	Feb 2008	Caroline Louveaux European Region Counsel
Consultation on PSD National Discretions: Response from Western Union	Feb 2008	Wolfgang Maschek
Consultation on PSD National Discretions: Response from Competition Authority	Feb 2008	
Consultation on PSD National Discretions: Response from American Express	Feb 2008	
Consumer Credit Directive Consultation: Response from Free Legal Advice Centres	Apr 2009	Paul Joyce
Consumer Credit Directive Consultation: Response from CUDA (Credit Union Development Association)	Apr 2009	Kevin Johnson, CEO
Consumer Credit Directive Consultation: Response from ILCU	Apr 2009	Breege-Anne Murphy
Consumer Credit Directive Consultation: Response from CUAC (Credit Union Advisory Committee)	Apr 2009	Michael O'Connor
Consumer Credit Directive Consultation: Response from Consumer Credit Association Republic of Ireland ('CCARI')	Apr 2009	
Consumer Credit Directive Consultation: Response from The Consumers' Association of Ireland.	Apr 2009	
Consumer Credit Directive Consultation: Response from IBF	Apr 2009	
Consumer Credit Directive Consultation: Response from Ulster Bank	Apr 2009	Walter van Dijk
Consumer Credit Directive Consultation: Response from MABS	Apr 2009	Annmarie O'Connor
Financial Services Legislation: Consultation on Consolidation and Simplification Bill Response from BUPA	Dec 2004	
Financial Services Legislation: Consultation on Consolidation and Simplification Bill Response from Competition Authority	Dec 2004	
Financial Services Legislation: Consultation on Consolidation and Simplification Bill Response from Consumer Credit Association Republic of Ireland ('CCARI')	Dec 2004	David Rees
Financial Services Legislation: Consultation on Consolidation and Simplification Bill Response from CUDA	Dec 2004	
Financial Services Legislation: Consultation on Consolidation and Simplification Bill Response from Financial Services Inter Association Network	Dec 2004	
Financial Services Legislation: Consultation	Dec 2004	

<u>on Consolidation and Simplification Bill</u> Response from Patrick McNutt		
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from ILCU	Dec 2004	
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from KPMG	Dec 2004	
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from PIBA (Professional Insurance Brokers Association)	Dec 2004	
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from Insurance Ombudsman Council	Dec 2004	Dr Maureen Gaffney
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from Skerries Credit Union	Dec 2004	Des Donnelly
<u>Financial Services Legislation: Consultation on Consolidation and Simplification Bill</u> Response from VIvas Health	Dec 2004	Maria-Teresa Kelly Oroz

THEME: R6

Relationship with and oversight by international stakeholders

LINE OF INQUIRY: R6b

Quality and effectiveness of European policies and regulations

88. **Deputy Alan Farrell** asked the **Minister for Finance** if he will outline the long term sustainable repayment plans for loans given to recapitalise the banking system and to fund the day to day expenditure of the State; and if he will make a statement on the matter. **[26840/12]**

Minister for Finance (Deputy Michael Noonan): I understand your question is intended to ascertain when the loans drawn down from the EU/IMF Programme will be repaid. I would first of all emphasise that the funds drawn down under both the EU/IMF programme and the bilateral loan agreements are not ring-fenced for particular uses and contribute alongside tax and other State revenues to meeting all calls on the Exchequer. However, the cost of bank recapitalisation to date has been met from our existing resources — cash reserves and the NPRF. Under Ireland's EU-IMF Programme, which is due to expire at the end of 2013, a total of €67.5 billion in loans will be provided from EU facilities, bilateral loans and the IMF.

At the end of April 2012, Ireland's nominal borrowings under the EU/IMF Programme amount to €48.97 billion.

The weighted average life of the loans drawn down to date is 9.8 years.

The estimated all-in fixed euro equivalent cost of loans received under the EU/IMF assistance programme is 3.46%.

When the programme was initially agreed the average maturity of all loans was set at 7½ years. Following the Euro Area Heads of State or Government meeting in July 2011, it was agreed that average maturities for the EU facilities, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF), should be extended. For the EFSF, maturities will now be a minimum of 15 and up to 30 years.

The repayment of the loans from the IMF commences in 2015, and that for the EU loans we have received from the EFSM and the EFSF also commences in 2015.

In the case of the bilateral loans from the UK, Sweden and Denmark, repayment is due 7½ years after each drawdown.

In relation to the schedule of the current interest rate being charged to Ireland on all forms of funding under the EU/IMF Programme of financial support, the following table supplied by the NTMA, provides the information for all amounts outstanding as at 30 April 2012.

INTERNATIONAL MONETARY FUND

IRELAND

Sixth Review Under the Extended Arrangement

Prepared by the European Department
(In consultation with other departments)

Approved by Ajai Chopra and Lorenzo Giorgianni

May 30, 2012

Ireland's ownership of the program remains strong and policy implementation has continued to be steadfast despite the considerable challenges. All quantitative targets for the review were met, maintaining the strong performance in earlier reviews. Fiscal, financial, and structural reforms are advancing as envisaged. The authorities remain committed to achieving the 2012 fiscal targets and are developing a package of specific measures to underpin the 2013–15 consolidation.

However, renewed tensions in the euro area have driven up Irish bond spreads, while growth remains weak and unemployment high. Public concerns about austerity will shape the outcome of the May 31 referendum on the European Fiscal Stability Treaty. If the referendum supports Treaty ratification, resuming Treasury bill issuance in the second half 2012 was expected to be feasible, but risks have grown recently with the escalation of financial market tensions in the euro area. Indeed, Irish sovereign bond spreads have risen in recent months to exceed the level at the outset of the EU-IMF program, increasing the challenge to enter bond markets at reasonable cost and on the scale needed in 2013 and thereafter.

Discussions focused on achieving program objectives for recovery and regaining access to market funding. The mission reviewed financial sector work streams, as well as personal insolvency reforms, with a view to ensuring the conditions to renew lending on a sustainable basis. Fiscal policy discussions focused on the outlook for 2012 and deepening the credibility of the phased medium-term fiscal consolidation plan. Discussions on structural reforms continued to be oriented toward enhancing growth and employment.

Risks to Ireland's program would be most effectively managed within a broader European plan to stabilize the euro area. Technical work has continued on the remaining issues from Ireland's deep banking crisis, especially the annual promissory note payments and banks' large holdings of legacy assets. Addressing these issues in a timely manner is important to enhance prospects for Ireland to regain market access, which would also be beneficial for the euro area. The stronger European support needed to address these issues would be most effective as part of a broader plan to stabilize financial markets and strengthen growth in the euro area.

Staff supports the authorities' request for completion of the sixth review. The purchase subject to completion of this review would be in an amount equivalent to SDR 1.191 billion (about €1.4 billion).

Publication. The Irish authorities consent to publication of the Staff Report.

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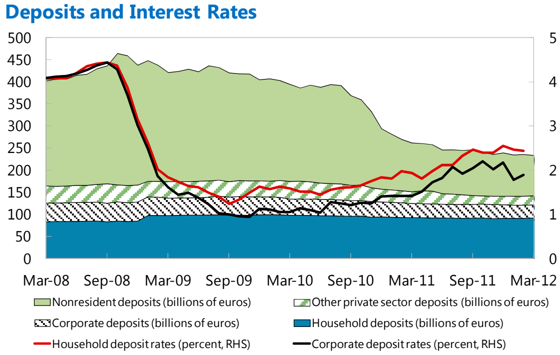
rate of mortgage arrears on principal private residences to 10.2 percent of mortgage accounts and 13.7 percent of mortgage balances at end March 2012. The share of mortgages that have been restructured—predominantly through payments of only the interest due or somewhat more—rose to 12.6 percent at end March 2012, but more than half of restructured loans are in arrears, indicating that deeper loan modifications are needed in some cases.

10. **Bank funding pressures appear to be easing as the overall level of deposits in the banking system has stabilized** (Figure 4)**.** The deleveraging process, and a modest inflow of deposits into the three banks included in the Prudential Capital Assessment Review (PCAR) in 2011 (Allied Irish Banks, Bank of Ireland, and Permanent TSB, or "PCAR banks"), is offsetting their maturing bank debt and has contributed to a gradual reduction in reliance on Eurosystem liquidity support in recent months.[5] The banks continue to access term funding collateralized by U.K. retail mortgages, with AIB recently reporting that it secured the equivalent of €395 million on a 3-year term with a 250 basis point spread over three-month Libor, which follows similar transactions by BoI and PTSB totaling €6.9 billion in late 2011. There are also some signs that competitive pressures on deposit rates may be easing.

Deposits and Interest Rates

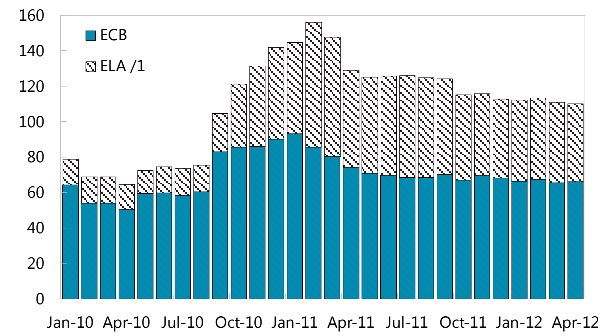


Source: Central Bank of Ireland.

Note: Deposit volumes refer to government guaranteed banks; interest rates refer to resident banks.

Eurosystem Borrowing, Government-Guaranteed Banks

(Billions of euros)



Source: Irish authorities; and IMF staff calculations.

/1 Proxied by the sum of CBI's Other claims on euro area credit institutions and Other assets.

11. **The PCAR banks are highly capitalized but report low profitability mostly due to weak loan quality**. At the end of 2011, Core Tier I capital for these banks averaged 16 percent, up from about 6 percent at end-2010, well above the regulatory minimum of 10.5 percent. However, bank asset quality indicators worsened sharply in 2011, with NPLs rising to 19.5 percent of total loans from 12.1 percent of end-2010, although this was in part driven by stricter CBI loan classification guidelines, and also by the reduction in the value of performing loans (in the denominator) due to deleveraging. Despite the sharp rise in NPLs, banks increased provisioning coverage to 50 percent of NPLs from 42.7 percent in 2010, in line with the new CBI provisioning guidelines. However, the deterioration in asset quality in 2011 has undermined banks' capacity to generate sufficient net interest income to provide for loan losses, with profits before provisioning and extraordinary income declining to 0.2 percent of average assets, from 0.4 percent in 2010 (Box 1).

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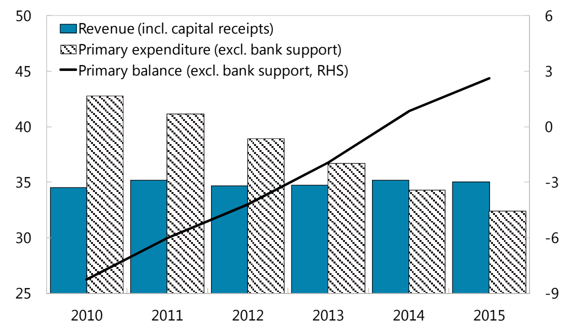
[5] Permanent TSB (PTSB) is the banking subsidiary of Irish Life and Permanent (ILP).

Figure 5. Ireland: Selected Trends in General Government Finances

An 11 percent of GDP rise in the primary balance is targeted by 2015 from 2010.

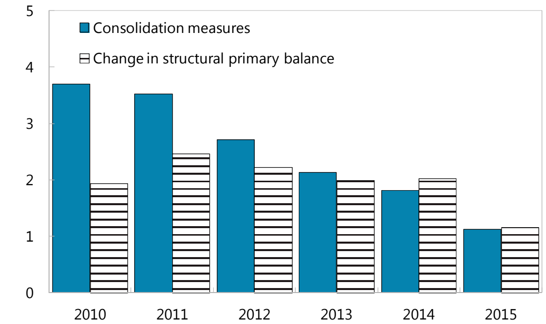
The fiscal measures are front-loaded, yet the fiscal overall adjustment is also phased over time to protect the fragile recovery.

Revenues, Primary Expenditure and Balance
(Percent of GDP)



Sources: Department of Finance; and IMF staff estimates.

Consolidation Measures and Structural Primary Balance
(Percent of GDP)

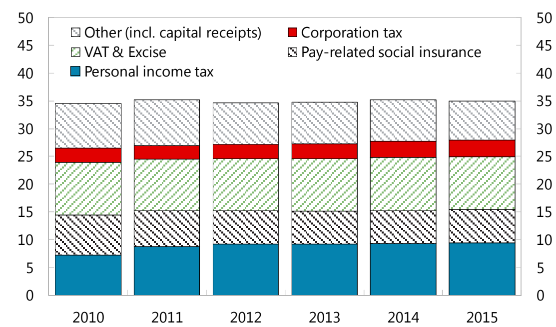


Sources: Department of Finance; and IMF staff estimates.

Tax measures are significant, although they will not raise revenues as a share of GDP given the slower recovery in domestic demand than in GDP.

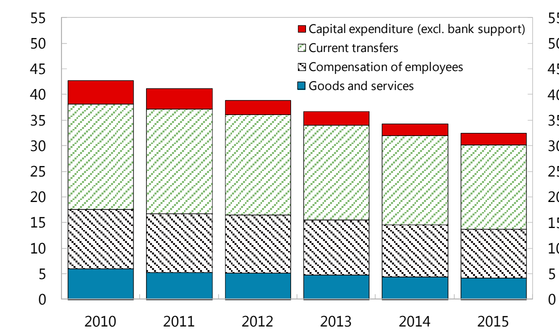
Primary expenditure is to decline by 10 percentage points of GDP from 2010, reflecting durable savings across all components.

Revenue Composition
(Percent of GDP)



Sources: Department of Finance; and IMF staff estimates.

Primary Expenditure Components
(Percent of GDP)

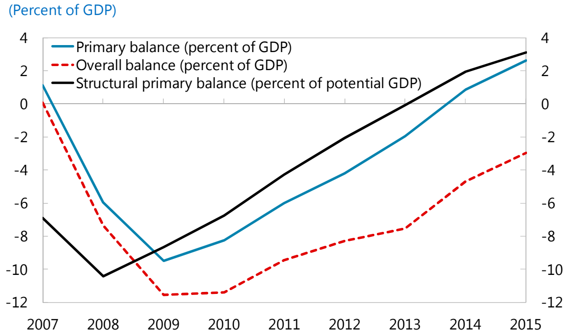


Sources: Department of Finance; and IMF staff estimates.

A 3 percent of GDP overall deficit, and 2½ percent of GDP primary surplus, are targeted for 2015.

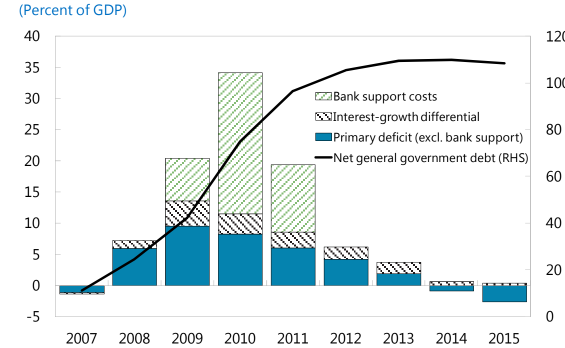
Over half of the increase in net debt arose from bank support costs.

Headline, Primary and Structural Balance 1/
(Percent of GDP)



Sources: Department of Finance; and IMF staff estimates.
1/ Excluding bank support.

Sources of Increase in Net Debt-to-GDP Ratio
(Percent of GDP)



Sources: Department of Finance; and IMF staff estimates.

B. Fiscal Policies

33. **The 2012 Budget is on track for the program's fiscal targets** (MEFP ¶13). The authorities have expressed their commitment to unwind the modest spending over-runs in health and social protection by year-end, and to accommodate the somewhat higher outlay for insurance sector support within the existing expenditure envelope.[15] Given the better than expected general government balance out-turn for 2011, and the on-track exchequer performance through April 2012, staff projects a 2012 general government deficit of 8.3 percent of GDP, in line with the authorities' *April 2012 Stability Programme Update* (SPU) and within the 8.6 percent program ceiling. Accordingly, no change is proposed in the quarterly performance criteria on the exchequer primary balance. Staff continues to support the accommodation of revenue shortfalls in the event of significantly weaker growth out-turn in order to protect the fragile economic recovery, and spreading over subsequent years the closure of any emerging fiscal gap arising from this accommodation.

Ireland: General Government Finances, 2007–15 (percent of GDP)

Ireland: General Government Finances, 2007–15 1/
(In percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Total revenue	36.3	35.0	33.9	34.5	35.2	34.7	34.8	35.2	35.0
Total expenditure	36.2	42.3	45.4	45.9	44.6	43.0	42.3	39.9	38.0
Current primary	29.5	33.8	38.7	38.1	37.1	36.0	34.1	31.9	30.1
Capital	5.6	7.1	4.7	4.6	4.0	2.9	2.6	2.4	2.3
Interest	1.0	1.4	2.0	3.1	3.4	4.1	5.6	5.5	5.6
Overall balance	0.1	-7.3	-11.5	-11.4	-9.4	-8.3	-7.5	-4.7	-2.9
Primary balance	1.1	-6.0	-9.5	-8.3	-6.0	-4.2	-1.9	0.8	2.6
Structural primary balance	-6.9	-10.4	-8.7	-6.7	-4.3	-2.1	-0.1	2.0	3.1
Structural balance	-7.5	-11.4	-11.0	-10.1	-7.9	-6.2	-5.7	-3.6	-2.5
Gross general government debt	24.8	44.2	65.1	92.5	108.2	117.5	121.2	119.7	116.2
Net general government debt	11.1	24.4	42.2	74.9	96.4	105.5	109.5	110.0	108.4

1/ Bank support costs are excluded; structural primary balance is scaled to potential GDP.

