



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta
National Economic & Social Council

Next Steps in Addressing Ireland's Five-Part Crisis: Combining Retrenchment with Reform

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Abbreviations

ALMP's Active Labour Market Policies	IDA Investment Development Authority	OECD Organisation for Economic Co-operation and Development
C & AG Comptroller and Auditor General	LDSIP Local Development Social Inclusion Programme	PES Public Employment Service
CSO Central Statistics Office	LES Local Employment Service	PRSI Pay Related Social Insurance
DSFA Department Social and Family Affairs	MABS Money Advice and Budgeting Service	SMEs Small Medium Enterprises
ECB European Central Bank	NAMA National Asset Management Agency	UK United Kingdom
ESRI Economic Social Research Institute	NPRF National Pension Reserve Fund	VAT Value Added Tax
EU European Union	NCC National Competitiveness Council	WEF World Economic Forum
GDP Gross Domestic Product	NESC National Economic and Social Council	
GNP Gross National Product	NESDO National Economic and Social Development Office	
HICP Harmonised Index of Consumer Prices	NTMA National Treasury Management Agency	

A Five-Part Crisis that Requires an Integrated National Response

In March 2009, the Council argued that there are five dimensions to Ireland's current crisis: a banking crisis, a fiscal crisis, an economic crisis of competitiveness and job losses, a social crisis of unemployment and income loss, and a reputational crisis. It argued that an integrated national response was required that addressed all five dimensions, since partial and sequential measures, even where necessary, would not be sufficient or effective. To find a way through the crisis, it is necessary to combine unavoidable retrenchment with major reform in a range of policy areas and systems.

Absence of an Integrated, Nationally-Supported, Way Forward

There has been a very significant policy response to the crisis. Yet, for a variety of reasons, there is little easing of the crisis in banking, the fiscal position, the economy and society. Despite important steps, an integrated, nationally-supported and widely-understood response has yet to be achieved. Indeed, reviewing developments since March 2009 confirms the Councils' fear that:

- ◆ a convincing approach to any one dimension of the crisis is, in part, dependent on a widely-understood approach to the overall national crisis: but equally,
- ◆ a widely-understood approach to the overall crisis requires a clear and purposeful approach to each of the five elements, taken one by one.

This creates a danger that the policy approach to the whole crisis could be compromised by the lack of conviction about action on each of the parts, while support for action on each of the parts could be withheld because confusion or disbelief remains about the effectiveness or fairness of the overall national response. This is the context in which, in the coming months, Irish society must make critical decisions.

In particular, it cannot be said that an integrated and evolving debate is occurring on the fiscal, social and economic aspects of the crisis. Government has achieved savings of €10.5 billion or 6.3 per cent of GDP and published the McCarthy Report. But there continues to be a huge gap in the public finances. Policy and public debate on the fiscal, economic and social aspects of the crisis still seem dominated by short-term, immediate and zero-sum aspects; it has not proven possible to secure

support for a perspective based on long-term mutual gains. Yet, Ireland's future depends on now addressing these difficulties with short-term measures that can be shown to have a long-term logic.

Towards a More Integrated Consideration of Fiscal, Economic and Social Policies

A more integrated approach can be achieved by combining ideas and action at three levels:

- ◆ A vision of the kind of society and economy that Ireland wishes to become in the decades ahead, and towards which responses to the crisis will help us move;
- ◆ Knowledge and ideas on aspects of economic and social development to ensure that crisis measures do not unwittingly damage economic recovery, innovation, future skills and capabilities, economic participation and social cohesion;
- ◆ Practical policy development, compromise and problem solving, based on the experience and capabilities of a wide range of organisations and people.

Working in this way, the Council suggests that the following criteria be applied:

- ◆ **Economic/cyclical:** The measures should, as far as possible, contribute to the revival of economic activity and employment;
- ◆ **Developmental:** The measures should, as far as possible, strengthen the foundations of Ireland's economic and social development;
- ◆ **Fairness:** It should be possible to explain how the chosen tax, expenditure and other policies are as fair as possible;
- ◆ **Sustainability:** The adjustment process must be sustained until Ireland comes through the crisis, must yield a sustainable public finance approach, and should, as far as possible, put Ireland on a path that is sustainable—economically, socially and environmentally.

These criteria can help to ensure that a response to the social and economic aspects of the crisis is embedded in fiscal policy in the coming months and years.

A Challenge for Government and Others

Finding an integrated and nationally-supported response cannot be a task for government alone. The inter-connected nature of the parts, inevitably means that the action and attitudes of many non-government organisations are critical in finding a way forward. The encompassing nature and severity of the crisis means that no economic or social organisation or interest can avoid its consequence or absent itself from the search for solutions. The clearest and most purposeful government policies still require significant engagement of individuals, firms and non-government organisations to achieve their most beneficial effects. This short report is addressed, therefore, not only to Government, but to the full range of economic, social and policy actors—all of whom have a role in finding and implementing a path through this national crisis.

1

Introduction

In March 2009 the Council published a report entitled *Ireland's Five-Part Crisis: An Integrated National Response*. That report advanced four central arguments:

- ◆ There are five dimensions to Ireland's crisis: a credit and banking crisis, a fiscal crisis, an economic crisis of competitiveness and job losses, a social crisis of unemployment and income loss, and a reputational crisis;
- ◆ An integrated response is required that addresses all five dimensions, since partial and sequential measures, even where undoubtedly necessary, will not be sufficient and effective;
- ◆ To find a way through the crisis, it is necessary to combine unavoidable retrenchment with major reform in a range of policy areas and systems;
- ◆ The actions Ireland takes in 2009 and 2010 are likely to shape the country's long-term future; in particular, our actions now will, in large measure, determine whether Ireland achieves the ambition of economic and social performance equivalent to that in the leading small European countries—such as Denmark, Finland, Sweden and the Netherlands—or whether, in twenty years time, we will be an EU state that lags in prosperity and social cohesion and is burdened by fiscal deficits and debt.

Since early 2009 there has, indeed, been a very significant policy response to the crisis. Yet, for a variety of reasons, there is little easing of the crisis in banking, the fiscal position, the economy and the society. Indeed, despite important steps, an integrated, nationally-supported, and widely-understood response has yet to be achieved. This is the context in which, in the coming months, Irish society must make critical decisions on a number of fronts:

- ◆ How to address the serious fiscal crisis;
- ◆ How to stem the flow of job losses;
- ◆ How to support the unemployed and others suffering in the crisis.

In this context, the Council has recently discussed the evolving situation and sought to update its understanding of the five-part crisis. In order to facilitate the Council's discussion, the NESC Secretariat has undertaken a descriptive review of policy actions and other developments from April to September 2009. This is presented in the appendix to this report.

The Council now wishes to re-emphasise the inter-connected nature of the banking, fiscal, economic, social and reputational dimensions of the crisis and to explore ways in which an integrated, nationally-supported, response might be found.

Chapter 2 is a summary of the analysis and argument in the Council's report of March 2009. Chapter 3 offers the Council's reflections on the evolving crisis and discusses the continuing challenges of finding a coherent widely-understood and nationally-supported strategy across the five dimensions of the crisis.

For reasons outlined in Chapter 3, this short report is addressed not only to government but to the full range of economic, social and policy actors—all of whom have a role in finding and implementing a path through this national crisis.

2

Summary of the Council's March
2009 Report *Ireland's Five Part Crisis:
An Integrated National Response*

2.1 Describing and Understanding the Crisis

In its report of March 2009, the Council sought to assist government in developing an integrated response to the crisis, by providing:

- (a) An accurate characterisation of the position in which Ireland found itself in March 2009;
- (b) A persuasive set of arguments that can build the widest possible shared understanding of the nature of the crisis;
- (c) An analysis of how Ireland might move from partial and sequential reactions to fast-moving events to an integrated national response that addressed the various dimensions of the crisis and could engage the Irish people in this critical period for our economy, society, reputation and independence.

