

POLICY PAPER

Policy Lessons from Ireland's Latest Depression*

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Abstract: This paper provides a selective review of Ireland's economic performance of the last 20 years, from the early days of the Celtic Tiger, through to the housing boom and the recent slump, and then attempts to draw a few lessons from the period. The paper argues, based on a range of observations, that a substantial slowdown was looming for Ireland by 2007, independent of what was going to happen in the global economy, and much of this evidence was ignored in the implementation of economic policy. The result was a range of policies based on an unwarranted over-optimism which left Ireland terribly exposed to the international downturn. Policy failures in the fiscal and banking sectors are discussed, as well as some common criticisms of policy that have less justification.

I INTRODUCTION

I have an interesting book on my shelves called *Ireland's Economic Success*. The book, edited by ICTU's Paul Sweeney and published in December 2007, features chapters by a range of eminent figures, with each contribution putting forward reasons why the Irish economy was such a great success: social partnership, sound management of the public finances, low corporation tax, good education policies and so on. An empirical economist looking for

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explanations for the Celtic Tiger would find Ireland's success to be over-explained and would have to sift through the competing explanations to get at the root causes of this economic miracle.

That seems like a long time ago now. These days, we are familiar with a far different story. This story concedes that, yes, perhaps things were ok for a while – back in the age of World Cups, Riverdance, Eurovision wins and the like. But then our government recklessly overheated the economy and created a bloated public sector. Irish people went on a credit-fuelled spending binge, enabled by reckless banks while our financial regulator stood idly by. A housing bubble that even a child could diagnose was allowed to get out of control and house building exploded, while the economy was allowed become wildly uncompetitive. Despite repeated warnings of doom from economists on the TV, the government did not listen and now we are enduring the inevitable crash, with the cumulative fall in output making us candidates for the only country to have two depressions since the Great Depression.¹

In this paper, I want to provide a selective review of Ireland's economic performance of the last 20 years, from the early days of the Celtic Tiger, through to the housing boom and the recent slump, and then attempt to draw a few lessons from the period. In contrast to much of the "Monday morning quarterbacking" that is currently taking place, I argue that some of the factors now widely cited as contributing to the downfall of the Irish economy, such as the emergence of a "bloated" public sector and the idea that Irish consumers behaved in a wildly reckless fashion are, at best, exaggerated. However, serious mistakes were made in financial regulation and also in the failure to design a fiscal policy based on sustainable economic trends.

Since Ireland is a small open economy, it would almost certainly have been in recession over the period 2008-2010 no matter what actions had been taken by governments during the prior years. I would argue, however, based on a range of observations, that a substantial slowdown was looming for Ireland by 2007, independent of what was going to happen in the global economy, and much of this evidence was ignored in the implementation of economic policy. The result was a range of policies based on an unwarranted over-optimism which left Ireland terribly exposed to the international downturn.

The rest of the paper is ordered as follows. Sections II and III review Ireland's economic performance from 1987 onwards, splitting these years

¹ Ahearne, Kydland, and Wynne (2006) define a Depression as requiring a cumulative drop in output relative to trend of at least 20 per cent with 15 per cent of the decline occurring in the first decade. One can argue as to whether the 1970s and 1980s in Ireland really corresponded to a depression. However, our current episode, with its double-digit peak to trough decline in output, fits with many definitions.

into two periods, pre- and post-2000. The case for the inevitability of a significant slowdown after 2007 is put forward. Section IV documents how unwarranted optimism about underlying economic growth led to poor policy decisions in the areas of fiscal and banking policy. Section V critiques arguments that a bloated public sector or a consumer-driven credit binge played key roles in Ireland's economic downfall. Sections VI and VII draw some conclusions.

II THE GOOD TIMES: 1987–2000

One of the things that makes the current period of high unemployment and crisis in the public finances so depressing is most of us have been here before and it was not much fun the first time. By the late 1980s, Ireland's economy was in crisis with unemployment of 17 per cent and a public finance problem that appeared out of control. However, at a time when few had much hope for the Irish economy, something remarkable happened – economic growth returned. It returned slowly enough at first, and partially thwarted by world recession in the early 1990s, but by the mid-1990s Ireland appeared to have a full-scale “economic miracle” on its hands.

2.1 *Initial Conditions*

In truth, the Celtic Tiger was perhaps less miraculous than it looked. My favourite discussion of this period in Ireland's modern economic growth is Patrick Honohan and Brendan Walsh's excellent 2002 paper “Catching up with the Leaders: The Irish Hare.” Honohan and Walsh pointed out that by the mid-1970s, Ireland had many of the policies in place that could work together with its native economic advantages to foster strong economic growth. Policies such as obtaining EU membership, focusing on industrial policies based on attracting foreign direct investment with low corporate tax rates, and the increased rate of investment in second and third-level education were primed to work with Ireland's natural advantages such as proximity to Europe, the English language and long-standing links with the United States which was a key provider of FDI. However, a decade of poor fiscal and monetary policies had failed to provide the necessary stability for these factors to deliver the expected economic growth.

When the late 1980s saw Ireland stabilise its precarious fiscal situation – thanks in large part to a short, but crucial, period of cross-party consensus – the Irish economy was finally ready for growth. As Honohan and Walsh put it “... inappropriate fiscal and perhaps monetary policies held Ireland back in earlier years, with the result that convergence, when it occurred, was

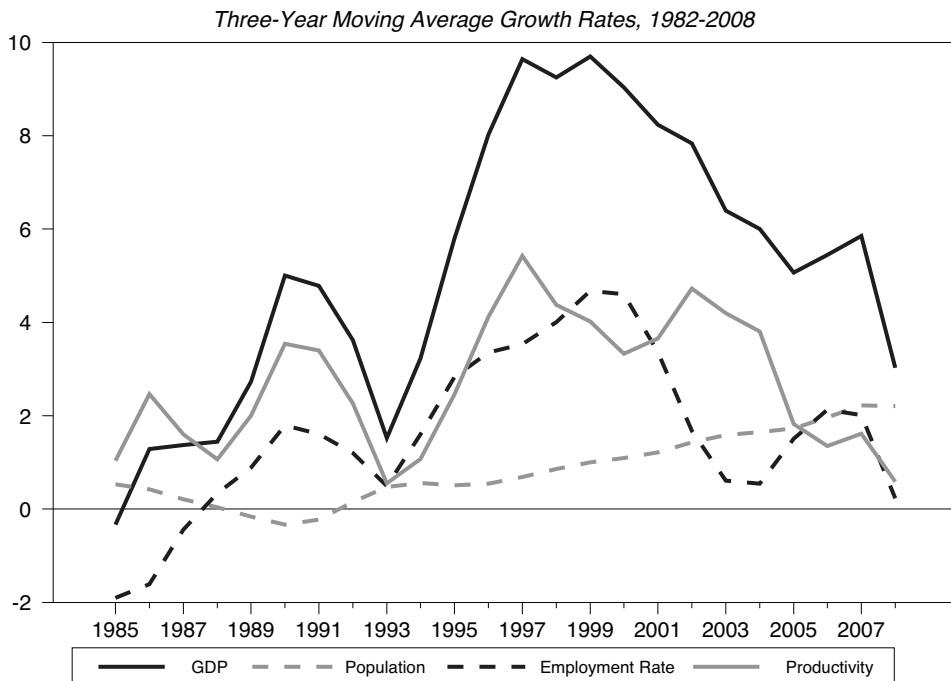
telescoped into a short period". Luck also played a factor, as Ireland's commitment to the EU began to pay off more than could have been expected. The fiscal stabilisation took place against a background of other positive factors such as the introduction of EU structural funds for poorer member states, the strengthening of the internal market and, during the 1990s, a return to stable monetary arrangements leading to Ireland's participation in the Euro.

Figure 1 provides a description of the factors contributing to Irish economic growth from 1985 onwards. The figure is based on the following simple decomposition:

$$\text{GDP} = \text{Pop} * (\text{Emp}/\text{Pop}) * (\text{GDP}/\text{Emp})$$

GDP growth can be broken into a part due to higher population, a part due to having a higher fraction of the population at work, and a part due to getting more output from the average worker. All three of these factors contributed over time to Ireland's boom but there are interesting stories to be teased out of how these contributions changed over time.