34. **A package of specific measures is being developed to underpin the programmed consolidation effort over 2013-15** (MEFP ¶15). Although *Budget 2012* identified measures and policy directions in relation to the majority of the €8.6 billion consolidation effort during 2013–15, some important decisions remain to be taken, especially on current spending. The authorities are working toward a more fully specified fiscal program by Budget 2013 in order to facilitate regaining access to market funding and reduce uncertainty for households and businesses about future tax and spending policies. This work is focused on a number of areas where close attention to equity considerations is needed:

- ***Public wage bill***: Following wage cuts in 2009–10, the authorities agreed with public sector unions (Croke Park Agreement) to rely on voluntary reductions in employment

[15] Budget 2012 provides for €396 million in liquidity support (temporary loan) to the insurance compensation fund (ICF) to help cover the losses of Quinn Insurance. However, it is now anticipated that an additional €60 million will be required for this purpose, taking the required injection above budgetary allocations.

VI. STAFF APPRAISAL

45. **The Irish authorities have demonstrated their ownership of the program by maintaining steadfast policy implementation in the face of considerable challenges.** The strong track record from the launch of the program has been extended as all quantitative targets for end March 2012 were met, and fiscal, financial, and structural reforms are progressing as envisaged. Financial markets had reflected these efforts in a significant narrowing of bond spreads. But these positive trends have recently been overcome by the renewal of financial tensions in the euro area that are widening spreads in the region.

46. **Bolstering growth and job creation is central to the success of the program**. Debt sustainability and regaining market access require a strengthening in growth, as the alternative of seeking substantial additional fiscal adjustment in a low growth environment would risk a pernicious cycle of rising unemployment, higher arrears and loan losses, and renewed erosion of bank capital. It is therefore welcome that the authorities are reviewing and adapting their strategy for growth and job creation. Amendments to the proposed sectoral wage reforms will enhance their labor demand benefits. Continued progress in implementing the authorities' jobs initiatives is essential, where additional resources may be needed to strengthen the effectiveness of labor activation efforts, potentially through private provision. Close monitoring of the appropriate application of sanctions for non-compliant jobseekers will be needed, and it is also important to ensure that the structure of social payments avoids unemployment traps for the long-term unemployed. Reinvesting part the proceeds from state asset disposals offers a useful spark for growth in the near-term, and it is important to maximize the longer run benefits through sound regulatory frameworks and strong competition enforcement.

47. **Budget design and implementation is a critical strength that the authorities should build upon to reinforce the credibility of medium-term fiscal consolidation.** The 2012 Budget is on track in the first four months of 2012, demonstrating the prudence of revenue projections, and the authorities are committed to unwind modest spending overruns by year end. Any revenue shortfall associated with significantly weaker growth should be accommodated in order to protect the fragile recovery, yet recouped in subsequent years to support debt sustainability. The work on a package of specific measures to underpin the fiscal consolidation planned for 2013–15, including in areas such as the public sector wage bill, targeting of social benefits, age-related spending, and property taxation, should be completed by the Budget 2013 to support efforts to regain market access. By giving statutory basis to the Irish Fiscal Advisory Council and enshrining EU fiscal rules, the fiscal responsibility bill, together with legislation to underpin the medium-term expenditure ceilings, will create a strong framework to give confidence that prudent fiscal policies and debt reductions will continue after the program.

48. **An integrated approach is required to restore banks' long-term viability and restart lending to support the nascent recovery.** It will be important for the central bank to continue to apply its supervisory powers consistently to bring about the needed strengthening of banks' capacity to manage distressed loans, which is critical to the health of the banks and

their ability to support Ireland's economic recovery. The intensive work on reforming the personal insolvency framework is also an essential element of promoting resolution of debt distress over time. Success will depend on appropriate eligibility criteria and income and expenditure thresholds to maintain debt service discipline, together with ensuring the infrastructure needed for the reforms to be operational is established in a timely manner. A fundamental restructuring of the credit union sector needs to be implemented in a time-bound manner to ensure its viability, supported by stronger regulatory and governance standards, while ensuring any fiscal cost is minimized and recouped from the sector over time.

49. **Addressing remaining vulnerabilities in the financial system will require stronger financial support from the European partners.** Putting PTSB on a sound footing will require the strong implementation of intensive restructuring efforts over a number of years. The success of this approach hinges on the timely separation a significant portion of legacy and non-performing assets to ensure the credibility of the business model for the new PTSB and hence its capacity to deliver on its restructuring plans. However, funding this carve out with Irish government securities is not consistent with restoring PTSB's viability or with program goals for regaining market access. There are a number of modalities by which stronger European financial support could enable PSTB's restructuring to proceed, and the specific approach needs to be determined at coming reviews.

50. **Tackling the issues remaining from Ireland's deep banking crisis in a proactive manner has become critical, and such efforts would be most effective as part of a broader European plan to stabilize the euro area.** PTSB's restructuring is part of a larger need to put the funding of the Irish banking system on a sustainable basis in the wake of an exceptionally costly banking crisis which has deeply stressed the finances of the state. Addressing this larger challenge, by extending the term of the promissory notes and the associated Eurosystem funding, and placing banks' legacy assets in a vehicle that does not rely on market funding, would much enhance the prospects for the banks to support Ireland's economic recovery and for the Irish sovereign to return to the market rather than rely on ongoing official financing. Temporary European equity participation in state owned banks would greatly reinforce these benefits, by weakening bank-sovereign linkages, immediately enhancing debt sustainability, and improving prospects to attract private owners. In view of the recent escalation of financial tensions in the euro area, the stronger European support needed to address these issues would be most effective as part of a broader plan to stabilize financial markets and strengthen growth in the euro area.

51. **Staff supports the authorities' request for completion of the Sixth Review.**

Annex I. Debt Sustainability Analysis

This Annex presents the public and external debt sustainability analysis based on staff's revised medium-term macroeconomic framework and the Irish authorities' fiscal consolidation plan. The analysis has been extended for a longer time horizon reaching until 2021. At this stage, no allowance is made for potential privatization receipts, including the disposal of Irish Life, but at the same time, no allowance for potential additional costs of restructuring the credit union sector is made, which could initially fall in part on the budget.

General Government Debt

The baseline debt scenario contains higher cash buffers in the medium term, resulting in an upward shift of the debt path. The increase in the end-2011 gross debt by €5.2 billion (2.8 percent of GDP) vis-à-vis the 5th review is mainly the result of higher financing generating higher cash buffers, including the timing of EFSF funding and higher rollovers of commercial paper by NAMA. The authorities plan to maintain the higher cash buffer in the remainder of the program, and further augment it with part of the cash savings originating from the payment of the Promissory note through a bond placement in March 2012, while unwinding cash balances over time in the post-program period. As a result, the debt path has shifted upward but converges towards the previous path in the post-program period. Notwithstanding the higher precautionary cash buffer, the debt trajectory is still expected to remain below the initial program projection, which peaked at 125 percent of GDP.

The implementation of the medium-term fiscal consolidation plan continues to underpin the baseline scenario of a declining debt path after 2013. A primary surplus above the long-run debt stabilizing primary balance puts the debt on a downward trajectory in 2014. The reduction in debt levels is bolstered by some unwinding of cash balances in 2014-15. A review of the interest expenditure forecast in view of recent market developments slightly reduces the contribution of the interest/growth differential.

The outlook continues to be subject to significant risks:

Lower growth would lead to a rising path for debt. In a low growth scenario with real GDP growth stagnating in the medium term at the 0.5 percent level projected in 2012, the debt-to-GDP ratio would increase to 133 percent by 2017 and 151 percent by 2021. As the primary surplus would remain below the threshold required to stabilize debt owing to lower revenues in this scenario, an unsustainable debt dynamic would emerge.

Contingent liabilities remain a risk to the outlook. Ireland's contingent fiscal liabilities relate to the banks covered by the eligible liabilities guarantee (ELG) scheme, the IBRC, and NAMA. The extent of reported contingent liabilities remains largely unchanged from previous reviews, aside from the removal of the UK subsidiary of BoI from the coverage of the ELG scheme.[19] Given last year's recapitalization under PCAR 2011 and notwithstanding the restructuring plans of PTSB, there is no expectation of contingent liabilities from the PCAR banks, but a further intensification of tensions in the euro area and renewed recession would pose risks of loan losses and capital needs. The IBRC meets capital adequacy requirements, and NAMA received assets at heavy discounts–averaging 62 percent–to protect its viability, yet the ultimate proceeds generated over the next decade from their asset disposals remain subject to property price and other risks. Using a standard 10 percent contingent liability shock to the current baseline in 2013, the debt ratio would suffer a parallel shift, peaking at 131 percent of GDP in 2013 and declining to 106 percent of GDP by 2021.

Ireland: Contingent Liabilities
(in percent of projected 2012 GDP)

Senior NAMA bonds	19.2
Guarantees for Emergency Liquidity Assistance	9.6
Deposits Covered by Deposit Protection Scheme	52.4
Other Bank Liabilities covered by Eligible Liability Scheme	19.6
Total	**100.8**

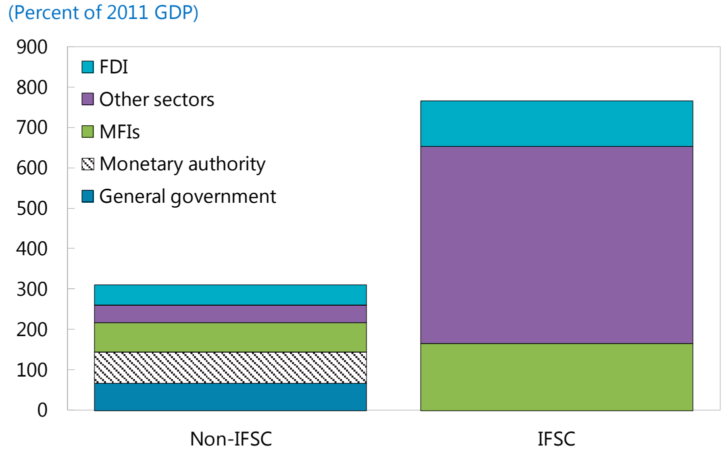
Source: Irish authorities and IMF staff calculations

Higher interest rates for new market funding would flatten the decline in the debt trajectory. At present, Ireland has a high share of fixed rate borrowing which shields it from the immediate effect of higher interest rates. A shock to the interest rate of 200 basis points, which is applied to short term debt and new market borrowing, would increase the effective interest rate by 140 basis points by 2021. As a result, debt would decline more gradually to 103 percent of GDP in 2021.

External Debt

Total external debt continues to decline, though from a very high level. At the end of 2011, total external debt fell to 1,075 percent of GDP, a modest decline from the end-2010 level of 1,105 percent of GDP. Most of the improvement occurred due to a fall in non-IFSC liabilities, where declining external debt of the Central Bank and the deleveraging MFIs more than offset the increase in debt of the General Government. At the same time, the IFSC sector (which holds around 70 percent of total debt but also has sizeable external assets) reduced its external exposure by 5 percentage points due to a decline in external debt of the MFIs. The overall net international investment position in 2011 increased by around

External Debt Composition, 2011
(Percent of 2011 GDP)



Sources: Central Statistics Office Ireland; and IMF staff calculations.

[19] See *Notice re Reduction of Participation in ELG scheme of BOI (UK) plc*.

10 percentage points to 102 percent of GDP, with increase in net external liabilities of the non-IFSC sector partially offset by improvement in the IFSC sector.

Despite a decline to 310 percent of GDP at end-2011 and projected fall in the medium-term, the non-IFSC debt is expected to remain elevated. By 2017, the external debt is expected to fall to 218 percent of GDP—a decline of 90 percentage points compared to the end-2011 outcome. However, substantial risks surround this forecast. A macro scenario at historical averages would fail to stabilize the debt-to-GDP ratio, resulting in debt of 382 percent of GDP in 2017. A permanent shock to growth would push the 2017 debt-to-GDP ratio to 250 percent of GDP, while a shock to current account flows would increase it to 238 percent. Given low share of FX denominated debt, the effects of currency depreciation would be moderate: a depreciation of 30 percent in 2013 would cause the external debt to peak at 318 percent of GDP in the same year, and subsequently decline to 215 percent in 2017.

Ireland: Net International Investment Position
(In percent of GDP)

	2005	2006	2007	2008	2009	2010	2011
Assets	1,029	1,128	1,195	1,269	1,506	1,691	1707
Direct investment abroad	54	51	54	67	125	167	160
Portfolio investment abroad	613	690	705	702	842	922	915
Other investment abroad	361	386	436	498	538	601	631
Reserve assets	0	0	0	0	1	1	1
Liabilities	1,053	1,133	1,215	1,344	1,610	1,782	1809
Direct investment to Ireland	85	67	73	75	107	119	120
Portfolio investment to Ireland	628	686	700	712	912	1,073	1105
Other investment to Ireland	341	380	442	558	591	591	584
Net investment position	-24	-5	-19	-76	-103	-91	-102
Direct investment, net	-31	-15	-19	-8	18	49	40
Portfolio investment, net	-15	4	5	-9	-70	-151	190
Other investment, net 1/	20	6	-5	-59	-52	10	47
Reserve assets	0	0	0	0	1	1	1

Source: Central Statistics Office.
1/ Includes valuation changes and errors and omissions.

163. Deputy Pearse Doherty asked the **Minister for Finance** if he will provide details of moneys drawn down to date from the EU-IMF programme; the dates on which the draw-downs took place; the interest rates payable on those draw-downs; and if he will make a statement on the matter. [30319/12]

Minister for Finance (Deputy Michael Noonan): Under Ireland's EU-IMF Programme, which is due to expire at the end of 2013, a total of €67.5 billion in loans will be provided from EU facilities, bilateral loans and the IMF. At the 15th of June 2012, Ireland's liabilities under the EU/IMF Programme amount to €51 billion.
In relation to the details of moneys drawn down to date from the EU-IMF programme; the dates on which the draw-downs took place; and the interest rates payable on those draw-downs, the table below, supplied by the NTMA, provides the information for all amounts outstanding as at 15th June 2012.
Table 1: Liabilities outstanding at 15th June 2012 under the EU/IMF Financial Assistance Programme

Lender	Nominal Loan Amount1	Date of Draw Down	Maturity Date	Term from Date of Drawdown	Interest Rate
European Financial Stabilisation Mechanism (EFSM)	€5.00 billion	12-Jan-11	04-Dec-15	4.9 yrs	2.50%
	€3.40 billion	24-Mar-11	04-Apr-18	7 yrs	3.25%
	€3.00 billion	31-May-11	04-Jun-21	10 yrs	3.50%
	€2.00 billion	29-Sep-11	04-Sep-26	14.9 yrs	3.00%
	€0.50 billion	06-Oct-11	04-Oct-18	7yrs	2.38%
	€1.50 billion	16-Jan-12	04-Apr-42	30.2yrs	3.75%
	€3.00 billion	05-Mar-12	04-Apr-32	20.1yrs	3.38%
EFSM Total	€18.40 billion			11.8yrs weighted average life	
European Financial Stability Facility (EFSF)	€4.19 billion2	01-Feb-11	18-Jul-16	5.5 yrs	2.75%
	€3.00 billion	14-Nov-11	04-Feb-22	10.2yrs	3.60%
	€1.27 billion	12-Jan-12	04-Feb-15	3.1yrs	1.73%3
	€0.48 billion	19-Jan-12	19-Jul-12	0.5yrs	0.37%3
	€1.00 billion	15-Mar-12	23-Aug-12	0.4yrs	0.29%3
	€2.80 billion	03-Apr-12	03-Apr-37	25yrs	Floating Rate4

EFSF Total	€12.74 billion			10.1yr weighted average life	
United Kingdom Bilateral Loan5	€0.50 billion €0.50 billion €0.50 billion	14-Oct-11 30-Jan-12 28-Mar-12	14-Apr-19 30-Jul-19 28-Sep-19	7.5yrs 7.5yrs 7.5yrs	4.72% 4.29% 4.44%
UK Total	€1.50 billion			7.5yrs weighted average life	
Sweden Bilateral loan6	€0.15 billion	15-Jun-12	15-Dec-19	7.5yrs	Floating 3 mths Euribor +1%
Sweden Total	€0.15 billion			7.5yrs weighted average life	
Denmark Bilateral Loan6	€0.10 billion	30-Mar-12	30-Sep-19	7.5yrs	Floating 3 mths Euribor +1%
Denmark Total	€0.10 billion			7.5yrs weighted average life	
International Monetary Fund7	€6.040 billion	18-Jan-11	Amortising: 18 Jul 2015-18 Jan 2021		
	€1.699 billion	18-May-11	Amortising: 18 Nov 2015-18 May 2021	4.5 -10 yrs	Floating Rate
	€1.589 billion	07-Sep-11	Amortising: 07 Mar 2016-07 Sep 2021		
	€3.987 billion	16-Dec-11	Amortising: 16 Jun 2016-16 Dec 2021		
	€3.357 billion	29-Feb-12	Amortising: 31 Aug 2016-28 Feb 2022		
	€1.435 billion	15-Jun-12	Amortising: 15 Dec 2016-15 Jun 2022		
IMF Total	€18.11 billion			4.5 — 10yrs	
Overall Total	€51.0 billion2			9.7yrs weighted average life	

Notes

1. Non-euro liabilities are translated into euro at the rates of exchange at 15th June 2012. The net euro amount received by the Exchequer was €49.4 billion after adjustment for below par issuance and deduction of a prepaid margin (Note 2), and also reflect the effect of foreign exchange transactions. Non-euro liabilities have been locked-in, as appropriate, in order to remove exchange rate risk.
2. A prepaid margin of €0.53 billion was deducted from the loan of €4.19 billion drawdown on 1 February 2011 giving a net liability of €3.67 billion. This margin prepayment will be refunded to Ireland in 2016. The total liability of €50.46 billion included in the National Debt (€130.1 billion at 15th June 2012) takes account of this reduction.
3. Short Term EFSF Funding of €1.48 billion maturing in 2012 is due to be replaced by longer term funding at a floating interest rate. The EFSF loan of €1.27bn maturing in 2015 is also subject to rollover at a floating rate.
4. The EFSF funding provided to Ireland under pooled issuance comes from a variety of fundings, and the EFSF will confirm the interest rate cost related to each loan coming from the pool on every interest payment date.
5. The Interest rates on the UK bilateral loans are subject to a reduction pending the signing of an amendment to the legal agreement. The reduction is estimated, at this stage, to be about 1.5%. Rate shown is an annualised rate.
6. The current rate on the Denmark bilateral loan is 1.787%. This rate resets every 3 months and is due to do so on 29th June 2012. Similarly, the Sweden bilateral loan is a floating rate loan which resets every 3 months. The current rate of 1.337% applies for a 2 week initial period.
7. The interest rate charged by the IMF is variable. It is composed of a weekly setting of the IMF SDR interest rate and surcharges which are volume and time dependent. As of 25 June 2012 the SDR interest rate accruing on Ireland's IMF loans is 0.12% and the surcharges are 2.50% making a total of 2.62%.