The Council argued that there are five dimensions to Ireland's current crisis:

- ◆ A banking crisis;
- ◆ A fiscal crisis;
- ◆ An economic crisis;
- ◆ A social crisis; and
- ◆ A reputational crisis;

It suggested that the Irish crisis could be understood as a combination of the following elements:

- ◆ Declining competitiveness as a consequence of Ireland's prolonged boom;
- ◆ A property bubble which Irish financial institutions, a regulatory system and system of land management did not prevent; and
- ◆ An international credit crisis and world recession caused by structural weaknesses in the current globalisation process.

Analysing the unfolding crisis, the report noted that the pressure of events had forced the Irish government to react to various aspects of the unfolding crisis in late 2008 and early 2009. While these included high-profile actions—such as the bank guarantee and budgetary announcements—a range of other Irish policy reactions to the crisis were summarised in the report. A key question, the report argued, is how to progress from reactivity to response?

2.2 The Crisis as the Manifestation of Risks and Vulnerabilities

In its discussion of the crisis, the Council drew on its existing understandings, developed over the past two decades. These included the macroeconomics of a small open economy, the close relation between the monetary regime, fiscal policy and wage bargaining, the conditions for effective social partnership, the mechanisms of economic adjustment in EMU, and principles of fiscal policy. The Council's earlier analysis also encompassed the vulnerabilities inherent in Ireland's growth as a regional economy, the developmental welfare state, principles of sustainable housing and the need for active land management, and taxation policy. It argued that the crisis can be seen as a manifestation of risks, vulnerabilities and weakness—in three distinct senses.

First, it concluded that the severe current crisis can be seen, at least in part, as the manifestation of a range of the international risks inherent in Ireland's economic position, identified in earlier studies. These include our dependence on the growth of the international economy, an asymmetric shock within the euro zone, a weakness of sterling, and the relatively large impact on our 'regional' economy of international flows of real investment, finance and people. It was admitted, however, that NESCC had not envisaged that these risks would materialise simultaneously and in such a mutually-reinforcing way.

Second, it was noted that the crisis is also a manifestation of a number of risks that were not identified—or were considered unlikely to materialise. These included the massive recourse to overseas borrowing by the Irish banking system, in order to finance property development and purchase, and the dramatic collapse of the model of international finance and financial regulation that had developed in the past 20 years.

Third, the Council's analysis suggested that the crisis can be seen as the manifestation of a number of vulnerabilities, the exposure to which is significantly shaped by national policy frameworks, institutions and processes. A number of features of Ireland's approach to economic and social development, policy implementation, coordination and bargaining have not sufficiently protected the economy against some of the known vulnerabilities. Among these were:

- ◆ The system of public expenditure management, especially methods of project appraisal, output and outcome measurement and accountability;
- ◆ A tendency to erode the tax base, by over reliance on unsustainable tax revenues from construction-related activity, rather than more predictable taxes on income and assets;
- ◆ The system of land management, planning and housing;
- ◆ The approach to pensions;
- ◆ A social policy framework that does not sufficiently complement and support our adoption of an internationalised economy and a social model based on high levels of participation;
- ◆ A range of features of national policy and partnership, as analysed by the Council in *NESCC Strategy 2006* and the OECD, that give rise to an 'implementation problem' with many dimensions (NESCC, 2009: 35).

In thinking about a way out of the crisis, the Council considered it important and informative that aspects of the crisis are a materialisation of risks and vulnerabilities that we had identified, discussed and reached broad agreement on in recent years. It reiterates this view now, since it points to areas where crisis response must be combined with underlying reform.

2.3 The Characteristics of an Effective Irish Response

In the Council's view an effective Irish response to the crisis must have a number of characteristics. As outlined in the report of March 2009, the response must:

- ◆ Address all five dimensions of the crisis: banking and credit, fiscal, economic, social and reputational;
- ◆ Be based on social solidarity, seen as sharing the burden of adjustment fairly and yielding a fair economy and society in years to come;
- ◆ Involve a consistent combination of macroeconomic, distributional and structural measures;
- ◆ Be framed around a positive perspective on the future of Irish society;
- ◆ Combine high-level coherence with maximum engagement and local problem solving;
- ◆ Take short-term measures that move us in the correct long term direction; and
- ◆ Have a sequence and timing that enhances these characteristics.

In explaining these characteristics, the Council drew attention to some fundamental aspects of the crisis and some indispensable elements of an Irish recovery.

First, the crisis poses profound challenges to many existing theories and models. Indeed, the high degree of uncertainty—particularly about the impact of conventional policy measures—provides further reasons for constructive, collective discussion of problems and solutions. The Council argued that countries capable of conducting such dialogue and implementing a coherent and agreed response quickly are likely to come through current difficulties better than those in which profound and protracted debate on diagnosis and cure occurs (37).¹

Second, Ireland's response must be attuned to international economic realities. Among these is the unavoidable need to reverse Ireland's balance of trade and capital flows. This requires a restoration of competitiveness.

Third, it is important to recognise the degree of irreversibility created by the current crisis. History suggests that macroeconomic and financial crises are a harbinger of much wider economic change—in technology, markets, economic hegemony, regulation and the way in which the economy is socially and politically embedded. In short, although the international economy will (almost certainly) revive, there will not be a return to the global economy which prevailed from 1990 to 2008. Yet it was in that economy that Ireland made its greatest convergence towards the

1. Hereafter, page references in brackets refer to NESC 2009.

levels of prosperity in Western Europe. This seems likely to have profound, as yet unknown, implications for Ireland. Consequently, NESC argued that no economic or social organisation or interest within Ireland can safely absent itself from exploration of these implications (38).

Fourth, notwithstanding the degree of uncertainty and irreversibility, Ireland's response to the five-part crisis has to be based on a positive perspective on Ireland's economic future. This is necessary to motivate wide engagement with the retrenchments and reforms that are now imperative and to guide us in which adjustments to make and which to avoid. Indeed, the Council argued that we can identify some necessary and desirable features of Ireland's recovery and future prosperity. These include adjusting the public finances, re-establishing export-led growth, strengthening indigenous resources for knowledge-based economic activity and innovation, positioning Ireland to continue attracting inward investment in high-value activities and enhancing individual and social capabilities and social cohesion even through a severe downturn. Indeed, the Council argued that Ireland should draw encouragement from research which suggests that the global crisis is a harbinger of the full deployment of the information and communications technologies. This will create vast business, technical, environmental and social opportunities—but only in countries where there is widely-dispersed digital capability, entrepreneurship and participation (Perez, 2009, 2002).

Fifth, a central argument in the Council's March report was that an effective Irish response must combine high-level policy coherence, on the one hand, and urgent search for new solutions at all lower levels, on the other. Some of the critical elements of an effective response—macroeconomic policy, incomes policy, banking policy and social policy—urgently require a coherent and clear government policy and, ideally, agreed approaches across a range of high-level actors (government, the social partners, major regulatory agencies and the financial institutions). But other critically important policy areas—such as skill development, aspects of social policy and wider public sector reform—require central government to set the parameters and a wide range of actors to jointly search for practical responses to the problems we now face.

It was noted that lack of agreement on a high-level strategic response (most critically, on fiscal policy and incomes policy) would certainly lead to inconsistent national policy and could further diminish Ireland's international reputation. But, the Council argued that it is likely to also prevent or postpone lower-level engagement in the kind of problem solving which is urgently required. It is critical to enlist hundreds of agencies, units, firms and associations in devising effective and imaginative approaches to the challenges of employment protection, skill development and activation (41). Once an integrated national response is outlined, the success of public agencies, social partners and firms in dealing imaginatively at a local level with the challenges of solvency, employment or unemployment can contribute to the coherence and discipline at national level. In a general way, it can inspire confidence in, and cooperation at, the national level. More concretely, the harsh economic realities mean that at local level—in both private firms and some areas of public services—we face a trade-off between numbers employed and remuneration levels. Resolving this in favour of employment at the local level can make a significant contribution to solving the national-level problems of aggregate demand and the public finances (42).