Figure 1: *A Decomposition of Irish Economic Growth*

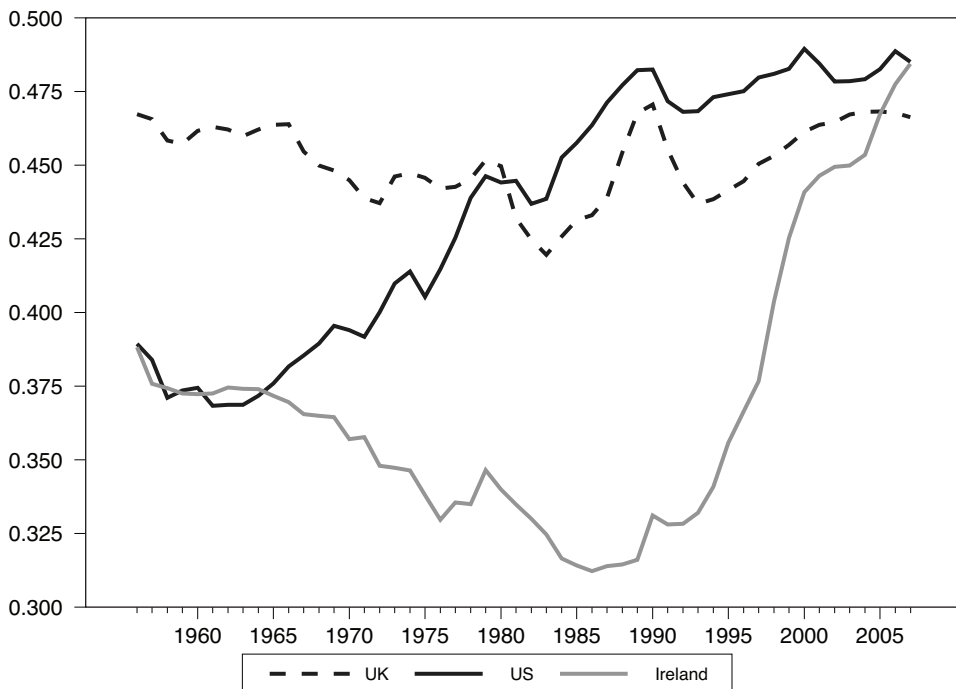


2.2 *Employment and Productivity*

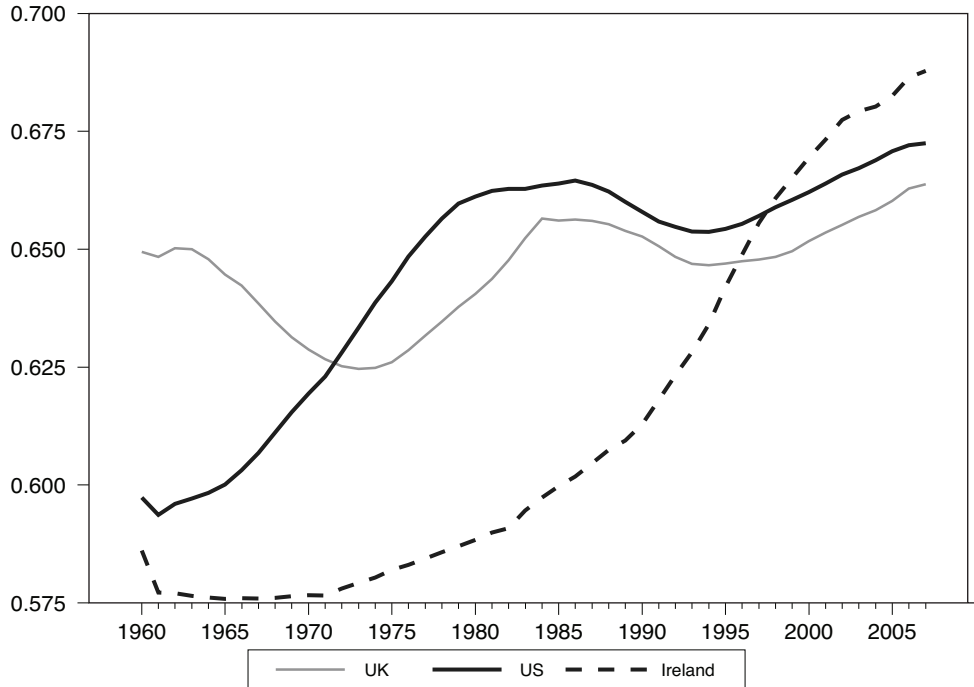
By the early 1990s, Ireland had a significant capacity to grow far faster than it had been doing. Perhaps the clearest way to illustrate how much room Ireland had to grow is to show how underemployed its people were. In 1989, only 31 per cent of Ireland's population was at work, the lowest in the OECD and fifteen percentage points below either the UK or the US (see Figure 2). To understand the factors contributing to Irish underemployment, consider another decomposition:

$$\text{Emp/Pop} = (\text{Workage/Pop}) * (\text{LForce/Workage}) * (\text{Emp/LForce})$$

Figure 2: *Employment-to-Population Ratios (1956-2007)*



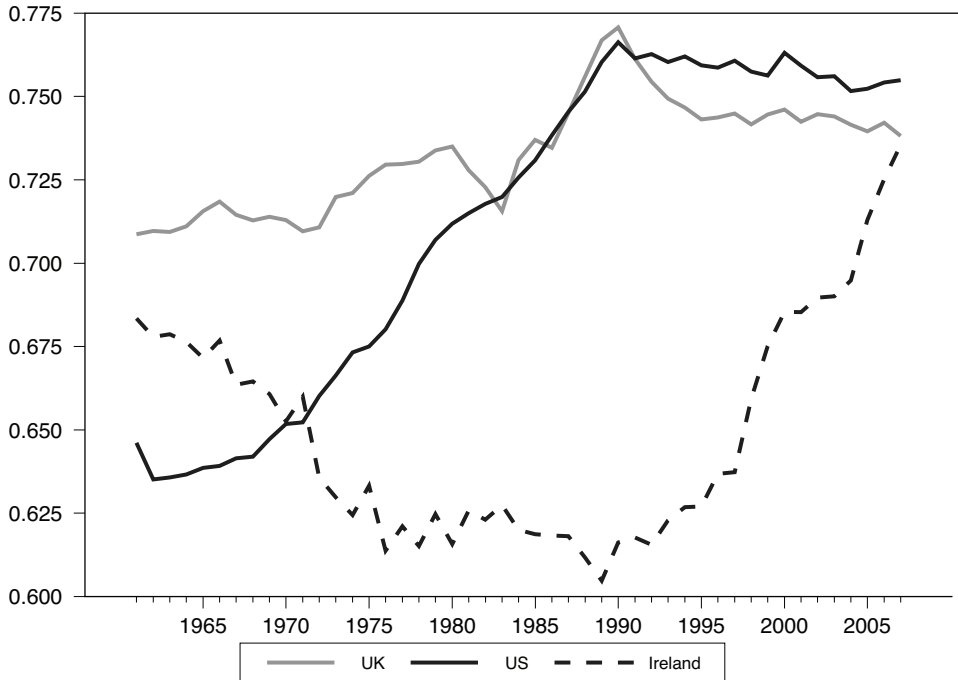
Ireland's underemployment partly reflected its exceptionally high unemployment rate. However, it also reflected demographic factors. Ireland's baby boom occurred in the 1970s and peaked in 1980, so the depressed Ireland of the 1980s was supporting a very large population below working age. This demographic factor gradually unwound over time so that by the late 1990s, Ireland had a higher fraction of the working age population than either the US or the UK (see Figure 3). Ireland in the late 1980s also had a very low rate of

Figure 3: *Fraction of Population Aged 15-64 Years*

labour force participation: while female labour force participation had increased steadily in other countries throughout the 1960s and 1970s, the increase in Ireland did not occur until the 1980s and still left Ireland far behind (see Figure 4).

However, when the economy recovered, there was a large female labour supply ready to enter the workforce. With good fundamental policies in place, the combination of macroeconomic stability and a starting point of severe underemployment meant that the Irish economy became an incredible employment creating machine. Employment rose steadily from 1.1 million in the late 1980s to 2.1 million in 2007.