Department of Finance

Relationship with the EU

Jim O'Brien

September 2010

Introduction

- Every Division of the Department has some involvement with the EU, but the main dealings are through the Budget, Taxation and Economic Divn and the Financial Services Divn.

- This involvement arises both directly with EU bodies and also through the Department's staff in the Permanent Representation in Brussels

- Our contacts arise in relation to both matters of policy and technical matters

- 6 Month Report to the Oireachtas (Irish national parliament) for Jan to June 2010 - gives an overview of issues recently dealt with and key issues coming up on our agenda

Introduction

- Relationship spans a number of broad areas:
  - Economic and Fiscal
    - e.g. SGP, Fiscal surveillance, EU 2020, European Semester
  - Taxation
    - e.g. Indirect and Direct Taxes - treated differently
  - Financial Services
    - e.g. supervision/regulation, crisis management, money laundering
  - Competition (State Aids etc)
    - e.g. Anglo Irish Bank
  - EU Budget
    - e.g. Annual process, Review of the Budget, next Framework

Overview

- States's obligations are set out in the EU Treaties e.g. Article 121(1) TFEU states:

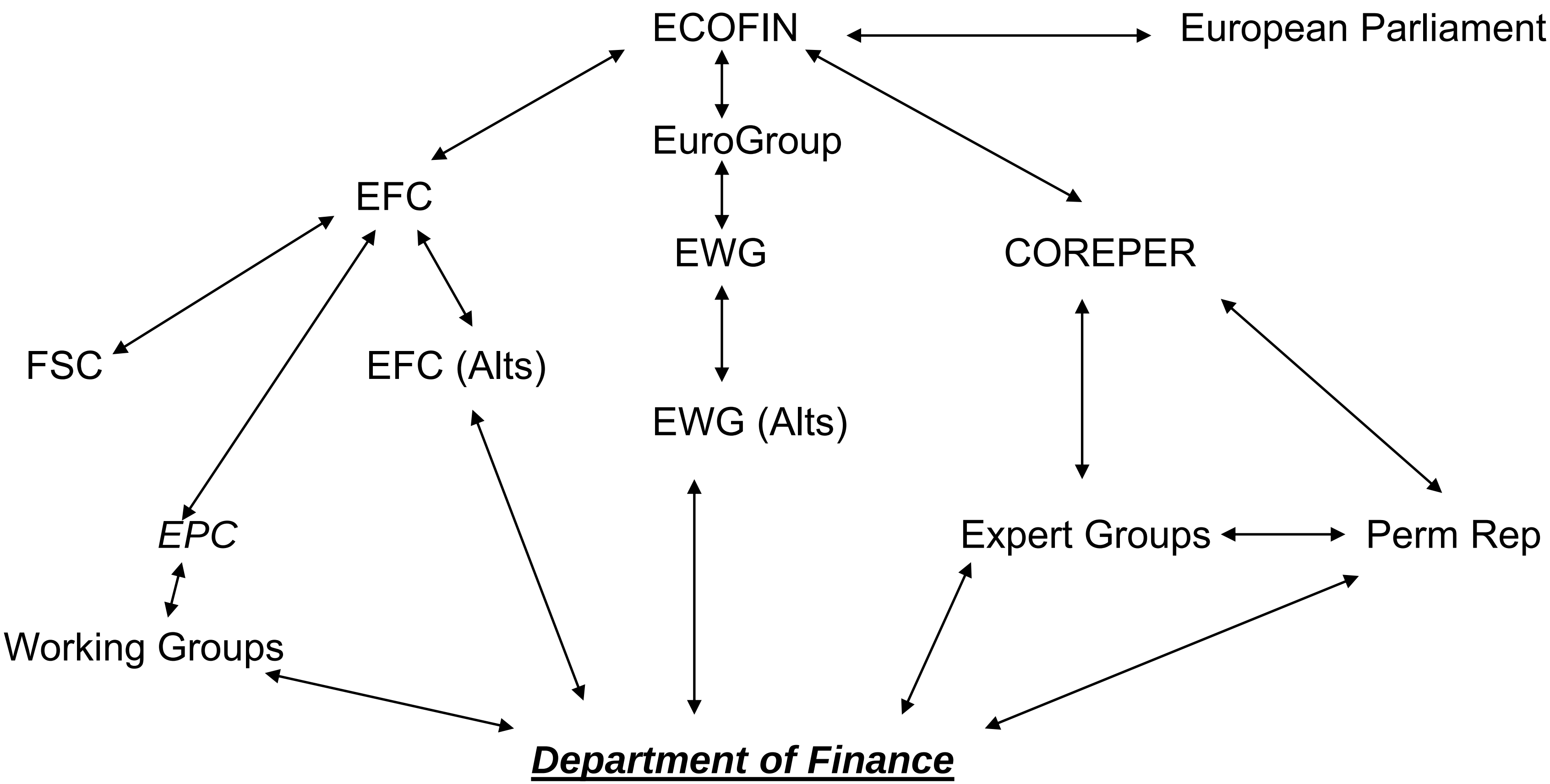
  "*Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council*".

  Coordination is reflected throughout the Treaties. EMU goes further

- The Ecofin Council is the primary Ministerial grouping that the Department deals with. It makes decisions and approves legislation in all the broad areas dealt with by the Department.

- The Eurogroup meets informally to discuss matters relevant to the euro area. Formal decisions are taken at Ecofin, although on certain matters only member states whose currency is the euro may vote.

EU Flow Chart



Overview (cont.)

- Ecofin generally meets monthly and is attended by the Minister, Second Secretary and Ambassador and staff. Eurogroup meets on the eve of Ecofin and is attended by the Minister and Second Secretary.

- The Economic and Financial Committee (EFC) prepares the work of Ecofin, as well as other functions such as delivering opinions at the request of the Council or Commission and keeping under review the economic and financial situation of the member states and the Union. It generally meets monthly and is attended by the Second Secretary and an Alternate. Central Bank also attend certain meetings.

- A subdivision of the EFC, the Eurogroup Working Group (EWG) prepares the work of the Eurogroup Ministers. This meets around the same time as the EFC and is attended by the Second Secretary

Overview (cont.)

- The EFC delegates some of its preparatory work to subcommittees, the principal one of which is the EFC Alternates which meets monthly. This is attended by a nominated official of the Department (Alternate) as well as by a Central Bank official, as appropriate.

- EFC agenda is determined by
  - regular items deriving from the Treaty, such as the examination of the stability and convergence programs, excessive deficit procedures and BEPGs;
  - Rotating Presidency Programme priorities
  - Preparation of international meetings e.g. IMF, G20 and Financial Stability Board (FSB)
  - Work of technical and task force groups such as the Van Rompuy Task Force

Overview (cont.)

- Other subcommittees include the Financial Services Committee, SCIMF and the Bills and Bonds Committee.
- Economic Policy Committee (EPC) also has a role in developing analysis and policy consensus in relation to the EU 2020 Strategy and also has responsibilities regarding the quality and sustainability of public finances and the impact of ageing on public finances

Overview (cont.)

- The Committee of Permanent Representatives (Coreper) consists of the member state Ambassadors and is a Council “formation”. It prepares some aspects of the work of Ecofin (such as the EU Budget and certain tax matters). In some cases it reaches final agreement on behalf of their Ministers and these issues are approved without discussion at Ecofin. The Department’s Counsellor and attachés (3), who consult with the Department on a regular basis, brief the Ambassador on these issues.

- The Council is assisted by various committees and working groups who report through Coreper. These committees are attended by either the relevant attaché (Financial Services, EU Budget or Fiscal Attaché) or by a representative from Dublin. Examples include the EU Budget Committee and the Working Party on Tax Questions.

Overview (cont.)

- The Commission also consults committees of experts from member states before drawing up a new proposal for legislation.
- The Department interacts directly with EU bodies such as the Directorates-General for Economic and Financial Affairs, Taxation, EU Budget, Regional Policy, European Court of Auditors, OLAF, etc
- As can be seen, the level of interaction with EU bodies and committees is extensive
- In addition, the Department keeps the Oireachtas informed about EU proposals, including attendance at parliamentary committees when requested.

Overview (cont.)

- Belgium holds the rotating Presidency of the EU at present, followed by Hungary from 1 Jan – 30 June 2011

- Ireland will assume the Presidency (Jan-Jun 2013) – Planning has commenced with the establishment of two interdepartmental committees chaired by D/Foreign Affairs. Ireland will participate in the Troika with Lithuania and Greece between Jan 2013 and June 2014

- Ecofin Priorities that Belgium is focussed on include
  - Van Rompuy Task Force – Final report to Oct European Council
  - Structural reforms eg. Financial supervision architecture, strengthening stability of the Euro zone, restoring budgetary discipline and innovation on foot of the Monti Report and EU 2020 Strategy
  - EU Budget - first budget preparation procedure (2011) in accordance with the Lisbon Treaty rules giving the European Parliament and the Council the same powers of budgetary authority; Review of the EU Budget

Relationship with the EU

- Important, highly sensitive and evolving relationship
- Government's obligations under the Excessive Deficit Procedure
- EU assessment of budgetary developments is crucial for Ireland's standing in international financial markets and for its credit rating
- In the light of the global economic and financial crisis, the related deterioration in public finances across the EU and the need to safeguard the financial stability of the euro area, the relationship is inevitably *moving towards greater EU input in budgetary policy developments.*

Economic and Fiscal

- **EU Budgetary surveillance procedures**
  - Submission of annual Stability Programme Update (incl. Progress Report under Excessive Deficit Procedure)
  - EFC Discussion of draft Council Opinion on Stability Programme
  - Input to periodic reviews of budgetary and macroeconomic developments at Eurogroup

- **Economic policy co-ordination/economic governance**
  - Van Rompuy Task Force (Minister) and Sherpa Committee (EFC member)
  - Due to report to European Council in October 2010.
  - Likely to result in substantial work programme at EFC and MS levels
  - Key issues include
    - Strengthening the sanctions framework of the Stability and Growth Pact,
    - Introduction of the European Semester

Economic and Fiscal

Key issues (cont)

- Strengthening national fiscal frameworks including consideration of independent fiscal councils
- Greater emphasis on debt criterion – with consideration of debt related sanctions
- Broader macroeconomic surveillance to prevent occurrence of harmful imbalances
- Stronger institutions for more effective governance at EU level.

Economic and Fiscal

- **Financial Stability in the Euro area – participation in recent initiatives**
  - Euro Area Loan Facility to Greece;
  - European Financial Stability Facility (EFSF)
    - Preparatory discussions at EWG
    - Preparation and enactment of legislation to provide for Ireland's participation
    - Second Secretary is a Director on the Board of the EFSF

Taxation

There are five main areas of interaction with the EU:

- International Taxation;
- Indirect Taxes;
- Income Tax Policy;
- Corporation & Pensions Taxation Policy;
- Capital & Savings Taxation Policy.

- Most interaction is through working groups of Council and the Commission.

- Tax policy is a matter for national Governments and any change in policy requires unanimity. Some areas e.g. VAT have high levels of coordination. Others do not and issues can be quite sensitive

- Constant evolution of debate around Tax policy. Latest example is the establishment by the EU of the High Level Tax Policy Group

Financial Services

- There is a significant amount of work on financial services reform as a result of the recent banking and financial crisis, including establishing the European Systemic Risk Board and European Supervisory Authorities

- Work will increase in the period ahead as the directives move from negotiation to transposition and the next wave of reform proposals move through the various drafting and negotiation stages.

- This level of work will be added to by the additional responsibilities and work load associated with the Troika as Ireland steps up to the Presidency role under the Trio process.

- Department has close engagement with the Competition Directorate of European Commission as banking rescue measures need to be approved at EU level in line with State aid rules.

EU Budget

- Manage Ireland's input to the annual Budget process through the Council's Budget Committee (attended by the Budget Attaché) and Ecofin (Budget) Council, as well as our payments to the EU Budget
- Role of the European Parliament under the new Treaty - codecision
- Represent Ireland's interests at related working groups, such as the Advisory Committee on Own Resources and the Working Group on Combating Fraud
- In 2009, Ireland received €1.8 bn from the Budget and paid in almost €1.5 bn

<u>Key issues</u>:

- Completion of the 2011 budget negotiation
- Review of the EU Budget (expected Oct 2010)
- Negotiation of the next multiannual Financial Perspective, due to begin in H1 2011

Structural funds

- Funds cover investment in human and physical investment. Ireland's allocation just over €900m for 2007-2013
- Department of Finance is the Member State Managing Authority
- Works in partnership with EU Commission and represents Ireland on working groups
- Department of Finance manages
  - Implementation of programmes
  - Annual examinations of programmes
  - Annual audit co-ordination meeting

Structural funds (cont.)

Key issues:

- Future of Cohesion Policy – Ireland contributing to the ongoing debate; the Fifth Report on Economic and Social Cohesion is due for publication this autumn.

- Proposed Financial Regulation may lead to additional control mechanisms

- [redacted]

- Closure of 2000-2006 funding period
  - Closure process to be completed by 30/9/10; approx €100 million ERDF outstanding

Conclusion

- EU is a critical relationship for Government and the Department
- Relationship is evolving and intensifying and is important strategically
- While the EU can constrain freedom of national governments, on balance it is considered to be constructive and supportive
- Managing and dealing with this relationship is a key priority

Informal Ecofin 13 September 2003

Monitoring Financial Stability (i)

Speaking Note (if required)

Mr Chairman, any assessment of the financial situation at a time of great uncertainty in the wider economy must be qualified by all sorts of caveats. That is essentially what the ECB's assessment boils down to.

At domestic level in Ireland, high levels of capitalisation and profitability in the banking sector have strengthened the banks' capacity to absorb the effects of potential adverse macroeconomic shocks without systemic distress. The concentration of risk exposure in the residential and commercial mortgage sectors is something which is being closely watched by the supervisory authorities. However, employment levels are holding up well and the overall outlook for financial stability is positive.

Informal Ecofin 13 September 2003

Monitoring Financial Stability (i)

Steering Note

What will happen today?

There will be two elements to this discussion, as follows:-

(i) a general discussion of financial conditions in the EU; and

(ii) the annual review by the Informal Ecofin of the implementation of the recommendations made in the two 'Brouwer' reports – on Financial Stability (in 2000), and on Financial Crisis Management (in 2001). [See separate on item (ii).]

The chairman of the EFC, Caio Kock-Weser, will make an oral introductory statement. His general line will be that while the financial situation is improving (e.g. equities up, corporates cleaning up their balance sheets, banks containing costs and maintaining capital ratios etc), there are still concerns in the financial sector and the wider economy (e.g. will the equity recovery continue, the increase in household debt, the downgrading of growth forecasts etc.).

Irish Position

No doubt some Finance Ministers from the larger member states will offer their assessment of the situation, but there is no particular Irish concern that needs to be covered by an intervention

Informal Ecofin 13 September 2003

Monitoring Financial Stability (i)

Background note on Financial Stability Position in the EU

Overview

1. At the EFC discussion on this topic on 4 September, in preparation for Ecofin, the conclusions drawn were as follows:-

   - Conditions have improved for the financial sector with greater profitability, but there are many areas of uncertainty, such as:
     -macro economy – re pace of revival
     -equity markets – re sustainability of the recovery
     -corporates – on-going need to clean up balance sheets
     -household debt – vulnerability of housing market and unemployment concerns
     -transfer of credit risks by banking sector to other financial sectors, especially the insurance sector.

   - Work to be done
     -need to investigate way in which credit risk has been transferred, and to whom
     -need for more cross-border information exchange between financial supervisors
     - need for more supervisory studies.

The general conclusion was that while there are no acute difficulties at present and the situation seems to be improving, but there is no room for complacency.

Irish Position

2. This is a topic which is covered in the Central Bank's latest Financial Stability Report which was published in the Annual report for 2002 in June 2003. Some of the main points made in the review are as follows:

Irish Financial System and Banking Sector

- The system continues to be stable and there is no significant cause for concern regarding financial stability in Ireland.
- High levels of capitalisation and profitability in the banking sector have strengthened the banks' capacity to absorb the effects of potential adverse macroeconomic shocks without systemic distress.
- The concentration of risk exposures in the housing and commercial property markets merits close attention and is being monitored by on-site visits by the Supervisory Authorities to credit institutions.
- Recent unification of prudential supervision under IFSRA will enhance the supervisory regime.

Household Sector

The financial health of the Irish household sector is dependent on developments in the economic environment in the coming year. Clearly, an increase in unemployment would place strains on the finances of those losing their jobs and would undermine their ability to service their debts, particularly in the light of increasing credit growth, leading to an increase in the level of defaults.

Lending to the personal sector is dominated by residential mortgage lending. However, the estimated average repayment burden has eased, from 28.7 percent in 2001 to 25.4 percent in 2002, due to a fall in the average mortgage rate. Households should remain in a reasonably strong position to meet mortgage repayments in this low interest rate environment and also given the forecast that disposable incomes and employment levels are unlikely to fall dramatically in the near future.

In fact, as regards employment levels, the results of the latest Quarterly National Household Budget Survey (published on 28 August 2003) show that the jobs market continues to perform strongly despite the economic slowdown. Total employment rose by 28,400 in the year to April 2003, with job gains in the construction, hotels/restaurants and the public sectors more than offsetting losses elsewhere. This increase in employment continued into the second quarter, with a 6,300 rise on the previous quarter to 1.778 million in employment in the March-May period.

While the banking sector has a high exposure to residential property, a steep decline in the Irish property market is unlikely. Moreover, the unemployment level is remaining relatively stable, with the prospect of the level of unemployment increasing to levels that would give rise to systemic concerns remaining remote.