Sixth, the logic of immediate measures that are in accord with long-term goals is strongly evident in the Government's document *Building Ireland's Smart Economy*. The main focus of that framework is infrastructure and innovation. An important argument in the Council's March report was that the same logic should be applied also to a range of other policy areas, including responses to unemployment, social policy, activation, pensions, infrastructure, land management and housing.

Seventh, the Council acknowledged that government must sequence its responses to the crisis. In some cases, this might involve large, early adjustments, for example, in order to limit the increase in public borrowing and to strengthen international credibility. In other cases, it will warrant gradual introduction of new measures. NESC's central argument was that both the rapid and gradual measures need to be embedded within a clear framework that illustrates that they are each part of a single, integrated, national project of adjustment, reform and recovery (44).

Finally, the Council argued that Ireland needs to combine retrenchment with reform. The severe reversal and pain could consist mainly of retrenchment, and be borne, reluctantly and passively, by all concerned. Or it could see the opportunity for major reform, enlisting the abilities and imagination of many organisations and individuals. The Council argued that Ireland needs to combine severe retrenchment with radical reform. This derives from the best available analyses of the five-part crisis. This, NESC argued, is the only context in which it will be possible to craft a persuasive set of arguments that can build a shared understanding on these policy actions and can engage a wide range of agencies and organisations in implementation and problem solving.

2.4 Towards An Integrated National Response

2.4.1 Limitations of Partial and Sequential Reactions

In March, the Council noted that it is possible to devise a set of further reactions to each of the five elements of the crisis. Indeed, the report considered a single-minded focus on, respectively, stabilising the banking system, correcting the public finances, addressing the crisis of competitiveness, closures and lay-offs, responding to increased social problems and restoring Ireland's reputation. That analysis certainly identified critical elements in each of these five areas, as we summarise below. But, in each case, the Council's analysis strongly suggested that a further series of partial and sequential measures, some of which are undoubtedly necessary, would not be sufficient and effective. This lack of effectiveness is likely for three related reasons:

- (a) Technically, action on each of the crises requires specific supportive and coordinated actions on several of the others;
- (b) It will be very difficult for leaders of various kinds to communicate the purpose of a series of partial and sequential reactions and how they amount to Ireland's overall response to the crisis;
- (c) Partial and sequential reactions are unlikely to achieve the central requirement for Ireland's survival: to energise Irish people to work together in a problem solving way, including adjusting our joint efforts in response to unforeseen successes and setbacks.

Consequently, the Council argued that Ireland needed to formulate an integrated response, an argument we return to below.

2.4.2 A Focus on Stabilising the Banking System

At the time of the March 2009 report the possibility of taking bad debts off banks' balance sheets was being explored.² NESC cautioned that this approach should not be used as a means of 'transferring capital to banks in a way that does not give the State an appropriate share of the potential future returns from the profitable parts of banks (48). NESC also counseled that 'an over hasty reduction in loan to deposit ratios should be avoided as it would add to deflationary pressure in the economy' (48).

While problems in financial institutions confront Government with an urgent problem to which it must react, the Council argued that there would be definite limitations to a national response which was dominated by a focus on recapitalising the banking system. First, as a response to the banking and credit crisis it is necessary but not sufficient. The policy response to the banking crisis needs also to address the following:

- ◆ The need to ensure that policy measures provide protection to the increasing number of households with mortgage arrears;
- ◆ The need to ensure that government action prompts a renewed flow of credit to businesses in Ireland;
- ◆ The need to convince Irish society as a whole, and particularly groups making visible sacrifices, that those who led Irish financial institutions into their current reliance on the state, and who were major beneficiaries of the boom, are being held accountable and bearing their share of the adjustment burden;
- ◆ The need to persuade our EU partners, other international institutions and the global financial market actors that a new regulatory regime and governance culture is being created in Ireland

Second, a dominant focus on the banking crisis would, of course, not address critical other dimensions of Ireland's crisis, notably the fiscal crisis and the economic crisis. Without progress on the crisis of competitiveness, business solvency and employment, even a fully repaired banking system is unlikely to see much increased credit creation.

2.4.3 A Concentration on the Public Finances

In March, the Council catalogued public finance measures taken since July 2008 and agreed that many further measures will be required to bring Ireland through this severe crisis. In January 2009, the government's objective of a GGD of 3.0 per cent in 2013 was endorsed by the social partners (*Framework for a Pact*, Department of An Taoiseach 2009) and the Council noted agreement that this should be achieved by a combination of expenditure reductions and tax increases.

It was argued that any combination of expenditure reductions, tax increases and increased borrowing needs to be assessed not only on how it narrows the gap

2. In its March 2009 report, the Council did not offer an opinion on the best technical approach to addressing the banking crisis. It simply identified a shared Council view on some factors which any technical approach should take into account and some requirements for an effective, sufficiently-understood, response.

between expenditure and revenue, but also on how it is likely to impact on key other dimensions of Ireland's challenge: the economic crisis, the social crisis and the country's reputation. This is particularly so, given that these crises call for major policy developments in pensions policy, labour market policy and activation.

It was noted that the tax share of GNP in Ireland had fallen by approximately 2.5 percentage points and is below the EU (15) average. The Council argued that in view of the large structural deficit in the public finances, and taking into account the undoubted scope for enhancing the effectiveness of expenditure, it seems certain that a medium-term strategy to restore balance to the public finances will require an increase in the tax share of GNP—from its reduced level in early 2009—if a satisfactory level of provision of services and benefits is to be achieved. In this regard, it noted that some, if not all, of our EU trading partners will increase their tax-take over the coming year. Changes to the tax system should not be considered solely in terms of revenue, but also in the light of principles of tax reform and the impact on economic growth.

In March, the Council argued that a strategy to restore sustainability to the public finances needs to take into account:

- ◆ The desirability of prioritising services and employment over remuneration in the adjustment period;
- ◆ The key role of the Special Group on Public Service Numbers and Expenditure Programmes in identifying opportunities for improved value for money;
- ◆ Ensuring the immediate retrenchment measures are consistent with desirable structural reform and long term goals;
- ◆ Ensuring that borrowing is kept at a manageable level; and
- ◆ Addressing the long-standing challenge of public sector reform to achieve a real improvement in value for money in the use of public resources.

The last point was emphasised strongly by the Council in its March report. It was noted that while increased expenditure during this decade was necessary to address long-standing deficits in services, it often took place without adequate arrangements to ensure that increased resources were used effectively. The Council again emphasised the need for much greater accountability by government departments and agencies for what is achieved with public money. Indeed, it argued that the work of the Special Group on Public Service Numbers and Expenditure Programmes should be closely aligned with the transformational goals set out in the Government's strategy in *Transforming Public Services: Citizen Centred – Performance Focused* (Government of Ireland, 2008).

The Council argued that the area of public spending and taxation illustrates more than any other the limits of partial and sequential reactions to the crisis and the need for individual measures to be placed within the framework of an integrated national response to the overall crisis. It observed that the cascade of expenditure reductions and tax increases in 2008 and early 2009, while understandable given the rapidly changing revenue and unemployment situation, had left most groups and individuals in the population confused. This confusion encompasses not only the

logic of particular measures but also the distribution of the burden of adjustment. In this context, it is relatively easy for groups to be persuaded that they are bearing the largest burden of adjustment. As noted in March, these observations were not made in a critical spirit. It was argued there that existing reactions to fast moving events have, probably unavoidably, been partial and sequential. The purpose of the observation was to underline the importance of finding and articulating a clear account of the crisis and elements of an integrated national response.