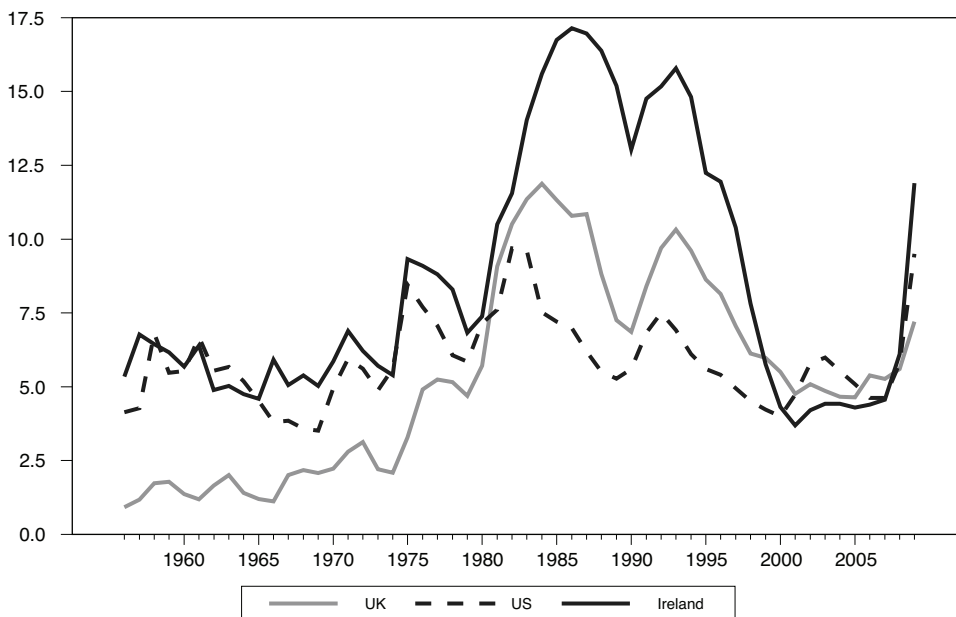
In most other countries in the world, the employment growth rates generated by the Celtic Tiger would have led very soon to low rates of unemployment, which would have provoked rapid wage growth and cut off the boom. However, in Ireland in the 1990s, the job creation machine only gradually outpaced the enormous increases in labour supply stemming from young workers entering the labour force, increased labour force participation and, by the mid-1990s a reversing of the traditional net migration outflow as Irish people abroad began taking jobs at home (note the upturn in the

Figure 4: *Labour Force Participation Rates*

contribution to economic growth of increases in population starting in the mid-1990s). As a result, for most of the 1990s, the average unemployment rate remained quite high: it was as high as 10.4 per cent as late as 1997. Only by the year 2000 had the boom generated enough jobs for the economy to reach effective “full employment” with the measured unemployment rate reaching 4.3 per cent (see Figure 5).

In addition to getting more people employed at a rapid pace, the 1990s saw a strong productivity performance. Productivity growth averaged just under 3 per cent per annum during the 1990s. As Honohan and Walsh (2002) emphasised, this was a highly positive but not miraculous productivity performance, falling short of other well-known economic miracles such as East Asia. Furthermore, Ireland went into the Celtic Tiger period with living standards that were well short of those in the rest of Europe and some amount of “catching up” would have been expected.

The exceptional capacity for growth unleashed during the 1990s had profound implications for Irish fiscal policy. After stepping away from the brink of a debt disaster in 1987, rapid economic growth allowed successive governments to achieve the fiscal holy grail of cutting taxes, raising spending and also achieving substantial reductions in the debt-GDP ratio.

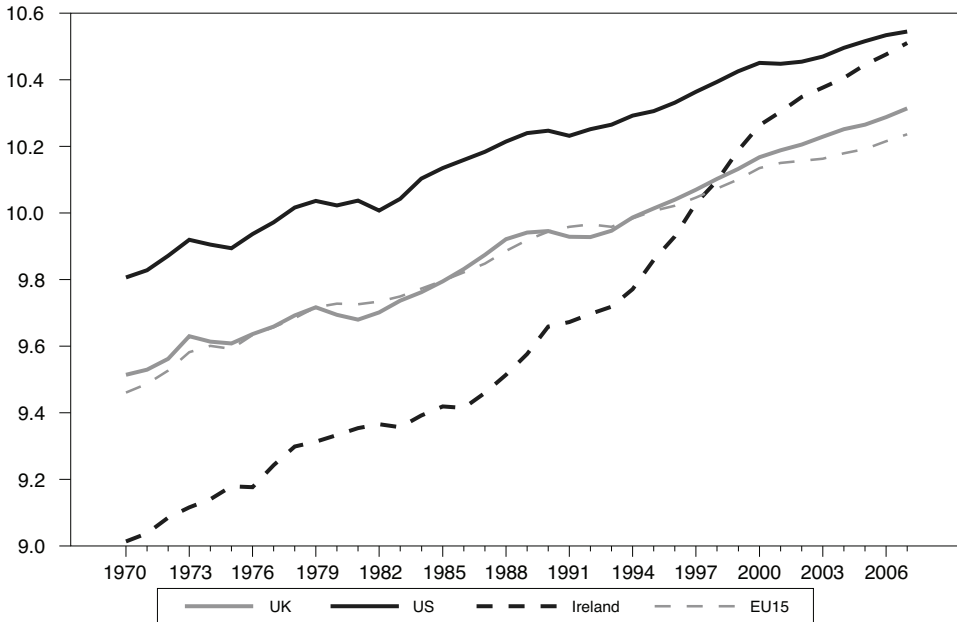
Figure 5: *Unemployment Rates*

III THE HOUSING BOOM AND THE INEVITABILITY OF SLOWDOWN

By the start of the new millennium, there was every reason to expect that the Celtic Tiger period of rapid growth was coming to an end. The unemployment rate was extremely low by international standards, GDP per capita had caught up with the EU average (see Figure 6) and the employment to population ratio was only just below the levels recorded in the US and UK. While there was still some limited additional growth potential left from demographic factors such as young workers coming into the labour force and a still somewhat low level of female labour force participation, these factors would only be capable of providing a more limited boost to future growth. Surveying the data up to 2001, Honohan and Walsh (2002) believed the “exceptional growth spurt” had come to an end and they worried about the more difficult times ahead “with most of the potential for catch-up exhausted.” They were right of course. It had to end. And it did. But it took longer than almost anyone could have imagined.

3.1 *The Housing Boom*

By 2000, average incomes in Ireland were far higher than they had been during the 1980s. However, income is not wealth and there are a number of

Figure 6: *Log of Real PPP-Adjusted GDP Per Capita, 1970-2007*

aspects of the economy that still reflected the country's poorer past. Public infrastructure such as roads and public transport were of poor quality by international standards and the first decade of the century saw a substantial programme of public investment.

More importantly, however, Ireland still had a relatively small housing stock, the smallest stock per capita in the European Union.² Higher incomes and lower unemployment rates were bound to lead to smaller average household sizes, as people started to be in a position to buy their own homes at a younger age.

The result was an extraordinary construction boom. The total stock of dwellings – which had stood at 1.2 million homes in 1991 and had gradually increased to 1.4 million homes in 2000 – exploded to 1.9 million homes in 2008. As house completions went from 19,000 in 1990 to 50,000 in 2000 to a whopping 93,000 in 2006, construction became a dominant factor in the Irish economy. With the economy already at full employment, much of the labour employed in the construction boom came from the new EU member states in Eastern Europe, and the inward migration further fuelled demand for housing. By 2007, construction accounted for 13.3 per cent of all employment, the highest share in the OECD. Indeed, with the exception of Spain and

² See Somerville (2007).

Portugal, Ireland's share of construction employment exceeded all other OECD member states by almost five percentage points.

This extreme concentration of the economy in the construction sector is something that marks Ireland's housing boom out from other recent familiar examples such as the house price booms in the UK and the US, where the share of employment accounted for by construction stayed below 8 per cent. The construction boom ensured that Ireland's unemployment rate remained at around 4 per cent until 2008 and the tight labour market associated with this low rate of unemployment naturally triggered high rates of wage growth throughout this period. The economy's loss of competitiveness at this time and the weakening in the performance of the traded sector has often been commented on. However, the loss of competitiveness and consequent crowding out of the tradable sector is perhaps best seen a consequence of the housing boom rather than an independent event triggered by greedy workers or trade unions.³

One might have expected the huge increase in the supply of housing to have cooled off house prices. Most likely, if the economy had not generated the substantial supply response, house prices may have gone higher for a while. However, the supply response was still not able to keep up with the growing demand and the increase in ability to pay generated by income tax cuts and the low interest rates regime that came with our membership of the Euro.

The result was an astonishing combination of rising house prices and an increasingly construction dependent economy. Figure 7 shows that the rise in house prices far outstripped the increases seen in the US that were widely viewed as remarkable: while US house prices doubled between 1996 and 2006, Irish house prices quadrupled over the period 1996-2007. An obvious reaction to Figure 7 is to declare that it was patently obvious that Irish house prices were driven by a speculative bubble. However, it is not quite so simple. Comparisons with the US need to account for the huge increase in disposable income for Irish households, which far outstripped anything that occurred in other countries with housing booms. One way to see control for this is to graph the average house price relative to per capital disposable income. Figure 8

³ It is common now to argue that social partnership was very constructive in the late 1980s and all through the 1990s and that it helped to keep wage growth restrained and the economy competitive but that during the later years the process was responsible for undoing all this good work, leading to uncompetitive wages. I suspect that both the positive and negative sides of this story are overstated. It is likely that social partnership contributed to wage moderation in its earlier days. However, it should also be remembered that these social partnership deals took place against a background of high unemployment rates while the later deals took place during an era when the labour market was continually overheated. Market forces rather than social cohesion were the most likely factors underlying the wage restraint of the earlier era and its absence in later years.