Corporate Sector

The full extent of corporate sector indebtedness is difficult to measure due to the availability of many alternative resident and non-resident sources of finance (for example, foreign banks and capital markets). Adding the value of borrowing from non-resident credit institutions and borrowing from resident institutions, the indebtedness of the corporate sector has fallen, in terms of the ratio of all bank loans to GDP, from just under 70 percent in 2001, to 62.6 percent in 2002. The situation, of course, varies across individual sectors

- real estate: credit growth is currently increasing at an annual rate of 28 percent
- wholesale/retail sectors: credit growing at 17.3 percent
- hotels/restaurants: growing at 14.5 percent
- manufacturing: a decline of 14.2 percent.

Overall, the growth of credit extended to the non-financial corporate sector increased by 9.4 percent in the year to 2002 Q4 (as compared to 17.4 percent in the previous year).

Manufacturing output grew by 8.5 percent in 2002. The high-tech sub-sector within the manufacturing sector grew by 11.5 percent but the output of the traditional sectors contracted by 4.75 percent. The services sector continued to grow in 2002.

Although rental values in the office and industrial sectors have weakened, capital values and rents in the retail sector are growing at a faster rate than in 2001. While commercial property prices remain a potential source of vulnerability for the Irish banking system, it is noted that the number of liquidations in Ireland remained constant in 2002, although the share of potentially insolvent liquidations in the overall total dropped quite significantly.

where progress can be made in improving transparency, including in arrangements for information exchange among themselves.

- **Improve valuation standards, including of illiquid assets**

7. The ultimate responsibility for the valuation and accounting treatment of assets lies with institutions holding the assets. However, supervisors, accounting standard setters and other relevant authorities also play an important role from a prudential perspective. More work is needed on standards to ensure reliable valuation of assets, particularly of those assets where markets are potentially illiquid in time of stress, while ensuring compatibility with international financial reporting standards.

- **Reinforce the prudential framework, risk management and supervision**

8. In recent years, financial markets have evolved both in terms of size and sophistication and it is essential that the framework for prudential regulation, supervision and financial stability arrangements keeps pace with these developments. In this context, the EU Finance Ministers have since 2003 been developing the arrangements for financial stability in the EU. On 9 October, the ECOFIN Council agreed on common principles and further actions to enhance the effectiveness of financial stability arrangements and the ability of authorities to respond jointly in serious disturbances in EU financial markets. In Spring 2008, a new Memorandum of Understanding (MoU) will be signed between Heads of Competent Banking Supervisory Authorities, Central Banks Governors and Finance Ministers in the EU he Commission and Member States will also work toward enhancing the availability of the tools, necessary in preserving financial stability in Member States and in ensuring their functioning across-border between relevant parties. The possible enhancement of Deposit Guarantee Schemes within the EU to ensure their effectiveness in stemming a loss of confidence in the financial system also needs to be examined.

9. The Lamfalussy framework will be reviewed in December 2007. This review will provide an opportunity to take stock of progress made and to identify further steps that would ensure that the EU framework for prudential supervision evolves in line with market developments.

10. The Capital Requirements Directive, which implements the Basel 2 framework in the EU, will fully enter into force on 1 January 2008. It will help to improve transparency, particularly in the context of securitisation), and will instil greater discipline in the transfer of risk from credit institutions, thus reducing the scope for regulatory arbitrage and limiting capital relief

Council Logo

COUNCIL OF
THE EUROPEAN UNION

Brussels, 5 April 2001

6168/01

LIMITE

PV/CONS 5
ECOFIN 31

DRAFT MINUTES[1]

Subject :	**2329th** meeting of the Council (**ECONOMIC AND FINANCIAL QUESTIONS**), held in Brussels on 12 February 2001

1 Information relating to the final adoption of Council acts which may be released to the public is contained in Addendum 1 to these minutes.

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1. **<u>Adoption of the agenda</u>**
5819/01 OJ/CONS 4 ECOFIN 24

<u>The Council</u> adopted the above-mentioned agenda.

2. **<u>Approval of the list of "A" items</u>**
5820/01 PTS A 4

<u>The Council</u> approved the "A" items as listed in doc. 5820/01 PTS A 4 **except for item 11**.

3. **<u>Taxation : Excise duties on mineral oils</u>**

<u>The Council</u>

- approved the conclusions set out in document 6172/01 FISC 22 + COR 1 (en,da,sv)

- took note of the statement of the Commission for the Council minutes as set out in the above-mentioned document.

4. **<u>Preparation of the Stockholm European Council (23/24 March)</u>**

- **The functioning of product and capital markets**
  = Presentation of Commission Report
  5301/01 UEM 5 ECOFIN 11 MI 5
  5300/01 UEM 4 ECOFIN 10 MI 4

<u>The Council</u> heard a presentation by Commissioner BOLKESTEIN of its Institution's third report of December 2000 on the functioning of product and capital markets which responds to the request formulated by the Cardiff European Council of June 1998 in the context of structural reform. This paper will be taken into consideration for the preparation of a paper on the key issues of the BEPG for the March Stockholm European Council.

- **Broad Economic Policy Guidelines**
  = Orientation debate
    5907/01 ECOFIN 25 SOC 41 MI 11
  = Contributions of other Council formations
    5797/01 MI 10 ECOFIN 23
    5617/01 SOC 28 ECOFIN 18

The Council held an orientation debate on the preparation of the Broad Economic Policy Guidelines on the basis of a note presented by the Presidency, contributions from the Internal Market and the Employment and Social Policy Councils and preparatory work done by the Economic and Financial Committee and the Economic Policy Committee.

During the debate, Ministers welcomed the Presidency's approach on the key issues paper which should be policy orientated, concise and well-focused to enable a constructive discussion on the BEPG by the European Council on both macroeconomic policies and economic reforms. Ministers expressed broad agreement on the suggestions made and on the selection of key issues to be focused upon in the next BEPG, including:

– the need to maintain macroeconomic stability, in particular to avoid procyclical budgetary policies, thereby allowing monetary conditions conducive to economic growth and continued employment creation. At the same time, the establishment of sound public finances are fundamental for dealing with the budgetary consequences of the longer-term challenge of ageing populations;

– the need to reform labour markets in order to reduce the rate of unemployment and increase labour supply;

– the need to continue to address the challenge of ageing populations and where necessary the reform of pension systems;

– the need to pursue the economic reforms in product markets in order to enhance the growth and employment potential in the EU, by promoting innovation and competitiveness while increasing the benefits to consumers;

– the need to create and integrated European financial market that will contribute importantly to stronger growth and higher employment by implementing of the various measures in the Financial Services Action Plan (FSAP) and the Risk Capital Action Plan (RCAP).

In the light of this debate, a draft of the key issues paper will be prepared in close co-operation between the Presidency, the Commission, the Secretariats of the EFC and EPC, as well as of the Council Secretariat. This draft paper will be discussed by the EFC and, in relevant parts, by the EPC at their next sessions. The paper will subsequently be forwarded to the ECOFIN Council of 12 March for adoption.

5. EMU

- **Regulation on the protection of the Euro against counterfeiting**
  = Political agreement
  6032/01 FIN 35 UEM 32 EUROPOL 15 DROIPEN 13

The Council reached a political agreement on the text of the ”agreed position” as presented in doc. 6281/01.

The following statements were made to the minutes of the meeting:

Re. Article 2(b)

1. « The Council notes that in Germany and Austria the definition of "competent national authorities" in Article 2(b) of this Regulation does not concern judicial or police authorities where they act in exercise of the competence of the Member States in the application of national criminal law or the administration of justice in the Member States.»

Re. draft Council Regulation based on Article 308

2. « The Belgian and Luxembourg delegations reiterate their reservations with regard to the adoption of two Regulations on the protection of the Euro against counterfeiting, one for Member States participating in the zone, based on Article 123(4) (EC) and the other for Member States not participating in the zone, based on Article 308 (EC), as they believe that only the adoption of a Regulation based on Article 123(4) (EC) is in conformity with the provisions of the Treaty.

Nevertheless, the Belgian and Luxembourg delegations will support the solution submitted by the Presidency, provided it does not constitute a precedent for the adoption of the measures necessary for the introduction of the Euro as a single currency. »

Re. Article 2(b)

3. « The Commission welcomes the fact that the essential features of its proposal appeared in the draft Regulation which today becomes the subject of a Council agreed position.

   It expresses its disagreement, however, with Council statement No 1 on the interpretation of the expression "competent national authorities" and indicates its preference for the following version :

   > « The Council notes that the expression "competent national authorities" used in Article 2(b) concerns judicial or police authorities only in the context of the Cupertino provided for in this Regulation, which applies without affecting the competence of the Member States as regards the application of national criminal law. » ».

- **Issues related to Euro coins**
  = Conclusions

Use of EURO coins and tokens for familiarising persons suffering from sensory or intellectual disabilities

1. For the broad acceptance of the Euro the population should be in a position to recognise the Euro banknotes and coins. Training of vulnerable groups of the population is of particular importance. Ongoing action is taking place in all Member States for that purpose.

2. The ECB, in collaboration with the Commission and the European representatives of vulnerable groups, is preparing dummy banknotes designed for training. The Commission, in collaboration with the Mint Directors and the European representatives of vulnerable groups, is preparing appropriate Euro tokens. Ministers welcome these initiatives.

3. Ministers consider that the vulnerable groups should also have the possibility to familiarise themselves with the real Euro coins on the available premises of the Mints, in the Euro coin Test Centres or in other secure locations to be organised by Member States in collaboration with the representatives of vulnerable groups at national level.

Adapting the conditions for loans of EURO coins and EURO tokens to relevant industries

4. Further to the Council conclusions of 14 December 2000 with respect to the adjustment of coin-operated machines, Ministers agreed on the adaptation of the conditions for loans of Euro coins and/or tokens to the coin-operated industry. According to that agreement, Member States may reduce, to specified levels, the financial guarantees applicable to such loans as from 1 April and 1 July 2001 respectively.

6. Supplementary and Amending Budget 1/2001 concerning BSE-related measures

5956/01 FIN 33
5955/01 FIN 32
+ COR 1

The Council :

- established the draft Supplementary and Amending Budget Nº 1 for the financial year 2001 by adopting, by qualified majority, the Commission proposal as amended and recorded in document 5956/01;

- instructed the Presidency to prepare the budget documents to be sent to the European Parliament.

Following the presentation by the Commission on possible future budgetary consequences of the BSE crisis and the exchange of views within the Council on this subject, the Presidency concluded the debate by stating that :

- with reference to the conclusions which were adopted by the European Council in Nice, the Council reminds that the financial perspective must be respected, even if additional measures would be needed in connection with BSE ;

- the Council calls attention to the fact that the Commission, in accordance with the Council Regulation on budgetary discipline, should present proposals for savings, if forecasts show that financial perspective is threatened, without any delay and at the latest on the occasion of adopting the 2002 Preliminary Draft Budget.

7. Financial Services

- Commission communication on e-commerce
  = Presentation
  6639/01 EF 18 ECOFIN 58 CONSOM 14

The Council took note of a presentation by the Commission of its communication "E-commerce and financial services" and had a brief exchange of views. The President noted that the Financial Services Policy Group would examine the communication at its meeting on 22 February 2001 and concluded that the Council would re-examine it at a later date.

- Directive on Undertakings for Collective Investments in Transferable Securities (UCITS)
  = Political agreement
  6015/01 EF 10 ECOFIN 26 CODEC 107
  + COR 1 (fr,en)
  6016/01 EF 11 ECOFIN 27 CODEC 108

Following an exchange of views, the Council agreed to instruct the Permanent Representatives Committee to pursue its work with a view to reaching an agreement by 1 March 2001.

8. Implementation of the Stability and Growth Pact and the Broad Economic Policy Guidelines (restricted session)

= **Examination of the Danish updated convergence programme**
5752/01 UEM 22

The Council examined the updated convergence programme for the period 2000-2005 that Denmark had submitted and gave the opinion set out in Annex 1.

= **Examination of the Irish updated stability programme**
14625/00 UEM 33

The Council examined the updated stability programme for the period 2000-2005 that Ireland had submitted and gave the opinion set out in Annex 2.

= **Examination of the Greek updated growth and stability programme**
5128/01 UEM 1

The Council examined the updated growth and stability programme for the period 2000-2004 that Greece had submitted and gave the opinion set out in Annex 3.

= **Examination of the French updated stability programme**
5467/01 UEM 12

The Council examined the updated stability programme for the period 2002-2004 that France had submitted and gave the opinion set out in Annex 4.

= **Examination of the Italian updated stability programme**
5468/01 UEM 13

The Council examined the updated stability programme for the period 2002-2004 that Italy had submitted and gave the opinion set out in Annex 5.

= **Examination of the Austrian updated stability programme**
5416/01 UEM 11

The Council examined the updated stability programme for the period 2000-2004 that Austria had submitted and gave the opinion set out in Annex 6.

= **Examination of the United Kingdom updated convergence programme**
5753/01 UEM 23

The Council examined the updated convergence programme for the period 1999/2000 to 2005/2006 that the United Kingdom had submitted and gave the opinion set out in Annex 7.

= Commission Recommendation and Council Decision relating to Ireland

The Council adopted a Recommendation with a view to ending the inconsistency with the broad guidelines of the economic policies in Ireland in application of Article 99(4) of the Treaty establishing the European Community and agreed to make these opinions public.

9. AOB

No "Any Other Business" item was discussed during this meeting.

Concerning item 8 of the agenda

COUNCIL OPINION

On the Updated Convergence Programme of Denmark, 2000-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1] , and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined Denmark's updated Convergence Programme, which covers the period 2000-2005. The updated Convergence Programme foresees general government budgetary surpluses of between 2.6-2.9 % of GDP over the entire period and projects the gross consolidated debt to be reduced to 34 % of GDP in 2005. In 2000 the budget surplus turned out to be higher than earlier projected and amounted to 2.7 % of GDP, mainly due to stronger-than-expected growth.

The macroeconomic scenario assumed in the updated Programme projects real GDP growth, following an upward revision to 2.4 % in 2000, to slow down to around 1.7 % annually for 2001-2005. The Council notes that this growth scenario has been lowered from the previous update and that the Programme's assumptions on productivity rises are moderate by international comparisons. Given the robust performance of the Danish economy in recent years, in particular the buoyant investment in equipment, and the structural reforms undertaken, a somewhat stronger growth and productivity performance could be expected. Moreover, such moderate productivity rises could imply a further loss in cost competitiveness for Danish companies if relative wage increases again turn too high.

The inflation rate started to rise in 1999 and has remained relatively high in 2000. The updated Programme expects inflation to gradually decline up to 2002 as externally induced price rises should taper off and wage growth should turn slightly more moderate in the light of a weaker

[1] OJ L209, 2.8.1997

domestic demand growth. While the Council considers that the inflationary outlook, as assumed in the updated Programme, seems plausible, the Council reiterates its recommendation to the Danish government to take further actions in case of significant upward deviations[1], including budgetary ones, the more so as ERM2 membership clearly limits the monetary policy's room of manoeuvre in addressing inflationary pressures.

The Council notes with satisfaction that Denmark has continued to fulfil the convergence criterion on the long-term interest rate and that the exchange rate has remained stable vis-à-vis the Euro, also after the referendum on 28 September 2000.

Regarding government finances the Council welcomes that the Danish authorities maintain their ambition of large budgetary surpluses. As a result, Denmark continues to clearly fulfil the requirement of the Stability and Growth Pact of a budgetary position of “close to balance or in surplus” over the entire period covered by the Programme.

The budgetary consolidation strategy outlined in the previous update of the Programme is largely upheld, with a declining primary expenditure to GDP ratio and tax burden over the programme period. However, for the year 2001 the updated Programme projects a small increase in both the primary expenditure ratio and the tax burden. The Council would have preferred that the decline in both ratios was implemented without disruption.

The Council calls on all levels of general government to make efforts to limit the real increase in public consumption to the target of an annual 1 %. Furthermore, in 2001 local and regional governments are expected to raise taxes clearly above the agreements with the central government. As these agreements between the central and lower levels of government, aiming at restricting increases in public consumption and taxes, frequently have been exceeded in the past, the Council invites the Danish government, in line with the recommendations in the Broad Economic Policy Guidelines, to strengthen the institutional framework, to avoid further slippage in the future.

The Council welcomes the Danish authorities’ ambition to continue to substantially lower the ratio of gross debt to GDP with a view to preparing for the forthcoming financial burden of an ageing population. The focus on longer-term sustainability issues in the updated Programme is welcomed and the Council encourages the Danish government to continue its efforts in preparing to cater for the ageing population.

The Council invites the Danish authorities to maintain the prominent place of structural reforms on the policy agenda. In particular, efforts to raise labour supply could prove necessary. The Council therefore encourages the authorities to consider lowering taxes on labour income also beyond 2002, for which a tax reduction is already planned. However, given that the Danish economy currently seems to be operating at a level slightly above its potential, such a tax cut would need to be compensated by offsetting budgetary measures in order not to add to the risk of overheating.

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[1] Council opinion of 28 February 2000 on the updated convergence programme of Denmark for the period 1999 to 2005.

Concerning item 8 of the agenda

COUNCIL OPINION

On the 2000 update of Ireland's Stability Programme, 2001-2003

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5-(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the 2000 update of Ireland's Stability Programme, which covers the period 2001-2003.

The Council notes that the Irish economy continues to grow rapidly in 2000, with real GDP growth of 10.7% expected in the 2000 update. Employment growth in 2000 is estimated at 4.5%, with the unemployment rate declining further to 4.1% on average. Inflationary pressures have intensified. Average HICP inflation rose to -5.3% in 2000. While this upsurge in price inflation is partly due to external and temporary factors, which are expected to gradually fall out of the consumer price index, domestically-generated inflation has increased too, house price inflation remains very high and wages are rising rapidly.

[1] OJ L209, 02.08.1997

As a result of strong economic growth, the projections in the 1999 update of the Stability Programme for the improvement in the budgetary situation were exceeded by a large margin. The Council welcomes the fact that the general government balance for 2000 remains in substantial surplus, estimated to be around 4.7% of GDP, and that another sharp reduction in the general government debt ratio was achieved.

Projections for the period 2001 to 2003 show an average surplus ratio of 4.2%, with the debt ratio declining further to less than one quarter of GDP by 2003. The Council welcomes the fact that, as in the original programme and its 1999 update, Ireland fully and comfortably fulfils the Stability and Growth Pact obligations throughout the period covered. The projected general government surplus is clearly sufficient in each year to provide a safety margin against breaching the 3% of GDP reference value in the event of normal cyclical fluctuations.