2.4.4 A Focus on Restoring Ireland's Competitiveness

A central argument of the Council's report of March 2009 was that we recognise and analyse not only the banking and fiscal crises, which have been discussed intensely since the crisis broke in 2008, but also the economic crisis—as evidenced in job losses, company closures and short-time working.

In arguing that a coordinated approach to income determination remains appropriate, the Council underlined the fact that this is premised on a shared analysis and understanding of Ireland's five-part crisis. This entails recognition that:

- ◆ Maintenance of employment, and minimisation of the increase in unemployment, are central concerns in an integrated national response to the five-part crisis;
- ◆ Over the coming years, Ireland's economy has to shift from growth driven by domestic demand, that prevailed from 2002 to 2007, to export-led growth, as achieved earlier;
- ◆ Economic recovery will be characterised by a fall in Ireland's price level and cost structure, relative to our trading partners.

It was noted that a difficult set of competing objectives confronts all those involved in finding a coordinated and integrated response to the crisis. It recognised that in the current context, a coordinated approach to income determination should take account of a wide range of factors, including employment, competitiveness, the fall in sterling, prices, domestic demand, state of the public finances, mortgage debt and social solidarity.

The encompassing view outlined above is one that places the highest priority on protection of employment and the problem of unemployment. It recognises that Ireland's price level will need to fall relative to that in our trading partners if Ireland is to restore its competitiveness. In the medium term it is not possible to envisage a path through the current crisis that does *not* include a significant improvement in Ireland's cost competitiveness. This is because the *price level* has to adjust if Ireland is to switch from growth driven by domestic demand (funded from overseas borrowing) to export-led growth. The Council was most anxious to emphasise that this will require that the full range of costs, charges, fees and rents that make up the Irish price level be reduced relative to those in trading partners. The Council emphasised that, not only for fairness, but also to achieve the necessary economic effect, it is vital that there be vigorous action to achieve reduction in prices, costs, fees and rents.

Consequently, the Council's analysis suggested that a coordinated approach to incomes—and other adjustments in the Irish private sector economy (in prices, costs, employment and working hours)—must be accompanied by at least six other policy approaches. Among these are:

- ◆ Stabilisation of the banking system in a way that re-established the provision of credit to business;
- ◆ A significant fiscal offset, in which temporary public borrowing supports key services and limits the contraction of domestic demand; and
- ◆ A re-targeting of NDP spending to support employment and enterprises.

This dependence of an effective response to the economic crisis on effective measures to address the banking, fiscal, social and reputational crises, underlines the need for an integrated, and clearly articulated, national plan.

2.4.5 A Focus on the Social Crisis

While the most prominent aspects of the current crisis are financial, fiscal and economic, the Council argued in March that the depth of these difficulties is giving rise to a significant social crisis. A single-minded focus on the social dimensions of the crisis would concentrate, first and foremost, on insulating the most vulnerable against the worst effects of the recession. As well as maintaining the existing infrastructures of care, this requires doing everything possible to continue with the reform agenda for Ireland's social policies and welfare state that tackles the deep social deficits which persisted during the period of strong economic growth; otherwise, in a period of recession, these deficits will only worsen.

NESC argued that a second area in which the crisis calls for major reform is activation policy. There is an urgent need to stimulate the search for practical measures that will re-order and re-fashion existing education, training and social welfare budgets in ways that more effectively help workers now losing their jobs and those seeking jobs for the first time during this recession. Only integration and innovation in how Ireland's educational system, training and labour-market policies, and welfare state respond at this time will ensure they are not scarred by the experience and that a new problem of long-term unemployment is not created. The aim must be to stimulate the creation of '21st century' equivalents to the special labour market programmes that were introduced in the late 1980s and early 1990s.

In particular, it was argued in the Council's March report that how jobless people access opportunities for retraining and further education should be immediately reviewed. For example, a large proportion of the people employed in sectors where job loss is particularly high in the current downturn—construction, retail, hotels and catering, and low-tech manufacturing—have a lower secondary education or less as their highest educational attainment. Urgent consideration should be given to measures that offer these people opportunities to upgrade their skills in a significant way and widen their options in a post-recession Ireland.

Overall, the Council urged the immediate establishment of a Jobs and Skills Summit at which the labour market authorities, and all bodies with a capacity to deliver high quality, market-relevant training and education programmes, would identify and implement a set of measures feasible and effective in meeting these goals. It argued that addressing the activation challenge requires a vigorous implementation of the Government's programme of public sector reform, cited above.

The Council also proposed that the economic recession and collapse of private construction provides an opportunity to address some outstanding housing issues. Among these was the proposal that intervention in the banking sector might be used to acquire public land banks on attractive terms.

2.4.6 The Reputational Crisis

In its March 2009 report, the Council reiterated its long-held view that Ireland's small size, location and model of economic development make it highly vulnerable if it were to lose influence or status in the EU or, worse still, if there was a return to a less rule-based international system. It was in no doubt that, as well as the banking, fiscal, economic and social crises, Ireland faced a reputational crisis. This makes itself felt in various ways. Among the most immediate is the increase in yields on Irish government bonds, as bond markets demand higher spreads to hold what are seen as riskier assets.

It was argued that the centrality of Ireland's reputational crisis in the grave overall situation is entirely consistent with some long-standing principles of Irish policy and with a modern understanding of sovereignty. In *The New Sovereignty*, Chayes and Chayes argue that for all but a few self-isolated nations, sovereignty no longer consists in the freedom of states to act independently, in their perceived self-interest, but in 'membership in reasonably good standing in the regimes that make up the substance of international life' (Chayes and Chayes, 1995: 27). If sovereignty is status or good standing, then Ireland undoubtedly faced a threat to its sovereignty. Perhaps the only consolation, the Council argued in March, is that most Irish people place a high value on our national status and independence, in this modern sense, and will want to restore it.

As in the case of the other crises discussed above, the Council argued that an effective response to the reputational crisis requires not only focused actions, but also that some wider conditions be met. Perhaps the most obvious of these is the need to persuade our EU partners, other international institutions and the global financial market actors that a new regulatory regime and governance culture is being created in Ireland's financial and business systems. Here, the Council argued, we come upon a most important aspect of the reputational crisis: the close connection between a country's international reputation and the domestic credibility and effectiveness of its governance arrangements. In the case of banking and financial regulation, the requirements for repairing Ireland's international reputation would seem to overlap with what is required to address several of our domestic crises. One requirement is the need to convince Irish society as a whole, and particularly groups making visible sacrifices, that those who led Irish financial institutions into their current reliance on the state, and who were major beneficiaries of the boom, are being held to account and bearing their share of the adjustment burden.

Indeed, the link between international reputation and the credibility and effectiveness of domestic governance goes much wider. International reputation is linked to the ability of a society to act collectively, recover and reinvent its economy. The more credible and effective are domestic governance, the higher is a country's international reputation. But it is also true that the more credible and effective are domestic governance, the less some aspects of international commentary matter. Countries with credible and effective domestic governance arrangements can have confidence that they will fix their problems.

2.5 Not Too Late to Find an Integrated Nationally-Supported Response

In summarising its analysis, the Council argued in March that it was not too late to formulate an integrated, nationally-supported, response to the five-part crisis.

The major scale of the crisis, and the fact that the crisis and its effects are likely to last for some years, means that it is a mistake to think that the reactions taken to date can constitute the main Irish or, indeed, EU response. It is not surprising that these reactions to fast-moving events do not yet constitute our full, considered, integrated and agreed response. Equally, the Council noted, while Government and some other actors have had to react to events, other processes have proved slow in responding. Furthermore, the analysis suggests that the crisis is likely to be deep and long, and will bring fundamental change in the economic and social system, in public policy and regulation and in international relations and governance.