Figure 7: US and Irish House Prices

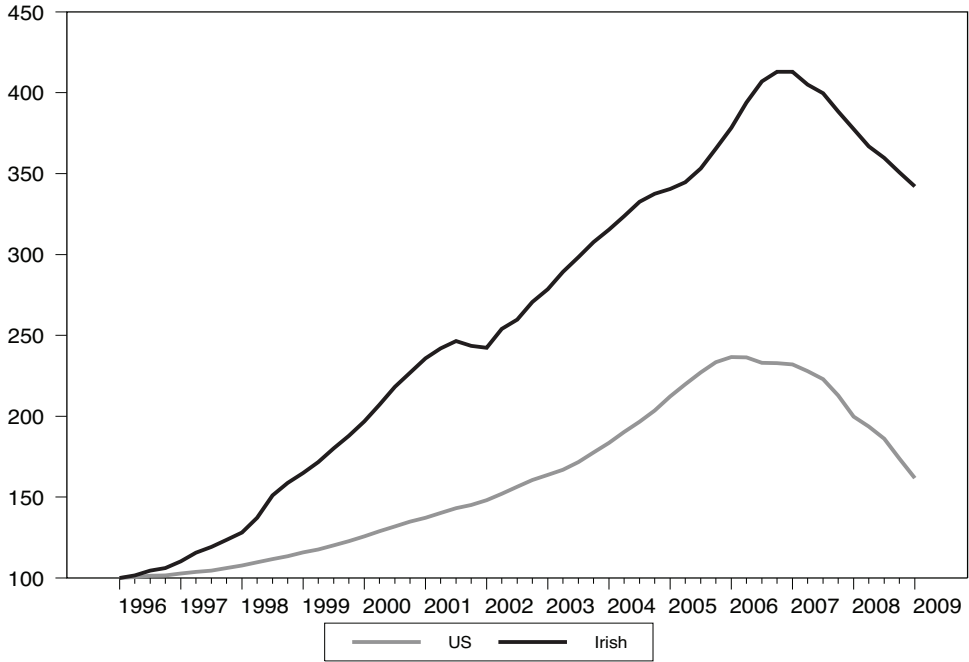
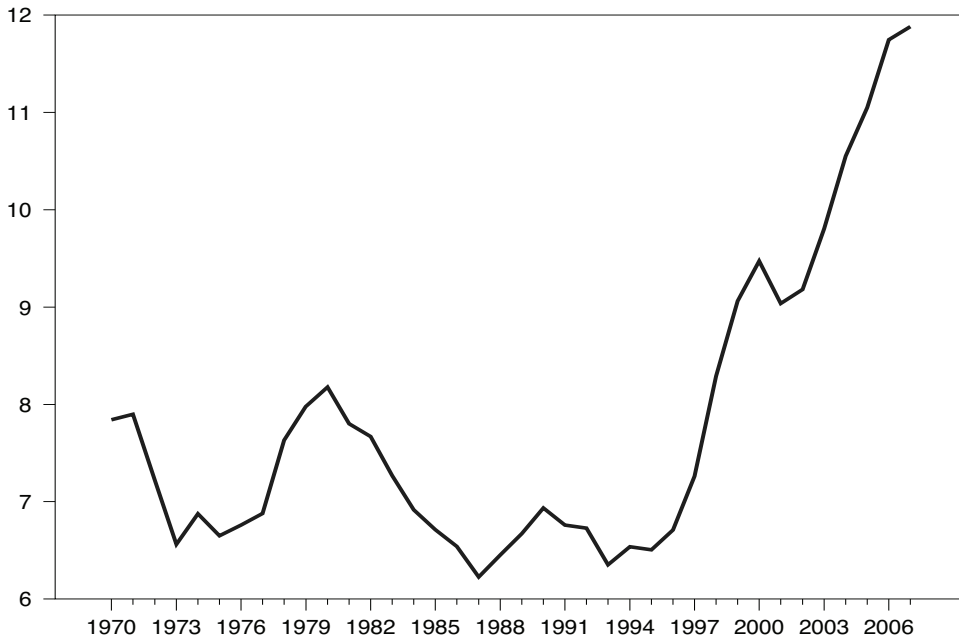


Figure 8: House Prices/Disposable Income Per Person Over 15 Years



does this by graphing house prices relative to the average disposable income per person aged over 15 years, the latter used to proxy for demographic pressures on housing demand.

Perhaps surprisingly, during the first ten years of the Celtic Tiger, house prices only rose in line with increases in disposable income and the ratio of prices to income remained at a relatively low level. However, over the period 1997-2007 this ratio rose above any levels seen previously. This on its own is not necessarily a sign that prices had lost links with reality because interest rates shifted to a lower average level than prevailed prior to EMU making housing more affordable.

However, most of the analysis that was undertaken at this time suggested that by 2007, Irish house prices were significantly over-valued, with 30 per cent being a conservative estimate of the extent of the gap between prices and what could be justified by incomes and interest rates.⁴

3.2 *Evidence That a Slowdown Was Coming*

My reason for documenting the evidence on Ireland's economic performance up to 2007 is to make one simple point: taken together, this evidence strongly suggests that a substantial economic slowdown was imminent.

- The factors underlying the long expansion in the employment-population ratio had run out. Labour force participation rates had reached the high levels that had been sustained by the UK and US and further growth was unlikely.⁶ Unemployment could hardly go lower.
- Demographic factors, often cited as a positive underlying factor for growth in Ireland, were no longer working to boost growth. In fact, the CSO were projecting that the share of the population that was of working age had peaked and was set to fall.
- The composition of growth had fundamentally changed: Figure 1 shows that productivity growth had slacked off during the later construction-dominated years of the boom, as the room for catch-up growth fell off (see Figure 6). Indeed, population growth driven by immigration had become the key factor driving growth. These patterns were not consistent with sustaining a high growth rate.

⁴ See, for instance, McQuinn and O'Reilly (2006) who estimated an over-valuation of 15 per cent by end 2005. With further growth in house prices through 2007, this suggested an over-valuation relative to then-prevailing income and interest rates of about 30 per cent.

⁵ According to the OECD's Social Indicators report, Ireland's employment to population ratio for females, at 60.4 per cent is exactly equal to the OECD average. However, most of the countries with higher ratios, such as the Scandinavian countries, differ from Ireland in providing substantial state supports, such as low-cost childcare, to enable high rates of female labour force participation.

- Both house prices and the level of construction activity were unsustainable. With house prices very likely to fall, much of the development and construction business was going to become unprofitable so that this sector was going to shrink.

Ireland had largely run out of room in relation to those factors that would let us grow faster than comparable economies. The growth picture in these other economies was not pretty. In my November 2006 working paper co-authored with Kieran McQuinn, we estimated that the potential growth rate of output per hour in the Euro Area appeared to be about 0.9 per cent per year.⁶ This combination of limited catch-up room and poor European growth would suggest that the ingredients for, at minimum, a slowdown in Irish economic growth were in place. Furthermore, the economy was going to have to be re-oriented away from construction and such economic re-organisations are rarely easy to undertake quickly. A baseline growth forecast of 2 to 3 per cent per year if a soft landing in the housing market could be engineered would, in my opinion, have been an optimistic one at this point.

3.3 *The Fast Growth Consensus*

Despite these signs that the Irish economy was running out of room to continue growing, there was relatively little discussion in Ireland in the years prior to 2008 of the likelihood of a slowdown in growth. Rather than go through various sources of forecasts such as those from stockbrokers, it is perhaps most useful to focus on the *Medium-Term Review (MTR)* forecasts of the Economic and Social Research Institute (ESRI). In singling out these publications for analysis, my intention is not to criticise the ESRI forecasts per se. In fact, quite the opposite, these forecasts are worth examining because they were by far the most detailed and considered forecasts at the time of Ireland's capacity for growth.

In December 2005, the *MTR* projected a strong baseline outcome for the economy in the coming years "The analysis in this *Review* suggests that the economy has the potential to continue growing at between 4 and 5 per cent a year out to the end of the decade." GDP growth over the period 2005-2010 was projected to average 5.7 per cent per year, based on productivity growth of 2.4 per cent per year. The period 2010-2015 was projected to have growth slowing to 3.9 per cent with a drop off in employment growth but productivity growth remaining at a healthy 2.2 per cent per year.

Indeed, even as the storm clouds of international recession hovered over the Irish economy, the conventional wisdom was that the current decade

⁶ This paper was published as McQuinn and Whelan (2008).

would see a fast pace of economic growth. The ESRI's 2008 *Medium-Term Review*, released during the summer of that year, still projected GDP growth of 3.6 per cent per year over the period 2010-2015, not too far away from the forecast for this period that had been provided in December 2005. The 2008 *MTR* projected lower average growth in employment of about 1.2 per cent per year for the period 2010-2015, thus implying a pickup in productivity growth of 2.4 per cent per year over this period.