The macroeconomic scenario underlying these projections assumes a gentle decline in real GDP growth and in inflation over the period. The positive output gap, after an estimated 4.5% of trend GDP in 2000, is expected to peak in 2001 at 5.4% and to gradually decline thereafter. In this context, the Council considers that the stimulatory nature of the budget for 2001 poses a considerable risk to the benign outlook in terms of growth and inflation portrayed in the 2000 update. The Council considers that this budget - the main measures of which are indirect and direct tax cuts and substantial increases in current and capital expenditure – is pro-cyclical. The Council finds that it will give a boost to demand of at least 0.5% of GDP and that its possible supply effects are likely to be small in the short term, thereby aggravating overheating and inflationary pressures and widening the positive output gap.

In particular, the strategy of inducing labour force increases through an alleviation of the direct tax burden, which was recommended in the 2000 BEPG with respect to the labour market,- may have become less effective than in the past because it took place in the context of an expansionary budgetary policy, and the tightness of the labour market could well hamper further attempts at encouraging wage moderation with direct tax cuts. Further, while indirect tax cuts have a once-and-for-all effect on the price level, they probably have no lasting effects on the rate of inflation but clearly further stimulate demand.

Given that the monetary policy is now set for the Euro area as a whole and no longer available as an instrument at national level, other policies, including budgetary policies, must be used more actively. Against this background, the Council finds that the planned contribution of fiscal policy to the macroeconomic policy mix in Ireland is inappropriate. The Council recalls that it has repeatedly urged the Irish authorities, most recently in its 2000 broad guidelines of the economic policies, to ensure economic stability by means of fiscal policy. The Council regrets that this advice was not reflected in the budget for 2001, despite developments in the course of 2000 indicating an increasing extent of overheating. The Council considers that Irish fiscal policy in 2001 is not consistent with the broad guidelines of the economic policies as regards budgetary policy. [The Council has therefore decided, together with this Opinion, to make a recommendation under Article 99(4) of the Treaty establishing the European Community with a view to ending this inconsistency.]

The Council welcomes the fact that the 2000 update addresses the issue of structural reform. In particular, the Council notes with satisfaction the progress made in the area of long-term sustainability of the public finances with the creation of a National Pensions Reserve Fund, which at end-2000 already amounts to about 6.3% of GDP. The Council also welcomes continued efforts to enhance the quality of public finances through reform of the tax/benefit system and an increased focus on capital expenditure in response to Ireland's infrastructural needs.

Concerning item 8 of the agenda

COUNCIL OPINION

on the Stability Programme of Greece, 2000-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001, the Council examined the first Stability Programme of Greece which covers the period 2000-2004. The stability programme was submitted by the Greek government within six months from the Council decision[2] of 19 June 2000 on the adoption by Greece of the single currency from 1 January 2001.

The stability programme is projecting robust real GDP growth rates, accelerating from 4.1% in 2000 to 5.5% in 2004, supported by high investment rates, strong exports and sustained private consumption. The Council considers the real GDP growth forecasts included in the stability programme as ambitious, at the upper range of possibilities. The programme presents also an alternative scenario projecting lower, though still robust, real GDP growth based in particular on a higher assumption for imported oil prices.

[1] OJ L 209, 2.8.1997.
[2] OJ L 167, 7.7.2000.

On the basis of the baseline macroeconomic scenario, the programme is projecting a general government surplus of 0.5% of GDP in 2001 which will rise to 2% of GDP in 2004. The programme is based on the fiscal consolidation strategy followed until now by the Greek convergence programmes, consisting in maintaining high primary surpluses supported, however, by a significant reduction in interest payments as percent of GDP, resulting from lower interest rates and a declining government debt ratio. The general government debt ratio is expected to decline by 20 percentage points of GDP, to 84.0% of GDP in 2004.

The Council considers that the projected budgetary position provide adequate safety margin against breaching the 3% of GDP deficit threshold in normal circumstances and is in conformity with the requirements of the Stability and Growth Pact. The Council commends the fiscal consolidation strategy of the programme, centred on high primary surpluses, which is essential in reducing rapidly the still very high government debt ratio and prepare for future challenges, notably the budgetary burden from ageing population. The Council considers, however, that such a strategy should be primarily based on an adequate control of primary expenditure increase through clear and binding norms with aim of reducing the current expenditure ratio.

The Council warns that under conditions of high GDP growth, according to the projections, combined with easing monetary conditions, renewed inflationary pressures may persist; the Council considers that risks of overheating of the economy need to be contained through determined support from domestic policies, mainly a tight fiscal stance, in particular through restraint on current expenditure, and by ensuring wage moderation.

The Council notes that the programme includes a number of market liberalisation measures, the setting-up of an appropriate regulatory framework and structural reforms in the labour, product and capital markets while a reform of the social security system is announced for 2001. The Council considers, however, that the ambitious growth and employment objectives of the stability programme, and future challenges, require a more determined attitude in the reform effort; the Council encourages the Greek government to accelerate the implementation of necessary reforms, in particular in the labour market and the social security system, in order to enhance the potential of the economy, strengthen its competitiveness and improve the conditions for sustainable growth and employment creation.

The Council considers that the stability programme is consistent with the Broad Economic Policy Guidelines. The Council invites the Greek authorities to pay particular attention to the need for reform of the pension system, and invites them to address the budgetary consequences of ageing in the next update of the stability programme.

Concerning item 8 of the agenda

COUNCIL OPINION

on the updated Stability Programme of France, 2002-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001, the Council examined the updated Stability Programme of France which covers the period 2001-2004.

Economic growth has been robust over the past two years, broadly in line with the projections of the 1999 updated stability programme. In 2000, the French economy registered a third consecutive year of strong GDP growth with relatively low inflation. The unemployment rate continued to decline and reached 9.2% in November, down from 10.9% one year earlier. Despite this sharp fall in unemployment, wage and price developments remained very moderate. Headline inflation increased from 0.5% in 1999 to 1.7% in 2000 mainly due to higher oil prices.

[1] OJ L 209, 2.8.1997.

The Council notes that, building on a more favourable outcome than expected in 1999 and an expenditure growth slower than initially projected, the general government deficit for 2000, estimated at 1.4% of GDP, will be lower than initially expected; the government debt ratio in 2000, estimated at 58.4% of GDP, was also lower than targeted by one percentage point. The Broad Economic Policy Guidelines aim at using better than expected revenues to achieve faster reduction in the government deficit. Therefore, the Council finds that a better budgetary outcome could have been achieved in 2000, taking into account the favourable economic and public finances developments.

The budgetary projections of the updated programme are based, as in the past, on two macroeconomic scenarios, a cautious scenario, in which potential growth stays at its current level of 2.5% a year, while in the favourable scenario, potential output is estimated to gradually increase to 3% due to stronger investment and employment growth. From 2001, real GDP growth is projected to follow one of the two non-inflationary scenarios. The favourable one is presented as the economic policy target and the most likely projection. In both cases, inflation is projected to stay at a low level over the entire period.

The Council considers that the two macroeconomic scenarios of the programme provide a plausible range of values for GDP growth between 2002-2004 and that the macroeconomic performance of France in recent years indicates a probable rise in the capacity of the French economy to sustain higher non-inflationary growth than in the past, resulting from a rise in capital accumulation and a fall in structural unemployment; the Council considers, in view of the above, the macroeconomic projections of the favourable scenario as attainable.

The updated programme is projecting a general government surplus of 0.2% of GDP in 2004 under the favourable scenario and a deficit of 0.5% under the cautious one. The government debt ratio is expected to decrease from 58.4% in 2000 to 54.5% or 53% according to the alternative macroeconomic scenarios. These developments reflect mainly structural progress; however, the Council regrets that a deficit remains in 2004 under the cautious scenario. Even if the projected budgetary position provides an adequate safety margin against breaching the 3% of GDP deficit threshold in normal circumstances - in conformity with the requirements of the Stability and Growth Pact - the Council considers that the French government should seek a situation of budgetary balance in 2004 also under the cautious scenario and to advance the timing of budgetary surplus ahead of 2004 under the favourable one. This would be in line also with its recommendation on the 1999 updated stability programme.

The Council welcomes that an important tax reform is being implemented without compromising the global fiscal trend. This reform is in line with the recommendations of the Broad Economic Policy Guidelines concerning the measures aimed at improving the functioning of the labour market. The Council commends the budgetary strategy based on control of real expenditure growth; however the Council considers that a budgetary policy based on expenditure ceilings requires an effective system to rein in spending as soon as any slippage is detected especially in the field of health care expenditure; consequently the Council invites the French government to introduce the appropriate mechanism enabling the respect of the expenditures norms. The Council notes that the increase in expenditure included in the Finance Law for 2001, 1.8% in real terms, accounts for a significant part of the norm for the cumulated increase for the period 2001 to 2003 fixed at 4% in real terms in the 1999 updated programme. Moreover the Council notes that the norm for the cumulated increase in expenditures has been revised upwards, real spending being allowed to increase by 4.5% in real terms from 2002 to 2004. In the view of the Council, a lower increase in expenditure would be desirable to allow a faster reduction in the government deficit.

The Council considers, further, that available budgetary margins should be used, as a matter of priority, in strengthening the budgetary position and preparing for future challenges, notably the budgetary burden from the ageing of population. In this respect, further progress with pension reform would be welcome.

Concerning item 8 of the agenda

COUNCIL OPINION
on the updated Stability Programme of Italy, 2002-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies [1], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined Italy's updated stability programme, which covers the period 2000-2004. The Council welcomes the revision of the objectives for the general government budget balance in 2000 and beyond, as recommended in the Broad Economic Policy Guidelines. The Council notes favourably that the reduction of the debt ratio to below 100% of GDP in 2003 is confirmed in spite of the higher target in 2000 compared to the first update of the stability programme. However, considering the still high debt ratio and the future challenges to the long-term sustainability of public finances from an ageing population, the Council considers that Italy’s revised fiscal targets could have been more ambitious.

[1] OJ L209, 2.8.1997.

The Council notes Italy's intention to continue the budgetary strategy outlined in the initial programme, which aims at keeping the primary surplus at a high level and reducing current expenditure as a percentage of GDP, in parallel with some easing of the tax burden. Higher than expected tax receipts are assumed to have provided backing for the tax and social security contribution cuts outlined in the programme. The primary surplus is expected to increase as a percentage of GDP, averaging 5.5% of GDP over the period. The underlying budgetary position over the programme period provides a safety margin against breaching the three percent of GDP deficit threshold in normal cyclical fluctuations, implying that Italy would continue to satisfy the requirements of the Stability and Growth Pact up to 2004.

The Council observes that there are risks that the budgetary framework outlined in the updated stability programme may not materialise as planned. The macroeconomic projections, which assume a significant acceleration in GDP growth from an annual rate of 1.4% in 1999 to over 3% in 2002-2004, may be optimistic also in the light of recent developments in the external environment; on the other hand, the assumptions on interest rates are rather conservative in light of recent developments in financial markets.

The available data do not allow at present a conclusive appraisal of the implementation of the budget in 2000. However if the general government deficit were higher than the new objective of 1.3% of GDP, Italy would not have fully complied with last year's Council opinion and with the recommendations of the June 2000 BEPG. As for 2001 and beyond, there are concerns that the increase in planned revenues, which has provided backing for the tax and social security contribution cuts, may not turn out to be fully structural and that the expenditure-reducing measures introduced with the Financial Law for 2001 could not be fully effective.

In the light of the considerations made above, the Council urges Italy to firmly commit itself to respect the programme's objectives. Primary surpluses should remain at the high levels projected in the programme. Any deviation from the planned deficit and primary surplus outcomes should be promptly addressed and corrective measures taken. This should be ensured through a tight control of current primary expenditure. The Council encourages Italy to accompany the reduction in the ratio of current primary expenditure to GDP with a more effective and more comprehensive rationalisation of public spending, aimed at improving the supply-side conditions of the economy.

Moreover, even though Italy fulfils the requirements of the Stability and Growth Pact, it should take every opportunity to improve future budgetary targets and speed up the consolidation process, in order to accelerate the reduction of the government debt ratio. The Council recommends that future decisions to reduce the tax and social security contributions burden should be matched by offsetting expenditure cuts.

In line with both its Opinion[1] on the original stability programme and its Opinion on the first updated programme[2], the Council notes that Italy has not taken further steps to address the medium-term structural challenges to public finances from pension and other age-related budgetary expenditures. The reassessment of the parameters of the pension system scheduled to take place later this year should not be postponed. The Council urges Italy to address this issue with determination. Although the Financial Law for 2001 includes a few isolated measures on pensions, the Council advocates a more comprehensive approach. The reassessment of the pension system should take place within the framework of a broader overhaul of the Italian welfare system.

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[1] OJ C68, 11.3.1999.
[2] OJ C98, 6.4.2000.

ANNEX 6

Concerning item 8 of the agenda

COUNCIL OPINION

on the updated Stability Programme of Austria, 2000-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the updated stability programme for Austria which covers the period 2000-2004.

The updated programme envisages a decline in the general government budget deficit from 1.4% of GDP in 2000 to a balanced position in 2002 and the following years. The government gross debt is expected to decrease from 61.1% of GDP to below the 60% reference value in 2002 and further to 55.3% in 2004. The Council notes with satisfaction that, in compliance with its recommendation on the previous update of the programme[2], the current programme envisages a much faster reduction of the government deficit. Moreover, the Council acknowledges that the budgetary goals are to be achieved without resorting to the one-off measures included in the previous update.

The Council notes that, in spite of higher-than-projected growth, the estimated deficit for 2000 in the current update is not lower than projected in the previous programme once originally

[1] OJ L209/1, 2.8.1997.
[2] OJ C162/1, 10.6.2000.

unbudgeted UMTS proceeds are excluded. The Council recommended in its opinion on the previous update and in the recommendations of the June 2000 BEPG that, in the event of higher growth, a better deficit outcome should be achieved. The available data do not allow at present a conclusive appraisal of the implementation of the budget in 2000. If, however, the outcome for the general government deficit were not lower than the objective of 1.7 % of GDP, Austria would not have fully complied with last year's Council opinion and the BEPG recommendations.

The deficit projections of the programme are based on a macro-economic scenario expecting output growth to decline from its cyclical peak of 3.5% in 2000 to 2.3 % in 2003 and resume to 2.5% in 2004, amounting to an annual average growth of 2.6% over the forecast period.
The Council considers that the expected growth is feasible in view of the presently good supply and demand conditions for the Austrian economy.

The underlying budgetary position implicit in the deficit goals is in line with the requirements of the Stability and Growth Pact from 2001 onwards, i.e. they provide Austrian government finances with a large-enough safety margin to withstand a normal cyclical downturn without breaching the 3 % of GDP reference value for the deficit. The Council notes with satisfaction that, in accordance with its recommendations, the Stability and Growth Pact is now respected earlier, which is appropriate in view of the currently favourable economic conditions.

However, the Council notes that in the initial years of the programme the deficit reduction relies heavily on revenue side measures. As a consequence, the already high tax burden in Austria rises further in 2001, thereby more than offsetting the effects of the income tax reform 2000. The Council, therefore, invites the Austrian government to consider measures which permit a significant decline in the tax burden, especially on labour, while preserving the budgetary adjustment path.

The Council considers that, to achieve a balanced budget by 2002, a strict budgetary implementation at all levels of government is crucial. This seems essential in view of uncertainties regarding the savings estimates of the public administration and pension reforms. At the level of the Bundesländer the expenditure cuts necessary to achieve the surpluses required by the national stability pact largely remain to be defined.

The Council acknowledges that, by 2003, more than half of the total envisaged consolidation originates from expenditure savings. This requires that achievements in budgetary consolidation are locked in and budgetary discipline is maintained in the years 2003 and beyond. Any additional spending or further revenue reductions, including those envisaged in the programme, should be made strictly contingent on compensatory expenditure cuts. In light of the medium- and longer-term challenges to public finances, not least due to population ageing, and the need to render government finances more conducive to investment and growth the Council considers that fiscal adjustment needs to be continued with determination.

The Council acknowledges ongoing structural reforms of the Austrian economy in line with the Broad Economic Policy Guidelines. The recent reform of early retirement is particularly welcome. However, the Council encourages the Austrian government to continue its reform efforts in order to better achieve and safeguard sustainable government finances in the medium and longer term, namely in the pension system and the health care sector. The Council invites the authorities to provide more information on this issue in the next update of the programme. The Council also encourages the Austrian government to continue determinedly with the reforms of product and capital markets, with a view to enhancing competition, fostering the provision of risk capital and improving entrepreneurial dynamism and corporate governance.

Concerning item 8 of the agenda

COUNCIL OPINION

On the updated convergence programme for the United Kingdom 1999-00 to 2005-06

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1] , and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the updated Convergence programme of the United Kingdom which covers the period 1999-00 to 2005-06. The programme envisages a government surplus of 1.1% of GDP in 2000-01, a smaller surplus in 2001-02, balance in 2002-03 and deficits around 1% of GDP in the three following years to 2005-06. The Council considers it appropriate that the programme stresses the securing of macro-economic stability supported by sound monetary and fiscal policies and continued structural reform.

The programme is built upon a macroeconomic framework showing a return of GDP growth from 3% in 2000 to close to trend – put at 2½% - thereafter, which the Council considers to be realistic if cautious. Moreover, the projections in the programme for the public finances are, for reasons of caution, based on a lower assumption for trend growth - namely 2¼%.

[1] OJ L209, 2.8.1997

With respect to inflation and interest rates, the United Kingdom continues to fulfil the convergence criterion with some margin. The Council notes that the monetary framework of inflation targeting, with operational responsibility for interest rate changes given to the Bank of England, has been an important condition for securing low inflation expectations. The Council notes that under the current policy framework, the programme projects the UK inflation target to be achieved over the programme period.

The United Kingdom has fulfilled the convergence criterion on the long-term interest rate for some time. This helps confirm the credibility given to the UK's stability oriented framework for macro-economic policy. It notes that while there are signs of reduced exchange rate volatility, it cannot be concluded that this policy framework has delivered a stable exchange rate. Therefore the Council recommends that the United Kingdom continue with the stability oriented policies with a view to securing exchange rate stability which, in turn, should help re-enforce a stable economic environment.

