Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Richard Bruton

Session 51a

23 July 2015 (a.m.)

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[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

SUBMISSION TO BANKING INQUIRY

Minister Richard Bruton TD

24th June 2015

INTRODUCTION

The seeds of Ireland's economic crash were sown over an extended period of time.

In the period 1994-2000 there had been a fairly large degree of common ground on economic management focussed on:

- Fiscal prudence (orderly spending growth was contained below the capacity of the economy to grow)
- Building a strong export-oriented sector
- Modest wage growth coupled with a lower tax take which maintained competitiveness
- Continuing Social Partnership to achieve better economic and social outcomes

This approach ensured that the various elements in the economy maintained a harmonious balance. [Public and Private sectors, Export and Sheltered sectors, Fiscal Balance, External Balance]

Ireland committed to the hard Eurozone currency policy in 1999. This made the avoidance of critical imbalances in the economy even more important because exchange rate policy and monetary policy had been surrendered. Far from strengthening this consistent approach to policy, this balanced approach started to be progressively undermined from 2001 onwards. On behalf of Fine Gael, I took strong issue with several strands of emerging public policy which we believed were undermining the sustainable competitive foundations essential for the long-term success of a small open economy:

- Erosion of competitiveness and the loss of our export markets was ignored as a growing construction sector temporarily insulated the economy from their effects
- A major restructuring of financial oversight in the banking system was driven through, without testing its robustness

- Public policy persisted in providing unnecessary tax supports to an overheating economy and the worst excesses of urban sprawl were reproduced in Ireland
- Fiscal prudence, abandoned in 2001/2002, was never restored as the building boom swelled Exchequer Revenue from an unsustainable source
- The refusal to reform a budgetary system, which was unfit for purpose, resulted in very poor impact from double-digit spending growth. This growth in spending was far outpacing the nominal growth in national income
- Social Partnership became more strident at a stage when it had lost its driving purpose and began inhibiting necessary change and accountability
- The benchmarking deal of €1.3 billion was paid out without any effort to deliver the promised reform and productivity improvement

All of this created huge vulnerabilities as the construction boom petered out and the banking system's concentration on property and reliance on external short-term funding sources was exposed.

Oireachtas Scrutiny

The weakness of Oireachtas scrutiny was undoubtedly exposed in the period 2002-2007. A trend towards policy-making that was not evidence-based took hold and the Oireachtas was unable to stop it. A few examples illustrate this:

- The new structure for Financial regulation introduced in 2002 was a cobbled together institutional compromise. On behalf of Fine Gael, I opposed it because it was being introduced without any assessment of the robustness of Ireland's regulatory supervision practices, nor any effort to take into account the lessons of the then known regulatory failures (Enron, etc.). The relationship between the Central Bank and the Financial Regulators was uneasy and unclear. It also swam against the prevailing practice of keeping prudential supervision of the banks separate from consumer protection. There were no opportunities for pre-legislative hearings. The necessity for scrutiny and oversight by the Oireachtas was ignored.
- The growing expansion of social partnership was buttressed by a rapidly growing institutional framework. This sharply contrasted with the weak influence of the Oireachtas for scrutiny or accountability. A clear sign of the dangers of this approach came with the concession in 2002 of €1.3 billion in benchmarking payments (equivalent to a near 10% increase in the Public Service Pay Bill) without any significant reform. It followed the earlier resignation of the economist to the Benchmarking Review Group and the destruction of the evidence on which it was allegedly based. Fine Gael opposed this Benchmarking deal. Indeed the problem was more pervasive. Government did not even see the need to bring Social Partnership agreements to the Dail for democratic approval. The strength of "producer interests" within this partnership and the weakness of democratic scrutiny undermined necessary economic reform in these years.

Perhaps the greatest weakness of Oireachtas scrutiny was in respect of budget setting where the Oireachtas has a specific constitutional role set out in Article 17. There are numerous dimensions of this process, in respect of which I had been a trenchant critic throughout those years:

- The Estimates of Expenditure at that time revealed nothing of the choices to be made, offered the Oireachtas no capacity for amendment, and provided no information on the impact of different programmes on which their success could be judged. The opportunity for any scrutiny of their contents only came half way through the year, when the money was already being spent.
- The secrecy of the lead up to Budget Day announcements encouraged Ministers to produce “rabbits out of the hat” for which no accurate costings needed to be made. Some of these, such as Decentralisation, was not only a costly failure, but it bypassed the Departmental scrutiny to which such a proposal, had it been produced as a normal Memorandum for Government, would have been exposed.
- Discretionary “tax expenditures” which at this time represented billions of tax breaks to the construction sector were introduced and extended without any scrutiny of their costs or benefits. Already in 2002, the then Minister for Finance had clear evidence that their impact was perverse but they persisted as the property bubble developed.
- The Public Service Management Act (1997) had ordained that there would be a series of key documents which would support Oireachtas scrutiny of the effectiveness of public service management – Strategy Statements, Annual Outcome Reports, and a Rolling Programme of Evaluation covering all programmes over a cycle of three years. This approach was never properly deployed as a genuine vehicle for scrutiny evaluation and accountability. At the same time Freedom of Information was restricted. The result was that over a 7-year period when public spending doubled, the delivery to the public fell far short of what should have been possible.