Two aspects of these forecasts are worth emphasising. First, the baseline forecast for these projections involved a soft landing in the housing market. Of course, there were some commentators warning of the potential for house price decline and the risk of a housing-driven crash.⁷ Indeed, the 2005 *MTR* explicitly contained a "housing shock" scenario in which house prices fell by one-third. However, like others, the ESRI were relatively optimistic about the ability of the economy to re-orient away from housing while sustaining growth. The projected outcome from the housing shock scenario was a reduction in growth to 1 per cent in the first year and under 3 per cent in the second year before returning gradually to its perceived trend of 4 to 5 per cent. Thus, even scenarios in which a housing shock occurred were perceived as likely to result in a "soft landing".

Second, these forecasts were very positive about the Irish economy's potential for productivity growth. For example, the forecast of 2.4 per cent average productivity growth over 2010-2015 could be compared with a worsening productivity growth performance such that, over the three years ending in 2007 of only 1.6 per cent per year. The idea that Ireland would sustain higher productivity growth than our European trading partners was one of the arguments that could be used to justify the likelihood of a soft landing in which the economy was re-oriented away from housing.

With an apparent consensus among economists that economic growth was likely to continue at a healthy pace, it was hardly surprising that Fianna Fáil was re-elected to government in 2007 on the basis of an election manifesto whose underlying assumption was that growth over the following five years would average 4.5 per cent per year. Rather than challenge these assumptions, the opposition political parties largely agreed with this assessment.

This over-optimism was, I believe, the fundamental source of a range of different policy mistakes which left Ireland badly placed for coping with the economic slowdown to come. Of course, events in the world economy turned

⁷ Alan Ahearne in particular provided a number of perceptive contributions pointing to the likelihood of large price declines and the disruptive consequences of this event. See, for instance, his 9 October 2005 *Sunday Independent* article "What goes up often comes down – with a bang" and his April 22, 2007 *Sunday Business Post* article "Don't bet your house on a soft landing."

out to be far more negative than almost anyone could have imagined. One could argue that it was these negative events that are to blame for Ireland's current economic crisis and, indeed, "twas Lehman Brothers what did it" is a common refrain. However, a fairer analysis was that policies were pursued that left the country poorly prepared to deal with any slowdown and hugely vulnerable to a large international shock.

IV CONSEQUENCES OF OVER-OPTIMISM

The over-optimism about economic growth that prevailed during the period leading up to 2007 was responsible for a number of serious policy errors. Here I shall discuss fiscal policy first and then banking and credit policy.

4.1 *Fiscal Policy*

The long boom that preceded 2008 had allowed successive Irish governments a freedom from the normal fiscal constraints faced by governments around the world. There were sizable increases in public expenditure, income tax rates were cut and yet the debt-GDP ratio had gradually tumbled to one of the lowest in Europe. However, by the later years of the boom, fiscal policy (like the structure of the economy) had become distorted by the housing boom.

While tax revenues had continued to rise throughout the boom, Figure 9 shows that composition of these revenues had substantially changed. Income tax rates, which had been very high in the 1980s, were repeatedly cut. The substantial increases in income meant that the income tax take still rose every year but income taxes as a share of GNP fell from 20 per cent in 1988 to around 13 per cent in the later years of the boom. In addition to rate cuts, exemption points were raised to a level that took significant numbers out of the tax net altogether. The result was that the income tax burden was exceptionally light, particularly for those on low to middle incomes.

Table 1 uses calculations from the OECD publication, *Taxing Wages* to illustrate how light the income tax burden had become by 2007. For example, the combined PAYE and PRSI average tax rate for a single earning married couple with two children, taking home the average wage, was 6.7 per cent in Ireland, compared with an EU-15 average of 23.7 per cent and an OECD average of 21.1 per cent.⁸

⁸ If one subtracts off government transfers such as child benefits, the single earner average-wage family have a negative net contribution to the state of -33 per cent. Admittedly, however, making comparisons of this figure with other countries is made complicated by the extent of free childcare and other state supports provided to families in other European countries.

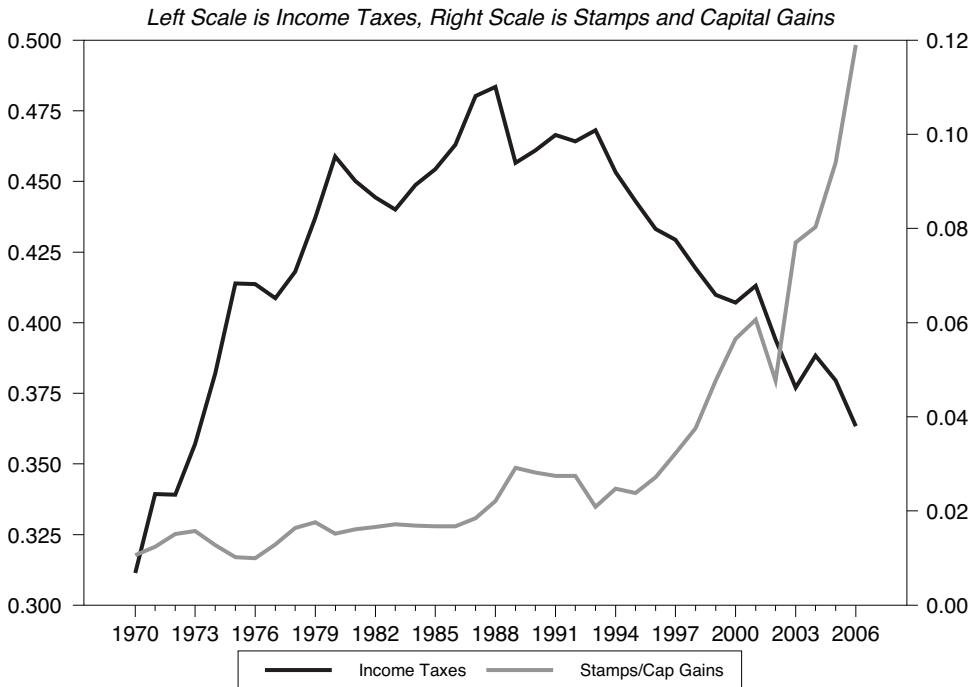
Table 1: *Income Tax plus Employee Contributions, by Family-type and Wage Level, 2007 (as Percentage of Gross Wage Earnings)*

<i>Family-type:</i>	<i>Single</i>	<i>Single</i>	<i>Single</i>	<i>Married* 2 Children</i>
<i>Wage level (% of Average Wage):</i>	<i>67</i>	<i>100</i>	<i>167</i>	<i>100</i>
Australia	19.1	23.4	28.8	23.4
Austria	27.9	33.6	37.9	31.8
Belgium	35.8	42.3	49.1	31.0
Canada	19.4	23.2	26.8	16.6
Denmark	38.8	41.0	49.6	35.8
Finland	23.3	30.1	37.4	30.1
France	25.8	27.8	33.1	21.7
Germany	37.3	43.1	46.1	24.2
Ireland	6.7	14.4	26.6	6.7
Italy	24.2	29.0	35.5	21.2
Japan	18.4	20.2	24.2	16.4
Netherlands	31.2	35.8	40.8	32.4
New Zealand	19.1	21.5	27.3	21.5
Portugal	17.1	22.9	30.0	15.0
Spain	16.2	20.5	25.3	12.5
Sweden	24.9	27.6	37.8	27.6
Switzerland	18.9	22.0	26.9	16.6
United Kingdom	23.9	26.9	30.6	25.2
United States	21.8	24.2	29.9	10.9
Unweighted average:				
OECD	22.2	26.7	32.3	21.1
EU-15	24.8	29.9	36.5	23.7

* One-earner family.

Despite this erosion of the income tax base, the Irish government's coffers remained buoyant due to revenues earned from other sources. In particular, the construction boom generated huge tax revenues in the form of stamp duty, capital gains taxes and VAT. Figure 9 shows that as income taxes (PAYE and PRSI) declined from 48 per cent of tax revenues in 1988 to 36 per cent in 2006, revenues from stamp duty and capital gains rose from 2 per cent of tax revenues to 12 per cent over the corresponding period.

Because these tax revenues were dependent on activity in the housing market which had reached extraordinary levels by international standards, it was as clear in 2007 as it is now that the government could not continue to rely on housing-related tax revenues. However, it appears that policy was based upon the assumption that the housing market, and by implication the rest of the economy, would glide towards the now-infamous soft landing. The

Figure 9: *Composition of Tax Revenues*

government seems to have been expecting the huge revenues from the housing boom to disappear only gradually, with strong growth allowing other sources of tax revenues to be found to replace them.