The general government finances are in 2000/01, 2001/02 and 2002/03 close to balance in underlying terms thus fulfilling the requirements of the Stability and Growth Pact. However, the Council notes that a persistent deficit of 1% of GDP emerges in the latter years of the plan; larger than the deficits of around ½% of GDP in the two final years of the previous update. This would not be in line with the prescription of "close to balance or surplus" contained in the Stability and Growth Pact. The Council acknowledges that this emerges in the projections as a result of the use of a very cautious trend growth assumption of 2.25 % per annum and as a consequence of increased government investment as a share of GDP within the expenditure totals. Should trend growth be higher, as expected, compliance with the BEPG will require more ambitious budgetary outcomes. While the specific recommendation to the UK in the BEPG advised the UK to pursue a policy of substantially raising the ratio of government fixed investment to GDP, it also recommended to do so within the context of firm control of government expenditure, thereby keeping the underlying position of government finances broadly unchanged. Therefore, the Council encourages the government to be alive to any deterioration in the public finances that would take them away from the terms of the Stability and Growth Pact and, if necessary, to take remedial action.

The Council notes that the government gross debt ratio in the United Kingdom remains below 60% of GDP and is expected to fall to 40% in 2000-01. The Council welcomes the envisaged further reduction of the gross debt ratio to 35% of GDP by 2004-05.

The Council welcomes the structural reforms included in the programme. It notes, with approval, that the progress on economic reforms should help to raise productivity levels to those of competitors and secure further improvements in the labour market.

The Council notes that the programme provides both long-term projections of public finances and a description of policies that could be addressed to minimize the impact of ageing, and welcomes the sustainable position which is projected.

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INFORMAL ECOFIN 9-10 September 2005

Stability of EU Financial Systems

SPEAKING NOTE

Financial System Stability and Financial conditions in the EU.

- The Irish banking sector is currently in a strong position, with good profitability and reserves well above minimum requirements
- The concentration of risk exposures in the residential mortgage sector is being closely monitored by the supervisory authorities. However, with good economic growth and low employment, there is no real concern at present
- In the corporate sector, a proxy for risk is the rate of closure among firms. The overall corporate liquidations rate last year was at its long run average, so there is no particular concern there.

Crisis Simulation Exercise (Only if necessary)

- I note with satisfaction the approval by the Economic and Financial Committee of the report of the High Level Working Group which clarifies the key elements of the crisis simulation exercise.
- The competent authorities in Ireland will be pleased to cooperate fully with the development of the arrangements for the exercise.

INFORMAL ECOFIN 9-10 September 2005

Stability of EU Financial Systems

BACKGROUND NOTE

Financial System Stability and Financial conditions in the EU.

Background Note on Irish Financial Sector Issues

Banking
The available information suggests that the banking system remains in robust health. Irish banks are comfortably profitable and remain well capitalised, with solvency ratios significantly in excess of the regulatory minimum.

Notwithstanding the significant slowdown in economic growth that occurred during 2003, aggregate data on asset quality suggest that non-performing assets stood at approximately 0.89 per cent of the value of outstanding loans as of end-2004. The low levels of interest rates and the strength of the labour market are key factors in keeping arrears at their historically low levels.

Mortgage Lending
Increasing house prices have contributed to strong mortgage lending growth. Strong house price inflation also increases the equity in existing loans thereby reducing the risk of loss-given-default for credit institutions. The share of credit institutions' aggregate loan book in property-related lending has increased persistently in recent years and is now approximately half of the resident loan book.

Households
With respect to households, personal-sector indebtedness continues to increase strongly, more than doubling in the past decade to approximately 110 per cent of disposable income by end-2004. This ratio will continue to grow strongly in 2005. The growth of personal-sector credit reflects the growth in residential mortgages, which account for approximately 80 per cent of personal-sector credit. However, personal-sector indebtedness is unevenly distributed across households. The latest census results suggest that 62 per cent of households have no mortgage debt. Of those with mortgages, household-level data would suggest that there is a small subset of households, most likely the group of new borrowers, with significant repayment burdens.

Labour market developments, an important determinant of credit risk arising from the household sector, continue to be positive. The unemployment rate was close to 4.5 per cent during 2004. The relatively strong performance by the construction and services sectors contributed significantly to this outcome. The economy is close to full employment. Despite the continued escalation of household indebtedness and property prices, the prospects for the financial health of the Irish household sector appear to be quite favourable.

dynamics of booms and busts continued to work at the national level and that the monetary union in no way disciplined these into a union-wide dynamics. On the contrary the monetary union probably exacerbated these national booms and busts. Second, the existing stabilizers that existed at the national level prior to the start of the union were stripped away from the member-states without being transposed at the monetary union level. This left the member states "naked" and fragile, unable to deal with the coming national disturbances. Let us expand on these two points.

4.1 Booms and busts dynamics

In the Eurozone money and monetary policy are fully centralized. However, the rest of macroeconomic policies has remained firmly in the hands of national governments, producing idiosynchratic movements unconstrained by the existence of a common currency. As a result, there is very little in the monetary union that can make the booms and busts converge at the Eurozone level. The effect of all this is that booms and busts originate at the national level and have a life of their own at the national level without becoming a common boom-and-bust dynamics at the Eurozone level.

In fact it is even worse. The existence of the monetary union can exacerbate booms and busts at the national level. The reason is that the single interest rate that the ECB imposes on all the member countries is too low for the booming countries and too high for the countries in recession. Thus, when in Spain, Ireland, Greece the economy started to boom, inflation also picked up in these countries. As a result, the single nominal interest rate led to a low real interest rate in he booming countries, thereby aggravating the boom. The opposite occurred in the countries experiencing low growth or a recession.

Thus, the fact that only one interest rate exists for the union exacerbates these differences, i.e. it leads to a stronger boom in the booming countries and a stronger recession in the recession countries than if there had been no monetary union.

THEME: R7

Effectiveness of the policy and institutional responses post crisis

LINE OF INQUIRY: R7a

Assessment of what has been done, work-in-progress and what remains outstanding from the recommendations of previous reports

Michael Noonan: Strategy for dealing with banks is working

http://www.irishtimes.com/opinion/michael-noonan-strategy-for-dealing-with-banks-is-working-1.2062113

Jan 12, 2015

At the very least, the State should recover all of the money it has invested so far

[Subtitle under picture of Michael Noonan]: Officials within my department are working with AIB on reconfiguring the capital structure. Goldman Sachs International has been appointed to provide financial advice.

The overarching objective of the banking strategy I set out in March 2011 was to have a functioning, stable banking system operating in support of the Irish economy and to reduce the cost of the banking bailout to the Irish taxpayer.

Our strategy is working. We now have two strong universal banks, AIB and Bank of Ireland, with Permanent TSB operating as a challenger bank focusing specifically on retail and consumer banking. The relationship between the banks and their customers is improving and the taxpayers' shareholdings in the banks are now valuable assets.

However, the cost the taxpayer has incurred to secure this has been unprecedented. Maximising the banks' value and ultimately the return of cash to the taxpayer is a key priority in 2015. Today I have appointed financial advisers to ensure we optimise the return on AIB, where more than €20 billion of taxpayers' money has been invested.

Between the banking guarantee in 2008 and the bailout in 2010, more than €46 billion of taxpayers' money was injected into the banks by the Fianna Fáil-led government with the majority – about €34.7 billion – going into Anglo Irish Bank and Irish Nationwide Building Society.

Upon taking office in 2011, and with the situation continuing to deteriorate, I set out this Government's strategy for the banking system. This was underpinned by an investment in the three viable banks of just less than €18 billion. This brought the cost to the Irish taxpayer to €64.1 billion; €34.7 billion into Anglo Irish Bank/INBS and €29.4 billion into the three viable banks of AIB, Bank of Ireland and Permanent TSB.

Stronger position

Over the past two years we have taken major steps in reducing the overall cost of this bailout. The liquidation of Anglo Irish Bank and the replacement of the promissory note deal in February 2013 reduced the amount of money that the State will have to borrow over the next decade by some €20 billion. In addition, through the sale of investments in Bank of Ireland and the sale of Irish Life, about €5 billion has been returned to the State, in addition to €5.9 billion from interest and fees across all the banks.

The Irish banking system is now in a much stronger position. The preliminary independent valuation of the shareholding, referred to last week by the NTMA, shows that as at December 31st, 2014 our equity and preference shares in AIB were valued at €11.7 billion and our 14 per cent equity interest in Bank of Ireland was valued at €1.4 billion. The State is also holding €1.6 billion of contingent convertible capital notes (CoCos) in AIB and €400 million of CoCos in Permanent TSB; which brings the total current value of the State's investment in the banks to more than €15 billion.

Permanent TSB is not as far along the road to recovery as the two pillar banks but has a viable business plan. The ECB recently endorsed Permanent TSB's capital plan and discussions are well advanced with the European Commission regarding its restructuring plan. Preparations for Permanent TSB to raise new capital are well under way and this is expected to be completed before the end of July.

Value for taxpayers

Much of the banking-related work in the Department of Finance this year will focus on AIB. Given the scale of the State's investment – some €20.8 billion – and the range of options available to recoup value from the bank, officials within my department are working with AIB on reconfiguring the capital structure. Goldman Sachs International has been appointed to provide financial advice.

The focus will be on ensuring that the best decisions are made regarding potential capital restructuring options and sequencing in order to maximise the return of cash to the State from our AIB investments. While this is just the start of the process, it is an essential first step on the road to recovering value for the taxpayer. All options remain on the table and it is too early to specify what steps will be taken next or to put a timeline on decisions.

The approach this Government has taken in dealing with the banks is working, is in the best interests of the Irish taxpayer and will deliver the best results. We have taken the opportunity to recoup taxpayers' money when the right opportunity arose and have walked away from other potential transactions that simply did not represent good value for the taxpayer. The success in restructuring the banking system is recognised by investors and rating agencies, and the banks are no longer viewed as a risk to the financial stability of the State.

I am confident that, over time, we will at a minimum fully recover the funds this Government invested in AIB, Bank of Ireland and Permanent TSB. If economic and trading conditions continue to improve over the next decade or so, the cash returned to the State combined with the value of any remaining shareholding may exceed the funds invested.

However, we will take our time in assessing all options to ensure the banks are operated in the best interest of the Irish economy and that the return to the taxpayer is maximised.

Michael Noonan is Minister for Finance

State gets €12.7bn back from banks since guarantee

Gordon Deegan

Irish Independent 18/07/2015

The State has received over €12.74bn from all bank-related levies, investment income and disposal of investments since the bank guarantee of 2008.

That's according to the Minister for Finance, Michael Noonan, who confirmed that between April 2010 and May 2015 the State received €6.58bn from the disposal of investments by the banks covered by the guarantee - Bank of Ireland, AIB and Permanent TSB.

In addition, Minister Noonan confirmed that the State has received €6.16bn in income, fees and the bank levy from the banking sector since 2008.

However, the €12.74bn income generated from the bank industry here is a fraction of the €64bn that tax-payers were forced to pledge to rescue the nation's banks after the worst real estate crash in western Europe.

In his detailed written Dail response to Deputy Joanna Tuffy (Lab), Minister Noonan said that the Government has raised €4.65bn from the Bank of Ireland through the disposal of investments.

In addition, the Government has received €1.88bn from the sale of Permanent TSB disposals including €1.34bn from the sale of Irish Life, while the State has raised €50m from the cancellation of AIB preference share warrants.

The State received €154m from the introduction of the bank levy in Budget 2014 with €130m received AIB, the Bank of Ireland and Permanent TSB.

Minister Noonan confirmed to Deputy Tuffy that €4.4bn of the €6.16bn came from payments by banks under the Eligible Liabilities Guarantee scheme (ELG) in relation to the bank guarantee.

Meanwhile, in a separate Dail reply to Fianna Fail Finance spokesman Michael McGrath, Mr Noonan confirmed that the estimated tax paid by companies operating out of the International Financial Services Centre (IFSC) in Dublin totalled over €950m in 2013.

In a breakdown provided to Deputy McGrath, Mr Noonan said firms at the IFSC paid out €621m in 2013 and he said the associated PAYE and USC is tentatively estimated to be around €332m, giving a total of €953m.

Irish Independent

File Note Extract

I met the Minister for Finance, Michael Noonan, at his request in his office on Thursday, 15 November 2012. The meeting lasted 40 minutes. (There were no officials present).

We discussed the following:

(i) My letter to him of 6 November 2012 regarding the recent round of NTMA investor meetings. The Minister said he found the briefing letter very helpful. He expressed some concern at the high level of cash balances but said that, nevertheless, he would be guided by the NTMA's views on the timing of future bond market issuance.

(ii) NewERA/Strategic Investment Fund (SIF) Legislation. He said that there was push back from the Department of Public Expenditure and Reform in relation to the proposals contained in the draft DoF memo for the EMC. He said that he was happy with the contents of the memo and that he would await the outcome of next Tuesday's (20 November) meeting on the matter between DoF/DPER officials and advisors before considering discussing it with Minister Howlin. On the SIF and the view of the NPRF Commission that amending legislation was required before they could commit to new projects in Ireland (including SME funds which were well advanced) I suggested that a way forward might be for the Minister to issue a letter of comfort to the Commission. It was agreed that I would let the Minister have a draft for his consideration.

16 November 2012

European
Commission

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Post-Programme Surveillance Report

Ireland, Spring 2015

INSTITUTIONAL PAPER 005 | JULY 2015

EUROPEAN ECONOMY

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594

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public commercial NPL restructuring targets. BOI and AIB have moved the majority of the challenged commercial portfolio to "end state" (i.e. entering a restructuring arrangement) but further migration from "end state" to performing is expected to take several years. As the property market recovers, it is important that banks encourage the implementation of workout plans with their debtors or undertake asset disposals. Attention should be paid to SME accounts with CRE connections, given their higher probability of default. The SME examinership scheme was made more affordable to firms in July 2014 but its use is still limited ([57]). Relatedly, NAMA has made advances in selling off its portfolios of large distressed CRE loans (Box 3.2).

Once in place, the creation of a central credit register will support prudent lending by improving the assessment of the borrowers' creditworthiness. The Credit Reporting Act 2013 was enacted in December 2013, followed by the development of the register's design and supporting regulation. A data questionnaire was sent to the main lenders in March and a public consultation was launched by the CBI in April. Both should inform the data collection process, leading to the finalisation of the regulations in the autumn of 2015. The credit register is set to become operational in late 2016 for consumer credit and in 2017 for corporate credit. The absence of a credit register makes supervision, credit underwriting and internal risk management more difficult. The register will also be an important component of calibrating some macro-prudential measures (e.g. total debt-to-income and debt-service-to-income ratios).

3.2.4. Boosting credit for economic growth

SME financing remains low for various reasons. In addition to low demand for funds, SME financing constraints stem in part from the banks' more cautious approach to new lending (rather than a lack of liquidity) and the concentrated system of lenders. SMEs are still reluctant to access equity financing because of a potential loss of upside to future profits and a general lack of non-bank financing knowledge. Although firms believe that banks are now more willing to lend, interest rates remain higher than the euro-area average, due to risk-pricing that reflects the still numerous distressed SME loans of the banks. The insistence on personal guarantees and certain types of asset collateral, costly external parties' credit worthiness reports for credit applications, and the time needed for refinancing loan decisions, are amongst SME concerns.

The Ireland Strategic Investment Fund (ISIF) aims at supporting economic activity and job creation through commercial investments. With an active pipeline of almost 60 projects, it has executed one investment deal and approved a number of further transactions since it was established in December 2014. The ISIF is managed by the NTMA. Its discretionary portfolio is valued at EUR 7.2 billion or 3.7% of GDP as of end-2014([58]), and its investment strategy will focus mostly on activities with a high impact on GDP growth, such as infrastructure, exports and manufacturing. About 20% of the funds will be marked for lower economic impact activities including SME equity funding. The ISIF hopes for its investments to have a signalling effect and attract further private investors. Given its new role in venture capital, the fund should be monitored and the take-up of such funding by firms assessed also in the context of the Investment plan for Europe ([59]), as the ISIF anticipates partnership with the European Fund for Strategic Investments.

The Strategic Banking Corporation of Ireland (SBCI) intends to diversify funding for Irish SMEs. It will do this by channelling its lower cost of funding to firms through on-lenders, including retail banks. Its initial products include longer-term loans, working capital facilities with durations of two years and loans for the refinancing of credit extended by banks who are exiting the domestic market. The lenders

([57]) Examinership allows a company that is experiencing financial difficulties a period of protection from creditor action during which a third party (the examiner) has an opportunity to study the affairs of the company and, if there is a prospect for the continuation of the company, to draw up a plan for its continuation. Only about 30 SMEs had sought the appointment of an examiner through the Circuit Court in 2014.

([58]) Quarterly Portfolio and Performance Update for Q4 2014, http://www.ntma.ie/business-areas/ireland-strategic-investment-fund/

([59]) http://www.eib.org/about/invest-eu/index.htm.

Unbelievably a central credit database still does not exist

Opinion: register will not be fully operational until 2017

Ciarán Hancock

Wed, Nov 26, 2014, 01:00

Six years after the crash of our domestic banks, you might have thought that there would by now be a central repository with detailed information on credit data.

Somewhere that institutions could go to get up-to-date information on the amount of credit held by individuals and whether or not they were in good standing with their lenders.

An extensive database to ensure informed lending decisions are made and borrowers are protected from excessive debt. Yet no such register exists and it won't be fully operational until 2017.

Fianna Fáil's finance spokesman Michael McGrath described this yesterday as "completely unacceptable" following a reply from the Minister for Finance, Michael Noonan, to a question he posed recently about the establishment of the new central credit register.

When the register is established, lenders will be obliged to report to the Central Bank credit information and personal information about loan applications and loan agreements that involve more than €500

Lenders will also be required to check the register before approving credit applications of more than €2,000 and they may also apply to check the register in cases involving less than this amount. The hope is that this leads to better lending decisions being made.

The initial phase of the register "will focus on the consumer credit market and is expected to become operational by mid-2016," the Minister said. "A later phase will address commercial credit and is tentatively scheduled to be operational by end 2017."