Key Drivers for Budget Policy

I have always held the belief that in a small open economy all elements of public policy must be designed to support a vibrant export-oriented sector. Small open economies must be alert and nimble, and quick to respond to changing opportunities. This requirement is essential to sustainable macro-economic and budgetary policy. This did not occur in the years 2002-2007. The electoral cycle rather than the economic cycle became the major driver of budgetary policy. No holds were barred in 2001/2 as the election approached. Public spending increased by a cumulative 35% over the two years leading up to the 2002 election. Spending was pulled back in the immediate aftermath of the election but shot back up to a 13% increase in 2007, the year of the next election.

Inflation in the domestic economy was being unleashed. It was swelling government revenue. Even though it was undermining competitiveness, it was insulating government from any adverse consequences of the growing imbalances in the economy. I flagged these growing imbalances in successive debates throughout 2002-2007 highlighting:

- The high rate of job loss in export sectors.
- The rapidly rising price inflation in the domestic economy, where widespread rip-off was a major concern, was in sharp contrast to the experience of the export sector where prices were falling as we had become members of a hard currency regime.
- The overheating construction sector yet the tax breaks persisted.
- The unsustainable approach of expanding expenditure much faster than the capacity of the economy.
- The pattern of expenditure with serious overruns, questionable project selection, the virtual abandonment of spending evaluation and the absence of performance accountability.
- The deterioration in cost and quality of infrastructures key to export competitiveness as the weakness of strategic planning were exposed.

- The perilous dependence on construction for more than a quarter of government tax revenue.

These were vulnerabilities that had been unnecessarily created. They left Ireland extremely exposed. There were other warning voices at this time - IMF, EU, OECD, NCC - but they did not get much traction. Criticism was judged to be “talking down the economy”.

As the election approached Fine Gael built a platform which sought to enshrine a different approach:

- The Buck Stops Here spelled out a new approach to managing expenditure
- Returning to a balanced Budget
- Reducing the growth in public spending to what could be supported by nominal growth in GDP
- Strengthening the competitive performance of the economy across key areas and within sectors of opportunity
- Promoting price competitiveness through Fine Gael’s ripoff.ie campaign and policy proposals for a single, strong advocacy body to defend consumer interests.

Appropriate Relationships

Clearly there were major failings in economic and regulatory policy. There were a number of systemic failures which contributed to inappropriate relationships and a laxity of approach:

- The Planning system conferred huge benefits from zoning and development. The inappropriate relationships are well documented. The urban sprawl it promoted created economically unsustainable costs which were not internalised in developer decisions.
- The lack of distance of the Central Bank from the Department of Finance was inappropriate.
- The weaknesses of the Oireachtas in scrutinising evaluating and holding government and its agencies to account were outlined above.
- The lack of independent economic scrutiny of “group thinking”. Conventional wisdom was that a “soft-landing” and that “high lending is matched by valuable assets”, points to weakness in advisers in the Central Bank and among economists, but also some of the relationships behind them.
- The growth of property lending on cheap Eurozone money exposed a huge weakness in the wider policy framework for a sustainable single currency.
- Producer interests dominated the Social Partnership model, and when it had lost its initial shared purpose, these comfortable relationships held back reform that should have been more pro-citizen and pro-consumer.

CONCLUSION

The hard lesson which Ireland has learnt from the crash is the central importance in a small open economy of strong export-oriented sectors supported by a suite of public policies that sustains strong jobs growth and improving living standards based on strong competitiveness. No other approach will allow enduring growth in living standards and improved quality of public services.

This was a policy approach adopted by me and my colleagues in government through the 1994-1997 period. It was the basis of the agenda pursued in Opposition through the period of time this Inquiry has signalled its interest in and, finally, it has underpinned my approach, and my colleagues' approach to the task of rebuilding our economy since March 2011.

Many reforms have been adopted to address the many weaknesses discussed here and better institutions are now in place to protect us from a repeat of such errors, but they do not fully insulate us. An economy like ours has to continually reinvent our competitiveness and constantly focus our energies on building our economic future on a strong, export-oriented platform. Much progress has been made on that front to date but constant vigilance, attention and policy discipline is required to avoid any prospect of a repeat of the mistakes that helped create the crisis that we are now emerging strongly from.