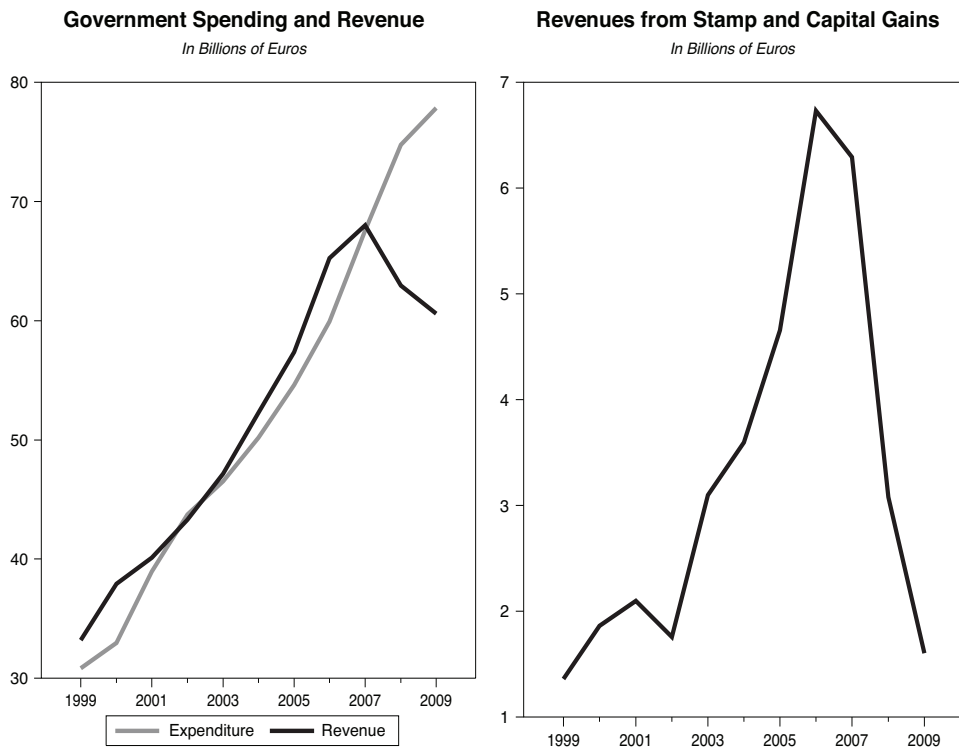
However, the evidence suggests a second soft landing was not going to be achieved even in the absence of an international recession. House prices peaked in early 2007, before the international financial crisis had begun. However, by late 2007, the US economy was in recession and by 2008 the world economy was in the midst of the greatest economic and financial crisis since the 1930s. By 2007, Irish house prices could only be rationalised on the basis of exceptionally optimistic future growth rates. Once this positive outcome failed to materialise, house prices were set for a large drop. With nominal house prices falling, potential home buyers had little incentive to buy and the housing market came to what Brian Lenihan, the incoming Minister for Finance, accurately referred to in June 2008 as “a shuddering halt”.

The implications for the budgetary situation were profound. Tax revenues, which had been running somewhat ahead of expenditures for a number of years, suddenly slumped far behind: total government revenue declined from €68 billion in 2007 to a projected €56 billion in 2009 as revenues from stamp

and capital gains dropped from €6.3 billion to a projected €1.5 billion in 2009 (see Figure 10) These figures underestimate the effect of the housing sector collapse on tax revenues since the sector contributed further direct revenues in the form of VAT as well as the income taxes from construction employment, which has collapsed from 270,000 in early 2007 to 126,000 in 2009:Q4, and likely has further to fall. The associated increase in unemployment has necessitated a substantial increase in spending, with transfers rising from €18.7 billion in 2007 to €23.5 billion in 2009. Within the space of two years, the budget went from being in surplus to having a deficit in the region of €20 billion.

We will never know how badly the Irish fiscal situation would have deteriorated without the world recession. What we can say for sure is that the over-optimism that pervaded economic policymaking in Ireland in the years up to 2007 left the economy in a very precarious position. In particular, the steady move away from income taxation as a source of revenues now appears to have been a strategic mistake.

Figure 10: *The Emerging Budget Crisis*



4.2 *Banking and Credit Policy*

The other key aspect of Ireland's current economic problems is the banking crisis. It is undeniable now that in Ireland, as with elsewhere, there were substantial financial regulatory failures. However, we should be wary of false equivalences between the banking collapse in Ireland and events elsewhere. For example, it is now commonplace to argue that the emergence of complicated financial instruments and their lack of regulation played a key role in the international financial crisis. In Ireland, however, despite the presence of a large number of international financial firms in the IFSC carrying out various intricate financial operations, complicated financial instruments have played little or no part in our banking crisis.

Lax mortgage lending is also commonly cited as a cause of the Irish banking crisis, with practices such as 100 per cent loan-to-value mortgages and subprime lending often raised. However, subprime lending was negligible in Ireland. Whilst loose mortgage criteria may have played an important role in fuelling the boom in house prices (high multiples being far more important than low-equity loans) it is also important to recognise that losses on mortgage defaults have not been the problem that has brought down the Irish banks. Mortgages are usually the last type of debt that people will default on, and though these losses will be significant over the next few years, the Irish banks were almost certainly well enough capitalised to have dealt with these losses.

Rather than mortgages or complex financial instruments, the demise of the Irish banks stemmed from their loans to property developers. The value of Irish houses is down significantly from their peak level; with housing activity at minimal levels, the value of much of the speculative development land bought near the peak is now close to zero.

A common criticism of international financial regulation has been the weakness of the Basle framework for banking supervision. International regulators spent years developing the Basle 2 framework, with its emphasis on more sophisticated capital adequacy rules to ensure that banks had appropriate capital cushions to absorb losses on bad loans. It is now widely accepted, however, that these new rules would have done little to prevent the global financial crisis (and in fact may have contributed to making it worse). In the case of the Irish banks, it appears that regulators and other monitors such as the IMF paid too much attention to capital adequacy. For example, the 2007 IMF Article 4 report has a heading summarising the position of the banking sector as "Banks Have Large Exposures to Property, But Big Cushions Too" which was consistent with the widespread belief that the highly profitable Irish banks were going to be safe even if the economy hit a serious downturn.

The focus on capital adequacy, Pillar 1, of the Basle framework, appears to have come at the expense of a lack of emphasis on the second pillar, which relates to the supervisory process. It's worth quoting the Basle 2 document at length on the issue of "credit concentration risk":⁹

770. A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to a bank's capital, total assets, or overall risk level) to threaten a bank's health or ability to maintain its core operations.

Risk concentrations are arguably the single most important cause of major problems in banks.

772. Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.

777. In the course of their activities, supervisors should assess the extent of a bank's credit risk concentrations, how they are managed, and the extent to which the bank considers them in its internal assessment of capital adequacy under Pillar 2. Such assessments should include reviews of the results of a bank's stress tests. Supervisors should take appropriate actions where the risks arising from a bank's credit risk concentrations are not adequately addressed by the bank.

Translation: rules about capital adequacy hardly matter if you let banks concentrate a lot of lending in a single risk area.

The failures in Irish banking regulation thus did not relate to financial innovations or regulatory arbitrage but to a failure to enforce the Basle recommendations about supervisory oversight of credit concentration risk. Irish banks were allowed to rapidly build up huge exposures to the property sector. For example, in 2003, AIB had €11 billion in property-related loans. This built up to €16 billion in 2004, €25 billion in 2005, €35 billion in 2006 and €47 billion in 2007. This represented over one-quarter of its total assets, and over half of the €81 billion that it had in the form of customer deposits. Anglo Irish Bank, which was even more focused on property lending, was allowed grow from having assets of €26 billion in 2003 to assets of €97 billion in 2007.

With the widespread belief that the housing market was heading for a soft landing, insufficient attention was paid to the extreme concentration of

⁹ See pages 179-180 of Bank of International Settlements (2006).

property development risk that could cause huge losses. Furthermore, because much of the funding for rapid expansion in property loans came from wholesale funding from abroad (for instance, AIB have run a loan-to-deposits ratio of about 150 per cent in recent years, while the corresponding figure for Irish Life and Permanent is about 300 per cent) any hint of a threat to solvency was going to trigger a withdrawal of funding. So, the Irish banks were left precariously positioned with respect to both solvency and liquidity.

Because the development loans that are causing the most problems for the banks are the substantial quantity that were lent out during the final years of the boom, the figures for property loan exposures by year show that an intervention even as late as 2005 to cool development lending could have prevented the upcoming meltdown. Given the likely cost to the Irish taxpayer stemming from the banking crisis, we can only hope that the simplicity of this lesson is not lost amid the various complicated debates in the coming years about principles-versus-rules and regulating complex instruments.