'On track'

A spokeswoman for the Central Bank, which will have oversight for the

register, said the project is "on track" and has met all of its deadlines set down so far.

The establishment of the register has been in the offing for years. The need was highlighted in a number of reports, including those from the Law Reform Commission, the Expert Group on Mortgage Arrears, and the Central Bank itself.

It was also a measure included in our financial assistance programme with the EU and IMF.

David Hall of the Irish Mortgage Holders Organisation, which has helped some 5,500 people in arrears with their home loans, thinks a register would be a good idea.Having a central register of credit ratings would give some certainty to borrowers and allow them to correct any mistakes about their status, he said.

Hall wants the new register to recognise those who are on track with their restructuring plans as being in good standing with their lenders.

To date, the Irish Credit Bureau has been the only equivalent register available in Ireland but the general consensus is that it hasn't been fit for purpose.

Set up in 1965, it is owned by a large number of banks and other credit institutions, but the problem over the years has been that some institutions didn't bother registering certain credit agreements.

Hit and miss

Data on mortgage lending was particularly hit and miss. A couple of years ago, just for the heck of it, I applied to the bureau to see what credit information it held on me. The answer was zilch, in spite of the fact that I had a mortgage with one of the pillar banks.

In spite of its shortcomings, it was a handy cash cow for the banks, paying out just shy of €11 million in dividends between 2005 and 2007.

The Central Bank is currently out to tender to find an operator for the new register. It is unclear whether this group will begin its work from scratch or perhaps draw on the existing database held by the Irish Credit Bureau.

The bureau's data might be patchy but it would be a good starting point for the register and would surely save some time and money.

The need for the central register is urgent. Demand for credit might still be muted compared with the boom years but lending is ticking up again – this year mortgage lending is expected to rise by about 50 per cent to €3 billion.

In the past, customers took out loans and credit cards from multiple institutions without the banks being able to run proper checks. This resulted in flawed lending decisions being made that many borrowers are now struggling to repay.

The regulator's seeming determination to get this "hugely complex task" right at inception is to be welcomed given recent controversies with Irish Water.

But it will have been almost a decade since the crash before the central credit register is fully up and running. It should not have taken so long.

Twitter: @CiaranHancock1

introduced in 2007, the growth in the Irish banking system and its concentration on property lending has led to the development of major systemic risks to the Irish financial system and the economy generally. It should be noted that the CBFSAI warned in its 2004 Stability Report of the risks of excessive credit growth and the property boom. However, notwithstanding that the Central Bank and Financial Regulator constituted a unified entity with a large element of cross-representation on the boards of each body and the powers assigned to the CBFSAI within the legislative framework, the actions to dampen speculative excesses taken by the Financial Regulator in 2007 were not sufficient to pre-empt the serious instability in the Irish financial system.

The principles-led supervision approach championed by the Financial Regulator was consistent with what was considered at the time as international best practice. However, a prerequisite for the effectiveness of this regulatory model is prudent risk management, appropriate management and controls, ethical behaviour and transparency in reporting business dealings by boards and senior management in regulated firms. It is now accepted that a significantly more intensive and hands-on regulatory approach is essential, particularly in sectors of the financial system with the potential to cause systemic disturbance to the financial system and the economy. Notwithstanding this need for a more hands on approach, the need to ensure that businesses can operate effectively must also be factor into the planned reforms.

6. Legislative Requirements

The legislative foundation for the regulatory structure for financial services in Ireland is set out in the Central Bank Act, 1942. This has been very heavily amended by a series of subsequent Central Bank Acts (1964, 1971, 1989, 1997, 1998), by the Central Bank and Financial Services Authority of Ireland Acts of 2003 and 2004 (creating the Financial Regulator), and by a series of other legislative provisions for specific purposes (Cheques Act 1959, Coinage Act 1950, etc). The net result is a complex, fragmented and disjointed framework of legislation governing a strategic national institution, which also has to fit within the European System of Central Banks Statutes. As set out in paragraph 14, this framework has been critically commented upon by the European Central Bank, which in published opinions of 2002 and 2003 called for this to be consolidated at the earliest opportunity.

Notwithstanding the desirability of consolidation, such an approach would necessarily take a considerable time. Given the need for urgent and demonstrable progress to reform of Ireland's regulatory structures, the Minister proposed to consult with Attorney General on the appropriate legislative approach to achieve the changes proposed considering in particular the possibilities of :

(i) Achieving structural change within the existing regulatory framework
(ii) Transfer the functions of the Financial Regulator to the new regulatory structures set out at paragraph 5 following with minimum change to the existing compendium of legislation.
(iii) Consolidating the existing framework, with appropriate amendment to provide for the changes proposed.

However, based on preliminary discussions with the Office of the Attorney General it is clear that there may be important obstacles to this approach so it may prove

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Ireland, 2010-2013

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EXECUTIVE SUMMARY

This document presents an ex post evaluation of the three year EU/IMF financial assistance programme that Ireland completed in December 2013. The Irish programme was the second euro area (EA) assistance programme, and the first financed by two new financial assistance instruments established in 2010, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). It was designed to address the effects of the severe banking and fiscal crisis that had caused Ireland to lose market access, and cover Ireland's financing gap until market access was restored. The Irish programme was novel, complex, and economically and financially important for both Ireland and the EA as a whole. An ex post evaluation of the design, implementation and outcome of the programme is required by European Commission rules and in line with best practice. ([1]) The aim is to draw lessons for the future from the programme as a whole.

In a global context of decreasing yields and risk premia, Irish economic growth from 2002 onwards was increasingly driven by a property bubble; the Irish banking sector overextended itself with the financial supervision and resolution frameworks proving to be inadequate. The property market crashed in 2007, exposing the vulnerability of the financial sector. The fiscal deficit exploded as cyclical revenues disappeared, and crisis-related spending pressures grew. These included significant financial support to Irish banks.

The Irish programme was put together in a climate of deep uncertainty in Ireland and the EA. The Irish authorities' initial response to the emerging financial and fiscal problems did not succeed in getting the situation under control. Developments elsewhere in the euro area also negatively impacted on the Irish situation. Continued uncertainty over the magnitude of the financial crisis, and the ability of the Irish sovereign to absorb its costs, drove sovereign bond spreads to record highs. At the same time, the EA crisis spread further across countries and sectors. On 21 November 2010, the Irish government requested external financial assistance.

Overall, the programme was relevant, appropriate and effective. Ireland regained market access and made significant progress on financial sector repair, fiscal consolidation and a return to sustainable growth. The financing provided under the programme enabled a smooth and sustained return to full market access for the Irish sovereign. The programme was effective in restoring creditors' confidence in the financial system, as confirmed by access to debt markets by the two pillar banks. Banking supervision improved significantly. The fiscal targets were realistic, and meeting them with a margin added to the credibility of the programme, including with respect to its effectiveness in breaking the vicious financial-sovereign loop that had proven so damaging to the Irish economy. Public debt is now on a downward path and fiscal governance has been strengthened. The Irish economy grew strongly in 2014 and is forecast to continue to expand. The current account balance has shifted into surplus, unemployment is falling, and cost-competitiveness has improved considerably. Nevertheless, challenges remain in fully addressing the legacy of the crisis. Long-term unemployment and youth joblessness remain at high levels and the risk remains that some cyclical unemployment becomes structural. The banking sector has been relatively slow to return to profitability. A high stock of public and private debt, including non-performing loans, continues to weigh on domestic demand. Structural reforms designed to make future growth more sustainable and inclusive are work in progress.

The €85 billion envelope agreed in December 2010 was appropriate: it proved sufficient to meet Ireland's financing needs until it regained market access at sustainable rates. **At that time, it was right to include sizeable contingency reserves in the funding envelope in a context of high financial market volatility and uncertainty.** The envelope, corresponding to approximately 50% of the Irish GDP, came from several sources. Nearly half were provided by the EFSM and EFSF. The remainder came from the IMF, bilateral loans, and Irish national funds. The funding envelope was consistent with the pace of fiscal adjustment envisaged, and was intended to ensure that Ireland would be able to roll-over

([1]) Communication to the Commission (COM), 'Responding to Strategic Needs: Reinforcing the use of evaluation' (SEC(2007)213), http://ec.europa.eu/smart-regulation/evaluation/docs/eval_comm_sec_2007_213_en.pdf provisions are now enshrined in the new EU regime. However, a careful assessment concluded that the conditions for such a bail-in were not present in Ireland nor in the EU at the time. With no legal framework in place to manage such an exercise, the legal and economic risks were considered too great in light of the potential benefits. The risks of spill-overs to the Irish and EU financial systems were highly uncertain and perceived to be very high, especially given the absence of a proper EU bank resolution framework. The alternative of a burden sharing that only applied to the senior creditors of the institutions that were to be resolved, Anglo and INBS, would have had fewer benefits to the Irish Exchequer but would still have entailed considerable risks.

The large upfront recapitalisation of banks was appropriate and effective: it helped to restore confidence in the solvency of the Irish banks and sovereign in a context of high uncertainty. In 2011, aggregate recapitalisation needs were finally agreed at €24 billion, of which the State provided the majority (€16.6 billion). This was lower than the €35 billion (including contingency reserves) envisaged in the programme envelope, but higher than the 2011 Prudential Capital Assessment Review (PCAR) assessment of €18.7 billion. The spreads on the senior bonds of the two pillar banks, Allied Irish Banks (AIB) and Bank of Ireland (BOI), started reducing after summer 2011. The two banks regained unguaranteed market access in late 2012. Given that large up-front recapitalisation could have impaired banks' incentives to clean-up their balance-sheet, an earlier introduction of mortgage restructuring targets could have been envisaged.

Bank restructuring was overall appropriately designed: Anglo and INBS were resolved. Competition and fiscal concerns justified the decision not to resolve Permanent TSB (PTSB), despite doubts over its viability. Decisions on whether to resolve or restructure institutions were timely and consistent, which lent the programme credibility. The resolution of Anglo and INBS was envisaged from the start of the programme, and by the end of it the two banks had been successfully put into liquidation. Taken in isolation, there could have been a case for also resolving PTSB (the banking operations of Irish Life and Permanent) given concerns over its viability. However, this option was not pursued because it risked harming competition. Moreover, the immediate fiscal cost of resolution was higher than for restructuring. The restructuring plan for PTSB was approved in April 2015 by the European Commission under State aid rules; the bank is making progress, including raising additional private capital in 2015, although it is yet to reach profitability.

Banks have downsized their balance sheets and stabilised their funding structure, but deleveraging targets did not translate into a reduction in non-performing loans (NPLs). In line with the deleveraging targets, the banks reduced their balance sheet by around €70 billion (45% of GDP). Significant progress was also made in reducing the banks' reliance on the Eurosystem and improving their loan-to-deposit ratio. The deleveraging process was managed flexibly in order to minimise unintended consequences such as high deposit rates or an excessive squeeze on new lending. Disposals – which were in line with EU State aid rules, requiring burden sharing by the beneficiary of aid – may have been too focused on foreign assets as they left Irish banks with less profitable businesses, although this helped to avoid domestic fire sales. Reforms to financial sector governance were much needed but required preparation before they could be implemented. The new personal insolvency framework was put in place only in November 2013 and gained consensus support, but has subsequently suffered from low take-up. At the end of the programme, the envisaged introduction of a credit registry had not yet happened. Also, a decline in NPLs was yet to be seen.

Ireland's fiscal targets proved to be appropriate: they were realistic and were met with a margin, aided by the easing of EFSF/EFSM loan terms, although measurement issues could have been more clearly addressed. At the start of the programme Ireland's structural deficit was assessed to be in double-digits and public debt had increased sharply. The size of the deficit, and worsened economic outlook, justified the decision in December 2010 to move Ireland's deadline for correction of the excessive deficit back by one year to 2015. Ireland implemented sufficient reforms to meet the fiscal targets set out in the programme, whether defined bottom up (consolidation measures) or top down (fiscal deficit reduction),

In the initial phase of the crisis, the problems in the banking sector were largely misinterpreted as a liquidity and confidence issue, triggered by the global financial crisis. ([19]) Given that the economic downturn and financial turmoil made it difficult to distinguish effectively between illiquid and insolvent institutions, the Irish authorities initially issued a 'blanket' guarantee on banks' liabilities and provided a large amount of capital support. In practice in September 2008, the authorities issued a two-year guarantee on existing banks' liabilities (Credit Institutions Financial Support Scheme - CIFS) amounting to €375 billion (200% of GDP), in order to overcome banks’ funding problems and address potential capital shortfalls. As a result, the solvency of the Irish sovereign and that of the banking system became directly intertwined. This eventually turned the banking crisis into a sovereign debt crisis. A further consequence of the guarantee was that the potential for any substantial burden sharing – by bailing in senior bondholders – was limited for its duration. ([20]) With hindsight the bank guarantee appears too generous, and the fiscal impact could have probably been limited if banks had been subject to stricter requirements, as was the case in Sweden in 1991-92. ([21]) However, the Irish authorities were constrained by high uncertainty, the absence of any credible financial backstop mechanisms for the financial system ([22]), and the potential for litigation from bondholders of domestic Irish banks. ([23]) In December 2009, the Eligible Liabilities Guarantee Scheme (ELG) was introduced to facilitate debt securities issuance by credit institutions, and deposit taking with a maturity beyond September 2010. In addition, the CBI provided emergency liquidity assistance (ELA) to the banks that were left with only a limited amount of eligible collateral for repo transactions with the ECB. ([24])

Uncertainty about the value of impaired assets and the high cost of banking sector support continued to undermine confidence in the Irish sovereign and Irish banks. Financial sector support also included an asset protection scheme and direct capital injections. In December 2009, the authorities established the National Asset Management Agency (NAMA), for the purchase, management and disposal of non-performing assets. ([25]) However, the lengthy process that led to the eventual agreement on NAMA, and the initial uncertainty about the discount at which assets would be transferred to it, continued to erode investor confidence in banks' balance sheets. Eventually, haircuts proved to be much higher than the preliminary estimates. As of mid-January 2011, assets initially worth €71.3 billion had been transferred with an average discount of 58% on the nominal value. The 2010 Prudential Capital Assessment Review (PCAR) indicated additional capital needs for Irish banks ([26]). However, these estimates became obsolete with the escalation of the banking crisis a few months later. Likewise, the results of the EU-wide stress tests published in July 2010 did not help clarify the situation of the Irish banking system, given that the main purpose of this exercise was to assess the resilience of the overall

([19]) See for example McGowan, M. A., ‘Overcoming the banking crisis in Ireland’, *Economics Department Working Paper* No. 907, OECD, November 2011, p. 6; Beck, T., ‘Ireland's banking system – looking forward’, in: G. Stull (ed.), Future directions for the Irish economy, *European Economy, Economic Papers*, No. 524, July 2014, p. 52.

([20]) See Letter from the ECB President to Mr Matt Carthy, MEP, on several aspects of the Irish adjustment programme, http://www.ecb.europa.eu/pub/pdf/other/150218letter_carthy.en.pdf

([21]) For example, banks requesting support were obliged to give disclosure of all their financial positions and were dealt with in a way that minimised moral hazard, see Jonung, L., ‘The Swedish model for resolving the banking crisis of 1991-93. Seven reasons why it was successful’, *European Economy, Economic Papers*, No. 360, February 2009; Laeven, L. and F. Valencia, ‘The use of blanket guarantees in banking crises’, IMF Working Paper WP/08/250, IMF, Washington 2008.

([22]) The EU governance tools allowing for the bail-in of (senior) creditors and set out in the Bank Recovery and Resolution Directive (BRRD) have been established only after the end of the Irish economic adjustment programme, see Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

([23]) See Letter from the ECB President to Mr Matt Carthy, MEP, on several aspects of the Irish adjustment programme, http://www.ecb.europa.eu/pub/pdf/other/150218letter_carthy.en.pdf

([24]) Costs and risks related to the provision of ELA are borne by the national central bank. This implies that the Irish government is to ultimately bear the risk of potential losses from ELA as the owner of the central bank or as the issuer of a specifically provided state guarantee. This contingent exposure further exacerbated the dangerous nexus between banking risk and sovereign risk, see: https://www.ecb.europa.eu/mopo/ela/html/index.en.html.

([25]) For further details on the set-up of NAMA, refer to section 5.

([26]) See CBI, ‘New levels of capital required for Irish banks’, Press release of 30 March 2010, http://www.centralbank.ie/press-area/press-releases%5CPages%5CFinancialRegulatorPublishesNewlevelsofCapitalRequiredforIrishBanks.aspx

The diverging lending terms of EFSF/EFSM and IMF loans raise questions for the future. Initially, the lending terms for the EFSF/EFSM loans included interest rate margins, which were tailored to match the level of interest rates of IMF loans, taking into consideration that EFSF/EFSM lending was based on back to back lending with fixed rates, while rates for IMF loans were flexible. ([59]) Again copying IMF lending policy, the EFSF/EFSM financial assistance framework agreement also included a proportionate early repayment clause that required the Irish borrower to reimburse all creditors proportionally in case of an early repayment. The initial inclusion of EFSF/EFSM margins responded to the request of some creditors, who sought to avoid moral hazard and see the beneficiary Member State return to market funding as soon as possible. However, these margins made it more difficult for recipients to achieve debt sustainability and made potential market investors wary about market access. Hence, as was done previously for the Greek Loan Facility, the Council decided on 11 October 2011 to cancel the EFSF/EFSM margins. In addition, Ireland benefited twice from substantial extensions of maturity of EFSM/EFSF loans. ([60]) The easing of EFSF/ESM lending terms lightened the debt burden and contributed to a faster market access. Hence, they also reduced the need for official assistance. However, EFSF/EFSM lending also became substantially more attractive than IMF loans, which include interest rate margins for both exceptional access and loans outstanding for more than 3 years. With declining yields, IMF margins also made IMF loans increasingly more expensive than market financing. As a result, Ireland requested the proportionate early repayment clause be waived, to enable an early repayment of IMF loans in October 2014. ([61]) The original alignment of IMF and EFSF/EFSM lending terms has therefore de facto been abandoned. The differences in lending terms between the EU instruments and the IMF makes the ESM as the successor to the EFSF, a much more attractive lender than the IMF for any future programme with exceptional access, particularly for large outstanding amounts. ([62]) These differences are also not fully aligned with the G20 principles for cooperation between the IMF and regional financing arrangements ([63]), which foresee consistency of lending conditions to the extent possible, in order to prevent arbitrage and facility shopping.