While the paper argued that action on each of the five crises depends on action on the other four, it noted that some policies are effective in addressing certain problems and others at addressing other problems. This is why NESC identified five distinct, but related, crises. Each sphere and crisis requires to be analysed correctly.

The Council emphasised that the essential argument of its March 2009 report was that there is an analysis and understanding of the five distinct, but related, crises which suggests that Ireland needs an integrated, and clearly articulated, national response over the coming years. Consequently, Government should frame an integrated response, as far as possible in engagement with a range of Irish organisations. But, the Council, emphasised 'It is the shared analysis and understanding that warrants the integrated response, not the joint engagement that warrants an agreed response' (5).

An integrated response would be characterised by wide societal ownership of the need to respond to all five dimensions of the crisis and of the framing, implementation and adaptation of the response. It acknowledged that the Council's work in framing a shared analysis and understanding is only a first step in creating such wide ownership.

2.6 What is Our Ambition?

The Council argued that, in the midst of the severe difficulties Ireland is currently experiencing, it is important not to lose sight of the fact that states and societies with impressive social and economic achievements have, at various times, experienced similar setbacks. Among these are small countries such as Sweden, Denmark, Finland and the Netherlands.

Several things characterise these countries and should be kept in view in maintaining Ireland's ambitions despite the severity of our current difficulties. In Sweden, Denmark, Finland and the Netherlands, dynamic firms have emerged from an effective national system of innovation—although the nature and size of the firms and the national innovation systems differ significantly from one to another. Perhaps the most striking feature is that these countries—that have achieved greater enduring prosperity and high levels of inclusion and solidarity— have radically changed their public systems, in order to make them more effective in providing economic and social services that support both citizens and enterprises. This willingness of Sweden, Denmark, Finland and the Netherlands to change can be seen as a reflection of the high expectations they have of their public systems; in turn, this reflects the way in which social solidarity and well-being is achieved and expressed.

In March 2009, the Council argued that the actions Ireland takes in the next two years will, in large measure, determine whether it achieves the ambition of economic and social performance equivalent to that in the leading small European countries, or whether, in twenty years time, we will be an EU state that lags in prosperity, social cohesion and is burdened by fiscal deficits and debt.

3

Next Steps: Linking Economic, Social and Fiscal Policy

3.1 Introduction

In this section, we offer some overall observations on developments since the Council published *Ireland's Five-Part Crisis: An Integrated National Response*. Section 3.2 discusses the on-going challenge of finding an integrated, nationally-supported, way forward and notes a policy bind that could hamper progress to such an approach. Section 3.3 argues that the evolution of debate and policy on bank stabilisation may be instructive in this regard. While that debate has progressively widened, it cannot yet be said that a similarly engaged and evolving debate is occurring on the fiscal, social and the economic aspects of the crisis. Section 3.4 suggests that a way out of the possible policy bind lies in combining ideas and action at three levels: a vision of the kind of society and economy that Ireland wishes to become, knowledge and ideas on key aspects of economic and social development, and practical policy development and compromises. Finally, Section 3.5 discusses the key challenge now, namely embedding the economic and social focus in fiscal policy in the coming months and years. This requires the identification of the kind of agreed criteria that seem lacking in discussion of possible policy responses to the fiscal, economic and social dimensions of the crisis.³

3.2 Absence of an Integrated, Nationally-Supported, Way Forward

The evidence assembled in the Appendix shows that there has, indeed, been a very significant policy response to the crisis. Yet, for a variety of reasons, there is little easing of the crisis in banking, the fiscal position, the economy and the society. Some stabilisation of Ireland's reputation does seem to have been achieved, but the desired level of benefit from a recovering reputation have yet to materialise, for reasons that we discuss below.

The Secretariat's review of developments in banking, public finance, the economy and society, and the Council's own discussion, highlights major challenges within each of these areas. But it also brings to light the continuing challenge of achieving a coherent widely-understood and nationally-supported strategy across the five areas. Indeed, the review of developments since March 2009 confirms the Council's view that:

- ◆ a convincing approach to any one dimension of the crisis is, in part, dependent on a widely-understood approach to the overall national crisis; but equally,

3. As noted in earlier NESC reports, the Secretary General of the Department of Finance did not consider it appropriate to comment on matters of budgetary policy.

- ◆ a widely-understood approach to the overall crisis requires a clear and purposeful approach to each of the five elements, taken one by one.

This creates a danger that the policy approach to the whole crisis could be compromised by the lack of conviction about action on each of the parts, while support for action on each of the parts could be withheld because there remains confusion or disbelief about the effectiveness or fairness of the overall national response.

This inter-connection underlines the difficulty of finding a way through the crisis and the risks involved. The risks are of several kinds. First, attempts to address any one aspect of the crisis are likely to fail if they are not integrated with demonstrable and clearly-understood action on the other fronts. Second, in responding to the fiscal, economic and social crises, actions could be taken that damage the economy and/or society in the medium term. Third, sectional pressure on policy makers could result in failure to take sufficient or correct action, leading to prolonged crisis and/or national insolvency. Finally, unless they are seen as a part of an integrated and fair overall approach, actions in response to parts of the crisis might prompt conflict which could weaken social cohesion and the ability of Irish society to find a coherent path through the crisis. Indeed, these risks apply in both the short and long run. Recovery of economic activity, employment and revenue could be delayed in the coming years; and Ireland's potential for real economic and social development could be weakened, with consequences lasting decades.

3.3 Integrated and Non-Integrated Policy Debates: Bank Stabilisation and Fiscal Policy

The evolution of debate and policy on the banking crisis may be instructive in this regard. Telling points have been made from several sides and public understanding of the policy options has undoubtedly advanced. Independent of one's view on the core substantive issue, the debate on the banking crisis has progressively widened from deposit guarantees, to bank stabilisation, regulation, the accountability of senior bankers and, more recently, credit provision, and consideration of one of the long-term weaknesses in Irish policy, noted by the Council in March: the system of land management, planning and housing. Given the evolution of the debate, it may be the case that some of the difficulties in generating a shared understanding of the banking crisis arise from doubts and fears about how the other aspects of the crisis—fiscal, social, and economic—will be addressed in the coming years.

If debate and policy on bank stabilisation has evolved, and become increasingly informed by awareness of long-term weaknesses in Ireland's policy system, it cannot yet be said that a similarly-informed and evolving debate is occurring on the fiscal, social and, indeed, the economic aspects of the crisis. Policy and public discussion on these aspects of the crisis seem still dominated by short-term, immediate and zero-sum aspects; it has not proven possible to secure support for a perspective based on long-term mutual-gains. Yet a huge amount—in the next few years and coming decades—depends on addressing these difficulties

with short-term measures that can be shown to have a long-term logic. Indeed, as argued by the Council in March, the central requirement for Ireland's survival is to energise Irish people to work together in a problem solving way (47).

As reported in the Appendix, there have undoubtedly been significant developments in fiscal policy. The Government has achieved savings of €10.5 billion or 6.3 per cent of GDP and published the McCarthy report. Despite this, there continues to be a huge gap in the public finances. In 2009, tax revenues are forecast to be 27 per cent below 2007 levels and in the same period total gross voted expenditure, which excludes debt service, has increased by 13 per cent. As a result, Ireland's general government deficit in 2009 is likely to be around 12.2 per cent of GDP. Indeed, the likely level of exchequer borrowing in 2009 will be the region of 15.6 per of GDP. Because of increased borrowing, interest costs are forecast to rise from 4¹/₂ per cent of tax revenue in 2007 to around 11 per cent in 2009 and, based on Supplementary Budget forecasts, will account for around one-fifth of tax revenue by 2013. Growth forecasts for 2010 suggest that little automatic correction is likely in the near term; in any case, there is a significant structural as well as cyclical component in Ireland's budget deficit. The gravity of the public finance position means that significant budgetary measures will be required for 2010 in order to begin the process of reducing the very large deficit described above.