Of course, when thinking about future financial regulation, we also need to be careful about fighting the last war. For example, stung by a series of high-profile scams ripping off Irish consumers, the Irish Financial Regulator devoted large amounts of resources to consumer protection and regulation, when we know that a stricter focus on prudential regulation would have been more helpful.

Financial regulation should and will be tighter in future: the recent G20 declarations on this issue are a welcome sign that steps will be taken in the right direction. However, just because an over-concentration of property development loans was the problem this time does not mean that it will be the problem next time; in fact, it almost certainly will not be. I suspect that general but simple rules such as strict limits on credit growth at individual banks may end up working better than complex capital adequacy rules in protecting the financial system from future unforeseen sources of risk.¹⁰ As Patrick Honohan (2009) has noted, even if supervisors were unable or unwilling to intervene to prevent reckless lending patterns, such rules would have at least curbed excessive lending growth at Anglo Irish Bank.

V SOME MYTHS

The previous discussion has made clear that serious errors were made in the formulation of Irish economic policy in recent years. Over-optimism about the growth capacity of the economy affected key decisions about fiscal and

¹⁰ Lord Turner's (2009) FSA report is an excellent review of the sources of the recent financial crisis and suggests a range of rule-based measures aimed at making the financial system more stable in the future.

financial regulatory policies and left Ireland in a poor position to deal with a global economic slowdown. However, I noted above that popular discussion of the boom and subsequent bust regularly overstate or misrepresent the roles played by other factors.

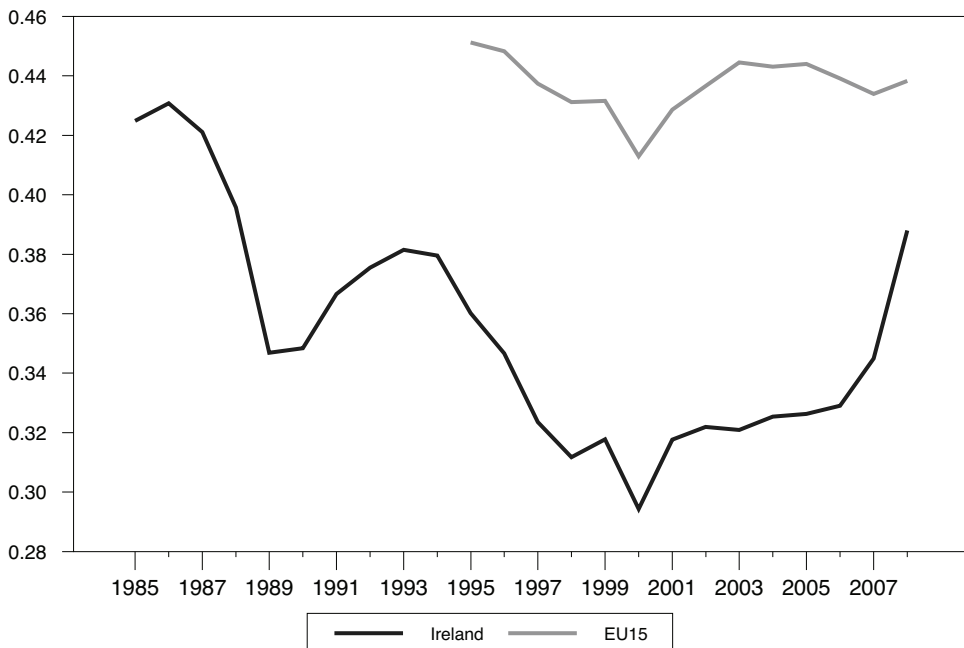
Here I shall focus on two.

5.1 *The Bloated Public Sector?*

A staple talking point in certain parts of the Irish media these days is that the Celtic Tiger was ruined by the government's decision to create an enormous public sector. The "bloated public sector" (as it is commonly labelled) caused the economy to become uncompetitive and is now regularly cited as the key source of our fiscal problems.

In truth, I think this characterisation is somewhat misleading. Consider, for instance, Figure 11, which shows the share of non-interest public spending in GDP. For most of the Celtic Tiger period, the share of public spending declined and by 2000 was well below the European average. The share moved up somewhat up until 2007. The last data point in the chart is for 2008 and by this time falling GDP and increasing welfare costs caused the ratio to jump further in 2009.

Figure 11: *Share of Non-Interest Public Spending in GDP*



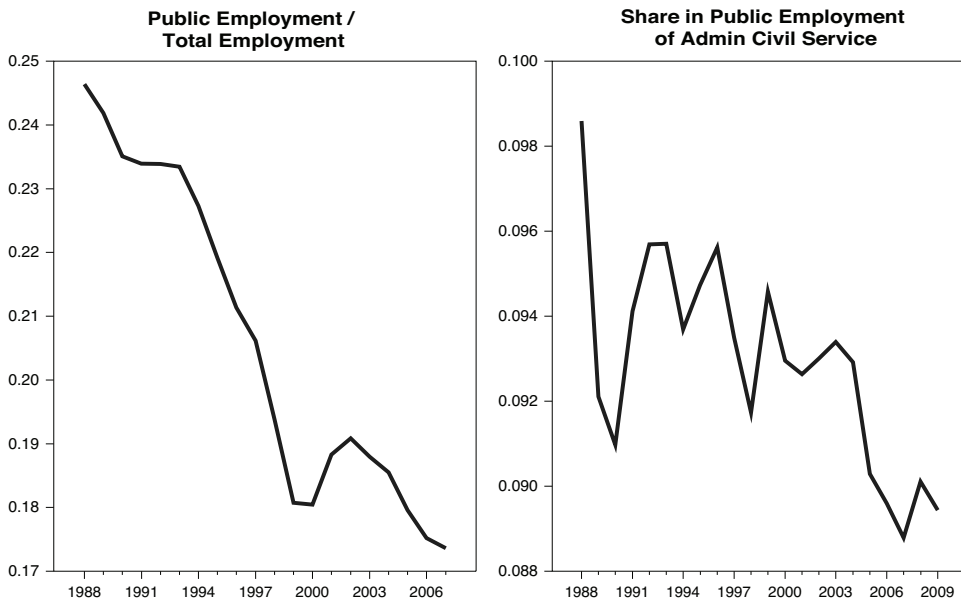
This series includes government spending on transfers, capital programmes and other items. However, much of the focus in public discussions of our bloated public sector is on the number of public sector employees and their pay. Perhaps surprisingly, Figure 12 shows that the share of GDP spent on public sector pay and pensions in Ireland has consistently remained below the EU15 average.

It is certainly true of course that public sector employment has increased substantially. But, as was discussed above, employment in the private sector of the Irish economy also increased substantially. In fact, the public sector's share of total employment in Ireland declined over the past 20 years (see the left panel of Figure 13). Also, despite the common focus on the bloated and bureaucratic nature of the public sector, the right panel of Figure 13 shows that the share of public sector employment accounted for by administration has barely changed over the past 20 years.

Note that I am not arguing here that there is no room or need to cut public expenditure or that there is no waste in public spending. The substantial loss in output from this recession is such that maintaining previous levels of public spending would likely see us shoot beyond European levels of spending relative to GDP, with clear implications for taxation.

Figure 12: *Share of GDP Spent on Public Pay*



Figure 13: *Irish Public Sector Employment in Context*

In addition, the argument that the size of our public sector is standard says nothing about the *quality* of what it provides and it is hard to escape the feeling that the substantial increases in public sector spending have not delivered as much as we might have hoped. There can be little doubt that the boom-era environment in which recent public spending decisions were made did not lend itself to extracting efficiency improvements from the public sector. Countries where public spending can only grow by 2 per cent per year are effectively operating under mini-Board-Snip conditions at all times: since new spending initiatives often have to displace old ones under such condition, this keeps pressure on programme managers to deliver in an efficient manner.

The available evidence also suggests that, even after accounting for the two rounds of pay cuts implemented in 2009, Irish public sector employees earn a substantial premium over their private sector counterparts, particularly when one factors in pension entitlements.¹¹ At the time of writing the “Croke Park” deal has seen the government offer an end to pay cuts in return for reforms to improve the efficiency of the public sector. Whether this will be delivered is unclear but without reforms it may be difficult to sustain the idea that public sector pay cannot be cut again.

¹¹ See Kelly, McGuinness and O’Connell (2009).