The set-up and operation of both the EFSM and the EFSF represented a major part of the added value of EU-level intervention. This is demonstrated by the significant spread between the average 10 year yield of the EA countries' sovereign bonds and the 10 year yield of the bonds issued by the EFSM and the EFSF (see Graph 4.2). ([64]) Tapping financial markets at the EU/EA level rather than relying on bilateral loans allowed Ireland to benefit from financial assistance at a very low cost once the interest rate margins were removed. This was possible because the EFSM is guaranteed by the EU budget, while the EFSF was supported by the explicit, irrevocable and unconditional guarantee of each Member State to back the issuance for up to 165% of its stake. The two facilities were originally assigned AAA rating, despite the high market volatility at the time. ([65]) ([66])

([59]) Initially, the carrying costs for IMF loans (flexible rate and surcharge) were lower than for fixed-rate EU loans. But the Irish authorities decided to hedge the foreign currency exposure which equalised lending rates between the two institutions.

([60]) From 12.5 to 19.5 years for EFSM loans and from 15 to 22 years for EFSF loans. This extension should also increase the period under which Ireland will be under Post-Programme Surveillance (PPS). This should normally run until 75% of the assistance has been paid back.

([61]) The request required approval of both the EUROGROUP/ECOFIN (12 September 2014), the EFSF's Board of Directors and the IMF board.

([62]) ESM lending rates have very small interest margins on top of the cost of funding and operations by the ESM. For detailed information concerning the pricing of ESM stability support instruments, see ‘ESM Pricing Policy’, http://www.esm.europa.eu/pdf/Pricing%20guideline.pdf

([63]) As endorsed by G20 Finance Ministers and Central Bank Governors, 15 October 2011.

([64]) Average is weighted for the GDP of each country. Smaller countries with a weight less than 1% are not included. Ireland, Portugal and Greece are also not included.

([65]) Shortly after the change of France's long term rating from Aaa to Aa1 in November 2012, Moody's also downgraded the rating of the EFSF to Aa1 and maintained the negative outlook. Since the 6th of June 2014, the outlook is stable. By contrast, the EFSF continued to be assigned the best possible long-term by Fitch (AAA) and the best and short-term credit rating by Fitch and Moody’s, http://www.efsf.europa.eu/mediacentre/news/2012/2012-37-esm-and-efsf-statement-following-moodys-rating-decision.htm

([66]) In June 2014, Moody's stabilised the outlook on the Aa1 rating of the EFSF due to a change in the default correlation assessment, https://www.moodys.com/research/Moodys-stabilizes-outlook-on-the-Aa1-ratings-of-ESM-and--PR_300813 have benefited public debt sustainability, but it would probably not have provided the substantial funds needed for recapitalising the faltering domestic Irish banks in due time, as analysed in Section 5.2.2. By the same token, the advantages of a fast and comprehensive deleveraging and loan restructuring process had to be weighed against the fact that front-loaded banks' balance sheet clean-up implied higher capital needs and hence higher fiscal costs. Another trade-off related to the hierarchy of priorities in bank restructuring. Rapidly restoring the sustainability of the banks - at a time when financial stability was at severe risk - had to be weighed against ensuring adequate competition in the sector in the medium term.

5.2. CURING THE ILLS OF THE DOMESTIC BANKING SYSTEM

The stabilization of the Irish banking sector, and its eventual return to profitability, required a substantial downsizing and a prompt clean-up of banks' balance sheets. These were essential elements of the adjustment programme. Non-viable banks were wound up and their remaining assets liquidated. The viable part of the banking system was recapitalised. Programme requirements included a specific plan for the resolution of Anglo and INBS (identified as non-viable) and for the four remaining domestic banks to submit restructuring plans to the CBI for assessment. An upgraded PCAR and a new Prudential Liquidity Assessment Review (PLAR) were used to gauge the recapitalisation and deleveraging needs of each domestic bank over the programme (see Table 5.2). In this regard, front-loading in the provision of programme funds allowed early recapitalisations and strengthened the banks' capital base beyond regulatory requirements. This enabled them to cover potential losses over the programme period. ([74])

The reform of banking supervision started early, while other elements related to financial sector governance were supposed to be implemented at a later stage of the programme. Legislation on special bank resolution regime was to be introduced in 2011 Q1, followed by legislation aiming at enhancing financial regulation and expanding the supervisory and enforcement powers of the CBI. In contrast, the reform of the personal debt (insolvency) regime and the setup of a central credit registry were only scheduled for 2012.

Table 5.2:
Irish domestic banks under the programme

	BOI	AIB	EBS	ILP	Total
Initial Deleveraging Plans					
Core deleveraging (€bn) (negative means growth)	2.6	-1.5	2.6	5.3	9
as a percentage of 2010 core loans	*3%*	*-2%*	*18%*	*20%*	
Non-core deleveraging (€bn)	30	20.9	2.3	10.4	63.6
as a percentage of 2010 non-core loans	*77%*	*83%*	*100%*	*100%*	
Total deleveraging (€bn)	**32.6**	**19.4**	**4.9**	**15.7**	**72.6**
as a percentage of 2010 total loans	*28%*	*22%*	*30%*	*42%*	
Recapitalization					
Needs					
Capital required 2011-13 pre-buffer (€bn)	3.7	10.5	1.2	3.3	18.7
Additional capital buffer (equity) imposed by the CBI (€bn)	0.5	1.4	0.1	0.3	2.3
Additional capital buffer (contingent) imposed by the CBI (€bn)	1.0	1.4	0.2	0.4	3.0
Sources					
Private equity raising	2.3	0.0		0.0	2.3
Liability Management Exercise (LME)	1.7	2.1		1.3	5.1
Public equity injection	0.2	11.1		2.3	13.6
Other Public injection (CoCos)	1.0	1.6		0.4	3.0
Total recapitalization (€bn)	**5.2**	**14.8**		**4.0**	**24**
Post PCAR pro-forma Core Tier 1 ratio	**16.1**	**22.0**		**32.4**	

Sources: The Financial Measures Programme Report, PCAR 2011 Review. *Notes*: for ILP, LME include €300million classified as "other" source. For more details on CoCos see related footnote

([74]) See European Commission, 'The Economic Adjustment Programme for Ireland', *European Economy*, Occasional Papers, No. 76, February 2011, pp. 24, 41-42.

5.2.1. A three-pronged approach – Resolution, recapitalisation and restructuring

In March 2011, the Irish authorities announced a strategy for restructuring the domestic financial sector around two pillar banks. The strategy envisaged a system centred on BOI and AIB. ([75]) BOI was the biggest domestic bank, with a relatively limited exposure to the property and construction sectors and limited losses. By contrast, AIB – the second biggest domestic lender at the time – was more exposed to the property and construction sectors. Anglo and INBS were to be liquidated. The Irish authorities decided to merge EBS with AIB because they had failed to get sufficiently attractive bids when they tried to sell EBS. ([76]) While the intention was for Irish Life and Permanent's (ILP) insurance operations to be sold, at this time no decision was made on the strategy for the banking operations (Permanent TSB - PTSB). While both EBS and PTSB were relatively small corporate lenders, and had plans to withdraw from that business, they had a more important role in retail banking, notably in mortgage lending (with market shares of 17% and 10% respectively). PTSB did not transfer assets to NAMA; 90% of its loan portfolio consisted of residential mortgages which were not eligible as NAMA was only acquiring land and real estate development loans. However, €16 billion - or more than half - of the PTSB mortgage book consisted of loss-making tracker mortgages. This put the bank's future viability in question as losses from trackers were accruing over time. If PTSB's resolution had been pursued, these losses (and/or the extra-costs for financing its assets) would have crystallised upfront. The cost would have fallen on the State's shoulders, as European solutions for financing a bank in resolution were lacking at the time (see Boxes 5.1 and 5.2). Hence, PTSB was kept as a stand stand-alone bank.

Bank recapitalisations were able to restore investor confidence because they were based on reliable estimates of banks' capital needs. The recapitalisation process helped restore confidence in the solvency of the banks, enabling the pillar banks to regain access to debt markets in the course of the programme (see Box 5.3). Two elements that helped restore confidence stand out. The first was the rigorousness and transparency of the assessment of banks' capital needs. It entailed a top-down stress test, under the 2011 PCAR, and an extensive bottom-up loan loss assessment by an independent expert. ([77]) Under PCAR, capital needs were calculated over a three year period, assuming a minimum Core Tier-1 target of 10.5% under the base case and 6% under the adverse macroeconomic scenario. The assessment of banks' capital needs also accounted for projected losses from disposals under the envisaged deleveraging process (as for 2011 PLAR). As a result of the independent loan loss assessment, additional buffers were added in the calculation of the capital needs to cover further potential loan losses after the three year programme period. The second key factor in the recapitalisation process was rapid implementation due to the timely provision of the required funds. In March 2011, aggregate recapitalisation needs were projected at €24 billion. This was significantly lower than the €35 billion estimate for financial sector support included in the programme financial envelope. The recapitalisations were completed by July 2011, lifting the aggregate Core Tier-1 ratio above the level of European peer banks and providing a substantial buffer for the adjustment process (see Graph 5.1a). At the end of the programme, the banks' aggregate Core Tier-1 ratios stood at around 13% and the buffers were preserved to some extent.

([75]) Source: the announcement of the Minister of Finance of 30 March 2011, available at http://www.finance.gov.ie/ga/news-centre/press-releases/minister%E2%80%99s-statement-banking-matters.

([76]) The merger was implemented after foregoing a bid from a consortium of private equity investors (including Cardinal Asset Management, the Carlyle Group and U.S. investor Wilbur Ross), submitted in January 2011, as not representing good value for the State.

([77]) The loan assessment was independently performed by BlackRock Solutions (BlackRock) considering potential losses over the life time of the loan. The resulting losses were then converted into the three year horizon.

recording prospective loan losses. However, it was only in 2013 that targets for banks to restructure loans in arrears were introduced, with a final date of implementation set for end-2014. ([103]) In light of the lengthy process of setting up appropriate operational frameworks to deal with mortgages in arrears, the targets on restructuring could have been introduced earlier, together with the elimination of legal constraints to writing-off uncollectable loans. ([104]) The targets could have been combined with a more timely reform of the insolvency framework (see section 5.2.5). An earlier and more rigorous clean-up of balance sheets could have given banks a head start, allowing them to stimulate lending and facilitate their re-privatisation process.

The programme maintained the structure of NAMA. This proved beneficial for banks' deleveraging, and contained losses for the Irish State. By using a centralised asset protection scheme, banks effectively reduced the burden of legacy assets and strengthened their deleveraging and recapitalisation process. NAMA was well placed to manage and liquidate the acquired assets, which were clearly defined, limited in size and relatively easy to sell. The prices at which banks transferred the assets to NAMA were in line with the underlying economic value of the assets. ([105]) A centralised entity like NAMA offered further specific advantages, such as economies of scope and specialised professional management. In addition, the joint private/public ownership structure kept NAMA relatively free of political interference. ([106]) Finally, NAMA's funding was ensured by financial institutions, which sold their loans and were compensated with ECB-eligible NAMA bonds. NAMA first sold assets located in the UK, whose valuations were generally higher than for assets located in Ireland. By the end of the programme, NAMA had liquidated more than 30% of project assets (worth €11 billion**),** of which only 20% were located in Ireland, and redeemed 25% of senior bonds (€7.5 billion). NAMA was profitable for three consecutive years, despite recognising sizeable additional impairment provisions. Deleveraging targets under PLAR did not include the €70 billion of "land and real estate development" loans already transferred to NAMA.

The ambitious bank deleveraging process included proper safeguards and was managed in a flexible way. It was effective in downsizing banks' balance sheets and reducing their funding gap. ([107]) Under PLAR, banks were initially required to achieve a LTD target of 122.5% by the end of the programme. To achieve this, workable plans for the amortisation and disposal of bank assets were put in place, together with safeguards to avoid fire sales. These plans envisaged aggregate deleveraging of over €70 billion, corresponding to around 45% of Irish GDP, over the programme period. The plans were subsequently marginally adjusted following the decision not to transfer loans of less than €20 million to NAMA. By the end of 2011, 40% of the required deleveraging had taken place, albeit with some differences across banks. In mid-2012, the target for the LTD ratio (122.5%) was dropped. This decision was based on the experience during 2011, when banks' competition for deposits was driving up interest rates to unsustainable levels. The LTD target was replaced with targets on nominal non-core deleveraging. In aggregate, deleveraging was complete by the end of the programme. The banks sold €45 billion of assets during the programme.

By liquidating mostly non-core foreign assets, Irish banks were left with less profitable domestic businesses. Non-core assets and businesses that did not offer clear synergies with banks' core activities

([103]) The "Impairment Provisioning and Disclosure Guidelines" were also revised in 2013 to (i) include a shifting emphasis from collateral to the borrower's creditworthiness assessment, when determining provision requirements, and to (ii) ensure proper recognition of problematic loans under restructuring.

([104]) Targets on loans to be restructured should be applied uniformly across banks to avoid discrimination across borrowers.

([105]) Loans were sold at their "long-term economic value", which resulted in higher prices than market value.

([106]) NAMA is structured in such a way that its debt is not treated as part of Ireland's General Government Debt under European accounting rules. In order to avail of this accounting treatment, NAMA established an investment holding company – National Asset Management Agency Investment Ltd – which is majority-owned by private investors: 51% of its shares are owned in equal proportion by three private companies and the remaining 49% are owned by NAMA. However, under the shareholders' agreement between NAMA and the private investors, NAMA can exercise a veto over decisions taken by the company. The entity is highly leveraged and at its inception its capital amounted to only €100 million.

([107]) A medium-term objective of deleveraging was also to ensure convergence to Basel III liquidity standards.

of state support schemes were gradually introduced later on. ([111]) These schemes had mixed success. There was a better take-up rate for those targeting the provision of credit and equity, introduced only in 2013. The lack of success of previous schemes can be explained by SMEs' lack of awareness, and their inability to handle application procedures. ([112]) To ensure a bigger impact in the future, SME funding initiatives should include earlier and greater efforts to increase their accessibility. This lesson has been taken on board by the Irish authorities in recently implemented initiatives, funded from additional resources from European and national business development banks, which have become available after the programme terminated. ([113])

5.2.4. Bank restructuring in light of competition concerns

The programme attempted to preserve an adequate level of competition in the Irish banking sector. While the initial restructuring plan for BOI was quickly approved under State aid rules, plans for AIB and PTSB raised concerns about the banks' long-term viability. ([114]) Subsequently, AIB took time to revise its restructuring plan as it was about to integrate EBS. ([115]) Since foreign-owned banks were reducing their market presence in Ireland, the European Commission expressed concerns that the Irish banking sector could become a duopoly after the merger of EBS with AIB. The decision to maintain PTSB as a separate entity was motivated both by these concerns and the need to minimise the fiscal costs potentially rising from the bank's liquidation. As EBS effectively exited the market, ([116]) PTSB was expected to challenge the dominant role of the two pillar banks. This strategy has not yet been successful since the Irish banking system remains highly concentrated. ([117]) Not merging EBS with AIB could have facilitated the restructuring of AIB, and could have provided another means to foster competition. ([118])

The process of restructuring PTSB was protracted and complex; additional public support risked worsening Ireland's fiscal position. Not resolving PTSB initially helped to contain the fiscal costs for the State and preserve the financial stability of the Irish banking sector. However, deleveraging and restructuring proved slower for PTSB than for other banks. ([119]) The second draft of PTSB restructuring plan, submitted in June 2012, envisaged splitting the bank into three business units. A major stumbling block was the uncertainty about the set-up and funding of the proposed asset management unit (AMU), which was intended to acquire most of the loss-making trackers and to function as a bad bank.

([111]) In 2012, two lending schemes were introduced to facilitate SME financing: Microfinance Ireland and Temporary Loan Guarantee Scheme. At the beginning of 2013, a further provision of funding to SME from the NPRF – in partnership with private investors – started to target credit, equity and turnaround financing.

([112]) Stakeholder consultation.

([113]) Also following up on the "High Level Expert Group on SME and Infrastructure Financing", in the second half of 2014, the Irish authorities created the Strategic Banking Corporation of Ireland (SBCI), which pools funds mainly from NPRF, the European Investment Bank (EIB) and the German state-owned business development bank (KfW) and distributes it through the banking networks. In May 2014, Irish authorities also launched an online campaign to increase awareness of available financing resources, named "Supporting SMEs".

([114]) Among other operational changes that could have explained some of the initial delays, there was the need to provide for an alternative deleveraging path to accounts for dropping the plan of transfer of loans of below € 20m notional to NAMA.

([115]) The restructuring plan of AIB merged with EBS was approved in May 2014. The restructuring plan of PTSB was approved in April 2015. Recently, the State aid rules have been changed, so that recapitalisation of a bank with public funds cannot take place before the restructuring plan is approved. This has significantly improved the incentives for prompt finalisation of the restructuring plan from the side of the bank and the national authorities. See Communication from the Commission of 10.07.2013 on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis.

([116]) Initially, Irish authorities deemed an independent EBS necessary to ensure competition in the Irish mortgage and savings market, see EC decision on restructuring of EBS of 11 October 2010, available at: http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_C25_2010.

([117]) While the level of competition in the Irish banking market does not appear worse than in other programme countries (notably, Cyprus, Greece) if measured by the cumulative share of the 5 largest credit institutions in total assets, the situation changes when measuring the market power of two largest credit institutions in terms of new lending, which represent some 70% of the banking sector in terms of domestic loans.

([118]) Dirk Schoenmaker discusses the alternative possibility to merge EBS and PTSB into a combined bank, which could have turned into an affective challenger of the two larger banks. "Stabilising and Healing the Irish Banking System: Policy Lessons" (2015)

([119]) By the mid-2012, PTSB achieved only €0.8 billion of its non-core deleverage plan, i.e. less than 10% of the total targets. LTD ratio stood above 190%. By the end of the programme, LTD ratio remained above 150%.