There remains a tendency for opinion on the fiscal crisis to polarise into two camps, with one stressing the need to reduce the gap between spending and revenue and the other the need to maintain existing services and conditions. These positions tend to cancel one another out, rather than pushing the debate into new terrain in ways that makes policy decision clearer and public understanding greater.

One of the reasons for the lack of progress might be that the fiscal debate may be seen as too 'fiscalist'. A single-minded focus on the necessity of addressing the growing budget deficit draws attention to the largest areas of programme expenditure—such as social welfare, health and education. Yet, framing a fiscal response in this way could be self-defeating, if it failed to *explain* why one set of options should be chosen over another, save for the fact that they are of a sufficient magnitude. The McCarthy report alluded to this problem when it noted that the commitment in the April 2009 Supplementary Budget to secure further expenditure savings needed to be 'matched with appropriate mechanisms to decide and deliver the savings at political and administrative levels' (McCarthy Report, 2009: 10). This suggests that proposals for budget adjustments need to be assessed against some set of criteria that offer both policy makers and the public reasons for adopting them, something we discuss further below.

The discussion on the banking and fiscal crises seem to differ because in the former proposals have broadened to include issues involving economic recovery, a social dividend and restoration of the banking sector's reputation. Not only does this begin to take account of the interdependence of the five crises, but it might also encourage action to address some of the long-term defects within Irish banking such as over-exposure to one particular market or product. The public response to the fiscal crisis has not yet witnessed a similar broadening. If it were to happen, the fiscal debate would need to extend to encompass issues of how fiscal consolidation

could aid the employment crisis, move in the direction of a developmental welfare state and, explore ways in which public sector reform can mitigate the impact of expenditure reductions and enhance the social investment character of social spending. Indeed, without full appreciation of the inter-dependence between the fiscal, social and economic dimensions of the crisis there is a tendency to insulate consideration of fiscal options from organisational and reform possibilities. In addition, it would also need to address in a convincing way some of the long-term defects in Ireland's fiscal system that have ensured that 'projections for expenditure are all-too-easily blown off course' (McCarthy Report, 2009: 10).

3.4 A More Integrated Consideration of Fiscal, Economic and Social Policies

Is it possible that consideration of policies to address the fiscal, economic and social aspects of the crisis could evolve, becoming more integrated? Could the policy approach to these aspects of the crisis be informed by both immediate pressures and longer-term understanding of the policy and institutional contradictions?

In emphasising the inter-connection between aspects of the crisis, and naming the policy bind that can result, the Council is aware that it has a duty to work with others to explore how we might escape from it. It suggests that the solution lies in combining ideas and action at three levels:

- ◆ A vision of the kind of society and economy that Ireland wishes to become in the decades ahead, and towards which responses to the crisis will help us move;
- ◆ Knowledge and ideas on key aspects of economic and social development: Ireland's structural position in the world economy, the sources of innovation, human development and skills, participation and the labour market, public services for the 21st century, the strengths and weaknesses of our policy and administrative systems, fiscal stabilisation, and taxation that is supportive of high participation;
- ◆ Practical policy development, compromise and implementation, based on the experience and capabilities of a wide range of people.

Below we briefly discuss why together these three may help escape from the possible policy bind described above.

3.4.1 A Vision of the Society We Want to Create in Ireland

First, an articulated vision of what a successful Irish society should look like can help by reassuring people that the undoubted sacrifices experienced already and further unavoidable costs will be worthwhile in the years and decades to come, because they are painful steps to a society people have reason to value. The crisis is clearly inflicting immediate damage on individuals, families, localities and enterprises. But the prospect of return to conditions of recent years is not a sufficient vision. For the crisis seems also to be depriving people of the prospect of some of the improvements, in services and life chances, that they had begun to expect, such as those aimed at in the National Disability Strategy. They will want to know whether the values and goals in these strategies are still shared, despite

the setback in progress towards them. Furthermore, the crisis has also made people aware of long-standing weaknesses in Ireland's social and economic policies, such as taxation, housing, land management and activation. They are unlikely to be motivated by the prospect of a society that does not fix these broken systems. A clear and credible statement of vision has the prospect of persuading diverse groups not only that current and forthcoming sacrifices are fair, but that the society that is to be achieved through sacrifice will be fair.

3.4.2 Knowledge and Ideas

Second, knowledge and ideas on a range of economic and social mechanisms are vital in choosing policies and reforms to address the crisis and, equally important, in avoiding crisis measures that unwittingly damage economic recovery, innovation, future skills and capabilities, economic participation and social cohesion. The necessary knowledge and medium-term perspectives to underpin each approach may be found in the following sources, among others:

- ◆ *The McCarthy report*, which includes an overview and catalogue of expenditures and explains the programmes, provisions and contracts that generate a given total expenditure in each programme and department;
- ◆ The Government's report *Transforming Public Services: Citizen Centred-Performance Focused* (2008), itself a response to the OECD's long-term analysis of Ireland's public service (OECD, 2008);
- ◆ *Building Ireland's Smart Economy* and associated knowledge on the sources and nature of innovation and on the green economy;
- ◆ *The Developmental Welfare State* and associated knowledge on labour markets and activation;
- ◆ Forfás' work on industrial development and policy, including *Ireland's International Engagement in Science, Technology and Innovation* and *Catching the Wave: A Services Strategy for Ireland* (Forfas, 2008a and b);
- ◆ *The Commission on Taxation, Report 2009*;
- ◆ The NESDO report *Ireland at Another Turning Point: Reviving Development, Reforming Institutions and Liberating Capabilities* (2009);
- ◆ Key knowledge on the role of land management in sustainable development—including the report of the All-Party Oireachtas Committee on the Constitution and Private Property (APOCC, 2009), the NESC study on housing (NESC, 2004) and the Department of the Environment, Heritage and Local Government policy statement *Delivering Homes, Sustaining Communities*.
- ◆ National and international evidence on fiscal policy, fiscal consolidation and associated public sector reform.

In different ways, these studies and bodies of knowledge throw light not only on immediate challenges, but also on relevant aspects of Ireland's structural position and some long-standing strengths and weaknesses of our public policies and institutions.

Indeed, the NESDO report, *Ireland at Another Turning Point*, notes the sense that this profound crisis is another turning point in national economic and social development (NESDO, 2009). In this context, it reflects on Ireland's past experience of crisis and our earlier approach to managing major turning points. That report argues that in both the 1950s and 1980s a way beyond the crisis was only found once recognition of the hard fiscal realities was combined with a revived developmental approach, institutional reform and some concentration of authority. In particular, at both these earlier turning points:

- ◆ the solution to the crisis was focused on development, both economic and social;
- ◆ the decision to make the crisis a turning point was marked by the reform of existing institutions and the creation of new ones;
- ◆ to the degree that the crisis-induced turning point involved a concentration of authority, this was done in order to liberate talent rather than increase control.

There are many reasons to believe that this Irish experience of dealing with crises and turning points in the late 1950s and late 1980s is relevant in current circumstances.

3.4.3 Practical Policy Development, Compromise and Problem Solving

Third, vision, principles and knowledge are of limited use if not reflected in practical policy development, appropriate compromises, effective implementation and joint search for new solutions to problems. This is true in general, for a number of reasons. Vision and principles are quickly seen as hot air if they are not expressed in practical action. Vision and principles can never anticipate all contingencies that practice must address; indeed, solving unanticipated problems can be the source of new vision and principles. Many concrete examples could be cited; one of the most striking and relevant is the way in which the crisis of the 1980s pushed Denmark to invent activation policies, which in turn prompted reforms of the welfare system. It was this search for practical responses to severe crisis that set Denmark on the road that eventually led to the 'principles' of flexicurity and the transition from a 'Keynesian welfare state' to what they now call 'an enabling welfare state' (Kristensen, 2009: 10). Practical policy development and compromises are especially important in Ireland right now. The depth of Ireland's problems and the need for immediate further responses means that any protracted wrangling over vision and principles will, correctly, be viewed with suspicion—as strategic rather than principled behaviour. Indeed, the severity and complexity of the crisis is such that practical policy development and compromise will have to be multi-annual, involving a sequence of actions, sacrifices and rewards. This is all the more reason why practical actions need to be placed within a framework of shared general goals and informed by the best available knowledge.