So, without doubt, there is some room to cut Irish public spending in ways that minimise delivery of services and the report of An Bord Snip has highlighted many areas where cuts should be considered. However, by most of the usual metrics, the characterisation of policy prior to 2008 as producing an outsized public sector does not quite fit the facts. Furthermore, there are likely to be limits to the efficiency gains that can be obtained from reform and also to further adjustments in pay without serious disruptions in service due to strikes. Once the lower-hanging fruits are dealt with – such as the trimming back on the proliferation of new agencies introduced in recent years with weak justifications – it is likely that further reductions in public expenditure will involve serious cuts in the delivery of popular public services.

5.2 *The Credit Binge?*

Those familiar with TV documentaries about the Irish economy will recall these programmes usually feature a segment in which we are informed that reckless Irish consumers went on an unprecedented spending binge fuelled by cheap credit (commentary usually intoned over pictures of frenzied shoppers at Dundrum Town Centre on a Saturday afternoon). According to these accounts, the current slump is just the inevitable hangover from this period of irresponsibility.

In truth, there is little merit in this theory. Those who propose it usually focus on statistics for debt (drowning in it we usually are). However, it is generally misleading to just focus on statistics for debt without looking at the other side of the balance sheet, i.e. looking at household assets.

The evidence shows that, while the boom period saw a substantial build-up in Irish household debt, it also saw an even bigger increase in assets. A recent Central Bank article by Mary Cussen, John Kelly and Gillian Phelan shows that household net worth (assets minus liabilities) rose from 640 per cent of net disposable income in 2002 to a peak of 800 per cent in 2006.

This substantial increase in the value of assets was, of course, mainly due to increases in the value of the Irish housing stock. However, it is worth noting that Irish households maintained moderate savings rates during this period and these savings also contributed to asset accumulation. For instance, during the booming period 2002-2005, Irish consumers saved a relatively healthy 6 to 7 per cent of their disposable income: see Figure 14. So rather than behaving irresponsibly, Irish households continued to save and despite the increased levels of debt, their net worth increased considerably.¹²

¹² As a general rule, I tend to be wary of moralistic commentators who warn that economic troubles are caused by greedy and feckless consumers. Most of the time, most of us are making the best decisions we can with the information available.

Figure 14: *Irish Household Savings Rate*

None of this is to say that all was perfect with the savings and investment decisions of Irish households during the waning years of the Celtic Tiger. Much of the increase in net worth has now been eroded as house prices have fallen (the Central Bank article only captures the start of this process as it ends at 2007) and the average figures for debt and asset levels likely hide enormous cross-sectional variations. Older people with houses purchased long ago saw huge increases in the valuation of their homes. Now they are seeing these “paper wealth” gains eroded but, by and large, they did not go on spending sprees during the boom and did not accumulate large debts.

Many younger people, however, ended up purchasing assets (houses to live in) at over-valued prices and paid for them with debt that still has to be paid off. So, the composition of recent changes in assets and debts likely differed substantially across demographic groups and it is the younger cohorts that are more likely to be in trouble now. But, to the best of my knowledge, we have very little data to put numbers on this story, with some limited information from the EU-SILC survey being the best we have.¹³ Even in these straightened times, the collection of a large sample of microdata to help us understand the growing problems of negative equity and housing defaults would be a very sound investment.

¹³ See McCarthy and McQuinn (2010).

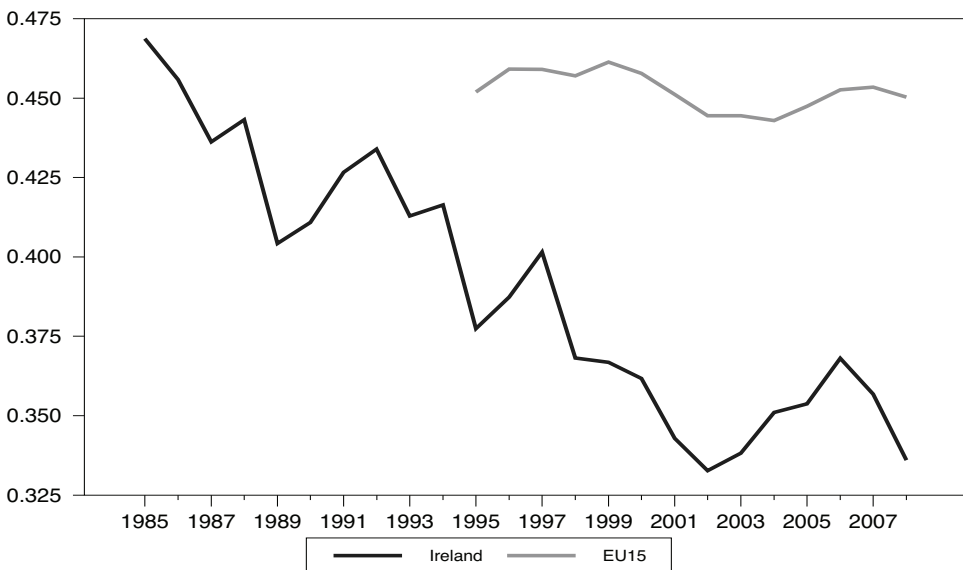
VI BOSTON VERSUS BERLIN: FOR REAL THIS TIME

At this time of fiscal crisis and in light of the mistakes that it has made in the recent past, the government is to be commended for commissioning expert advice on public spending and taxation from An Bord Snip Nua and the Commission on Taxation. However, it is important to remember that decisions on the balance of public spending and taxation are political decisions. We cannot simply hope that Bord Snips and Taxation Commissions will solve for us the difficult tradeoffs that exist between spending priorities and taxation levels.

The famous remarks in 2000 of former Tanaiste, Mary Harney, about the choice between Boston and Berlin sparked off regular debates in Ireland about the socio-economic model being chosen by Ireland. In retrospect, these Boston-versus-Berlin debates now seem somewhat false. Ireland had increasing public spending and falling taxes rates and governments did not have to confront the long-run incompatibility of these developments. If, as I believe likely, economic growth resumes at significantly lower average rates than in the recent past, we will have to confront a range of difficult choices that go beyond our current difficulties in achieving fiscal solvency.

Figure 15 shows that, even prior to the collapse in construction-related revenue, the Celtic Tiger left Ireland with a tax take relative to GDP that is

Figure 15: *Share of Government Revenue in GDP*



well below the European average. Such comparisons are undoubtedly odious (and difficult) given differences across countries in the need for military spending and in the treatment of pensions. However, my assessment of the evidence is that Ireland's tax take is still relatively low by European standards, even after controlling for such factors.¹⁴ After the various tax levies that were introduced in 2009, the idea that Ireland has no further room for income tax increases has gained much currency. However, the OECD calculations reported in Table 1 show that, even after accounting for the new levies, income tax rates for average families in Ireland are still very low by international standards.

What is true, however, is that the recent increases in taxes have raised marginal tax rates to uncomfortably high levels. Calculations reported by the Commission on Taxation show a combined marginal tax rate (including levies and PRSI) of 54 per cent at income levels as low as €36,400. The government's approach to income tax has left us with a system that achieves the dubious trick of raising comparatively little money while imposing high marginal tax rates on people with moderate incomes. This year's budget provides an opportunity to overhaul the current complex and inadequate system with one that raises more money and has lower marginal tax rates. My preference is for a flat income tax with a large exemption.¹⁵

A broadening of the tax base, along the lines suggested by the Commission on Taxation, with the introduction of a property tax and the elimination of a large number of tax exemptions, should also be considered. At the time of writing, the Minister for Finance is suggesting that the adjustments undertaken in the next budget will again focus mainly on expenditure cuts. Clearly, some adjustments of this type are necessary. However, a decision to keep our income tax take at its current low levels will have clear consequences for spending options.

Ultimately, our governments will have to face up to serious tradeoffs in dealing with expenditure and taxation issues over the next few years. How they deal with them will have fundamental implications for the type of Irish economy and society that will emerge.

¹⁴ Another argument is that GNP rather than GDP should be used for such comparisons. I disagree with these

arguments because all income produced in Ireland is eligible for taxation by the Irish government.

¹⁵ See my post on the Irish Economy blog "A Flat Tax for Ireland?": www.irisheconomy.ie/index.php/2009/11/20/a-flat-tax-for-ireland/

VII CONCLUSIONS

If I had to offer one over-riding lesson to be learned from our recent economic history, it would be that Irish economic policy should be formulated on the basis of an expectation of relatively low sustainable growth rates, and that it is far safer to have a pessimistic bias than an optimistic one.

If the Irish economy stabilises in the coming year with a very high unemployment rate, then Ireland will again be starting from a point of having a significantly underemployed population. If our major macroeconomic and financial problems are dealt with successfully in the coming years and the world economy picks up again, then this starting point will allow room for a period of growth above what will be sustainable over the longer run. It will be essential, however, that future periods of fast growth not be interpreted as a return of the Celtic Tiger. Analysis based on a clear understanding of our demographic profile, labour market structures and productivity performance are unlikely to justify such a conclusion.

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