3.5 Key Challenges Now

3.5.1 Embedding the Economic and Social Focus in Fiscal Policy

In its review, the Secretariat reports very significant developments since March 2009. As noted in our introduction, the country now faces some immediate decisions on fiscal, economic and social aspects of the crisis. In this context, the most concrete requirement for an integrated, nationally-supported, approach is that a response to the social and economic aspects of the crisis be embedded in fiscal policy in the coming months and years.

From existing analyses, we know many ways in which our systems of social policy, activation, training and education are not sufficiently supportive of participation, up-skilling and inclusion. *The Developmental Welfare State* and many other studies give us guidance on ways in which income transfers, services and activation measures could be re-cast to achieve better outcomes. Indeed, adopting this reforming approach, it will often be possible to achieve better outcomes while achieving necessary budgetary adjustments.

From current experience—of firms, the newly-unemployed, departments, agencies, colleges, the social partners and other groups—we are beginning to see new ways in which existing policies and systems are not yet adequately addressing the problems thrown up by the crisis. A response to these economic and social problems also needs to be embedded in upcoming budgetary decisions and the fiscal adjustment of the coming years.

3.5.2 Criteria for Selecting and Designing Further Policy Responses

The Council believes that these considerations could aid the identification of the kind of agreed criteria that seem lacking in discussion of policy responses to the fiscal, economic and social dimensions of the crisis:

- ◆ **Economic/cyclical:** The measures should, as far as possible, contribute to the revival of economic activity and employment;
- ◆ **Developmental:** The measures should, as far as possible, strengthen the foundations of Ireland's economic and social development;
- ◆ **Fairness:** It should be possible to explain how the chosen tax, expenditure and other policies are as fair as possible;
- ◆ **Sustainability:** The adjustment process must be sustained until Ireland comes through the crisis, must yield a sustainable public finance approach, and should, as far as possible, put Ireland on a path that is sustainable—economically, socially and environmentally.

While these criteria might seem obvious and bland, they do differ in quite specific ways from other approaches to addressing the fiscal, economic and social crises.

- ◆ A narrow, fiscalist, view that considers only the budgetary arithmetic—concentrating on adjustments that have two kinds of certainty (i) cuts which will have known impact on total expenditure in the short term and/or (ii) cuts that can definitely be achieved since they are under direct control of central government;

- ◆ Special pleading that very particular programmes should be spared from budgetary adjustment;
- ◆ Generalised pleading, that all programmes with an ‘economic’ function or a ‘social’ function, depending on the point of view, should be left unchanged;
- ◆ Approaches which take an undifferentiated view of either the budgetary or demand effect of policy measures, not recognising that various elements of public spending have different effects on the national output, employment, social equality and development;
- ◆ A view which assesses all policy proposals mainly by reference to the *immediate burden/benefit* they might impose on households or firms, ignoring any deeper understanding of the economic and developmental criteria mentioned above.

While the four criteria—cyclical, developmental, fairness and sustainability—will, of course, leave policy options hotly debated, they do offer the possibility of a more coherent and widely-understood policy response. Indeed, the evolving debate on bank stabilisation, discussed above, can be seen as an example of these criteria coming increasingly and jointly into play.

3.5.3 A Challenge for Government and Others

We have argued above that an integrated, nationally-supported, approach now requires that responses to the social and economic aspects of the crisis be embedded in upcoming budgetary decisions and in fiscal policy in the coming years. These arguments suggest that in focusing on the severity of the fiscal position, thought might be given, as a matter of urgency, to finding structures and processes that are capable of selecting the tools to be used in each policy area. In selecting which approach to adopt in each area, account needs to be taken of the speed at which each tool can be designed and used; and the likely timing of its impact on the deficit, economy and society. It is then necessary to combine, sequence and implement the chosen changes. In selecting, combining, sequencing and implementing the chosen changes, such a process should aim to design fiscal, economic and social policy actions that are the start of a deeper process of reform, which will address the fiscal problem but also be socially inclusive and citizen-focused.

In making these observations, the Council acknowledges that finding an integrated, nationally-supported, response cannot be a task for government alone. The interconnected nature of the banking, fiscal, economic, social and reputational aspects of the crisis, inevitably means that the action and attitudes of many non-government organisations are critical in finding a way forward. The encompassing nature and severity of the crisis means that no economic or social organisation or interest can avoid its consequence or absent itself from the search for solutions. If the Council’s analysis is correct, the clearest and most purposeful government policies still require significant engagement of individuals, firms and non-government organisation to achieve their most beneficial effects.

For these reasons, this short report is addressed not only to government but to the full range of economic, social and policy actors—all of whom have a role in finding and implementing a path through this national crisis.

A

Appendix: Responses and Developments Since March 2009

By the NESC Secretariat

A.1 Introduction

In this Appendix the NESC Secretariat describes the responses to Ireland's five-part crisis since March 2009. It notes the policy measures adopted, the main trends in the economy and society and some of the challenges that have yet to be resolved.

A.2 The Banking Crisis

In its March 2009 report, the Council did not take a view on the best technical approach to bank stabilisation. There was Council agreement on some requirements for a successful and socially-supported approach to the banking crisis and on the goals that should guide government action on the banking system. This remains the position of the Council. Consequently, this text is the Secretariat's description of policy actions and banking developments since the publication of the Council's crisis report in March 2009.

A long period of high growth in the Irish economy provided the context in which 'the steepest and longest of the several national property bubbles of the late 1990s and early 2000s around the world' (Honohan, 2009) was allowed to develop. When the global credit crunch of September 2008 struck, it exposed serious weaknesses in Ireland's banks and financial system. These included the large scale of lending by banks into overheated property markets at home and overseas, their excessive reliance on wholesale money markets to do so, instances of poor governance and flawed corporate ethics, and a regulatory apparatus, code and practice that was insufficiently robust to protect the common good.

A.2.1 The Principal Measures taken in Response to the Banking Crisis

Significant government measures have been taken since September 2008 to mitigate the consequences and address the root causes of these shortcomings on several fronts. The most significant measures include:

2008

20 September: The statutory deposit guarantee for banks and building societies was increased from €20,000 to €100,000 per depositor per institution.

30 September: The Government guaranteed all deposits (commercial, institutional and of other banks) with, and loans (holders of senior debt, subordinated debt and covered bonds) to: AIB, Bank of Ireland, Anglo Irish Bank,

EBS, INBS, Irish Life and Permanent and Postbank for a two-year period. The covered institutions pay a fee in return. A new Act at the end of June provides an enabling power to extend the guarantee by order beyond its current expiry date of 29 September 2010. Work is continuing on the drafting of a longer term guarantee Scheme, the introduction of which will require Oireachtas and EU State aid approval.⁴

2009

21 January: Anglo Irish Bank was taken into public ownership.

11 February: A major State recapitalisation of AIB and the Bank of Ireland was agreed. Each bank received €3.5 billion in Core Tier 1 capital in return for giving the State preference shares paying a fixed dividend of 8 per cent and a 25 stake in its direction. The State's investment was funded from the National Pensions Reserve Fund (€4 billion) and by frontloading the Exchequer contributions for 2009 and 2010 (€3 billion). Specific credit supply measures were incorporated into the recapitalisation packages. In June and August, State-owned Anglo Irish Bank was recapitalised to the tune of €3.8 billion.

7 April: The Government announced its intention to establish a National Asset Management Agency (NAMA) to buy property-related loans from the six covered financial institutions at an appropriate discount and pay for them with government bonds. Draft legislation outlining how NAMA is to operate was published for public consultation on 30 July. Second Stage of the Bill commenced on 16 September.

19 May: The Government announced the terms of reference of a Credit Supply Steering Group bringing together representatives of the principal banks and business to identify blockages in the flow of credit to SMEs and identify solutions.

18 June: The Government announces significant reform of the structures for financial regulation through the establishment of a new single, fully integrated regulatory institution, the Central Bank of Ireland, with responsibility for both the supervision of individual firms and the overall stability of the financial system.

3 September: Professor Patrick Honohan was announced as the next Governor of the Central Bank.

16 September: The Government issued its estimates of the scale and cost of NAMA's operations. It proposes to purchase property-related loans with a book value of €77bn on bank balance sheets, but an estimated current market value of €47bn, for €54bn. Of the €54bn in NAMA IOUs to be issued, it is proposed that around 5 per cent will be in the form of subordinated bonds putting the banks at risk if NAMA loses money. Allowance is also made for a levy on financial institutions at the end of NAMA's life if property and land values have

⁴ In this regard, an outline of draft terms was published on the Department of Finance's website on 16 September, <http://www.finance.gov.ie/documents/speeches2009/sfblo34guaranteee.pdf>.

not recovered sufficiently. Some 40 per cent of the loans being acquired are estimated to be performing ('cash-flow generating') and capable of financing the interest the government is to pay on the bonds plus the administration costs of NAMA.

In addition to these major developments, obligatory and voluntary changes in senior management and directors at the six Irish financial institutions have gathered pace. By mid-September, 2009, some 40 per cent of directors were new since the start of the year, and four institutions had (or were about to have) a new CEO appointed from outside (*The Irish Times*, 11 September, 2009). Other than the intention to set up and operate NAMA, other policy changes have been announced for implementation in the near future. They include windfall gains on rezoned land being made subject to Capital Gains Tax at the rate of 80 per cent (a tax change that must wait until the next Finance Act.), a prohibition on a CEO immediately becoming the chairman of a bank, and the consolidation and restructuring of the banking sector to form a third major Irish bank.

It is too soon to assess the cumulative impact of these measures, most of which will take time for their effects to register. By far the most significant of them, NAMA, is still the subject of public and Oireachtas debate and of on-going refinement.

A.2.2 Overarching objectives

All the measures are being taken in pursuit of two overarching objectives:

- (i) Seeking to ensure that the availability of credit to the corporate and household sectors will not delay or prevent the Irish economy recovering when international conditions improve. Where the flow of credit remains frozen or only a trickle, recessions tend to be particularly long-lasting. Ensuring that credit flows freely into and around Ireland's banking system is integral to national economic recovery. For the real economy to function, banks need to regain financial health and public confidence 'on the basis of sustainable and welfare-enhancing business models' (ECB, 2009); and
- (ii) Seeking to generate trust that the cost of stabilising and cleansing the Irish banks is not borne unfairly by the taxpayer. Recoveries from banking crises typically entail large costs for the State and taxpayer. This seems unavoidable. It is vital, however, that those whose business models and decisions weakened the banks in the first place bear their full share of the responsibility and are seen to, even while the State shoulders long-term commitments in pursuit of the first objective.

A.2.3 The Flow of Credit

The level of outstanding loans in the Irish economy is continuing to fall at a rapid pace (see Figures 1 and 2). This is partly a book-keeping phenomenon as banks write down some of their existing loans, but it also reflects the continuing stringency of banks in extending new loans and continuing weak demand for credit from enterprises and households as a result of the recession.

The level of loans to the non-property, non-financial corporate sectors (where loan write-offs may be expected to play a smaller role) was down 7.7 per cent over the year to the end of June 2009, with loans to the wholesale and retail trade and to manufacturing recording the largest absolute falls. The level of loans to the household sector for mortgages witnessed 'the first decline in outstanding private residential mortgage credit on record' in the second quarter of 2009. This, however, was made up of a small, positive year-on-year increase in mortgages for principal dwellings (up 2.9 per cent, but it had risen by 9.5 per cent a year earlier) more than offset by drops in mortgages for buy-to-let and second homes (down by 0.5 per cent and 14.8 per cent respectively). Finally, the level of non-mortgage personal loans has declined by 11.5 per cent over the year to the end of June 2009, as compared with an increase of 5 per cent in the year to the end of June 2008. The pace of quarterly decline, however, eased somewhat in the second quarter of 2009.

A more nuanced view of the actual flows of credit is provided by the ECB's latest quarterly survey of euro area bank lending. Banks are asked to indicate on a five point scale whether the credit standards they are applying on loans to enterprises and households are being relaxed or tightened, and whether the demand for loans from each sector is growing or declining. The results, quarter by quarter, for the two and a-half years to July 2009, are shown in Figures 3 and 4.

Credit standards on loans to SMEs have been tightening each quarter since April 2007 but there is some evidence that the degree of tightening eased during the six months to July 2009 (Figure 3). An increase in banks' cost of funds, balance sheet constraints and the perception of greater risk were the principal factors contributing to this tightening. Loan demand from SMEs declined most sharply in Autumn 2007 but the decline has been easing steadily since then. The Mazars report, which reviewed the availability of credit to SMEs over the period June 2008 to February 2009 in some detail, found that credit demand on the part of SMEs is increasingly for working capital and cash-flow, i.e., to redress reductions in revenue and slow-downs in debt collection. During the third quarter of 2009, the overall pattern of tighter credit standards and declining loan demand is expected to remain.

Credit standards on loans for house purchase began to tighten at the end of 2007 (Figure 4). There was some easing in the tightening during the second half of 2008, but a return to more stringent conditions in 2009. As with lending to SMEs, this is attributed to an increase in banks' cost of funds, to balance sheet constraints and the perception of heightened risk. Demand for mortgages, also, appeared to dip during the second quarter of 2009. While the fall in house prices would normally prompt more people to seek mortgages, the impact of rising unemployment on household incomes and consumer confidence may be mitigating this to a significant extent.

Figure 1 NFC Credit Year-on-Year Change, Property and Non-Property Sectors

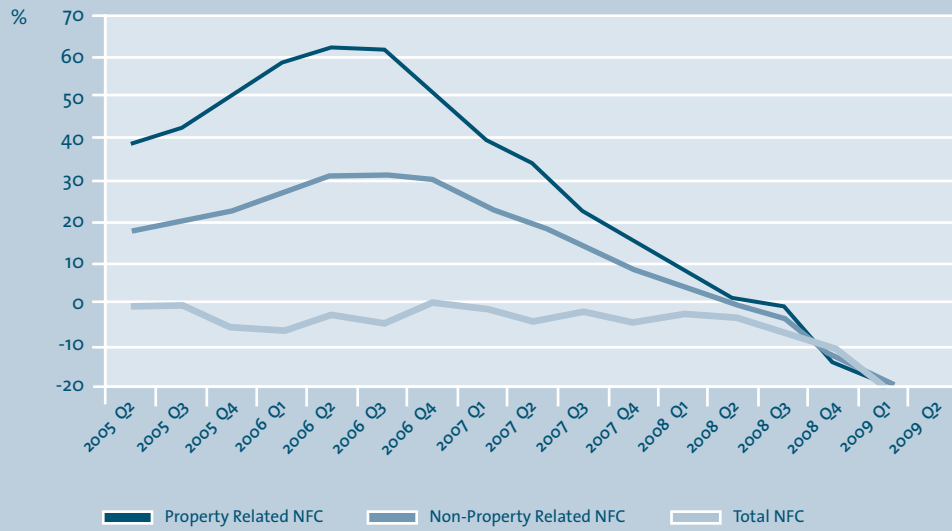
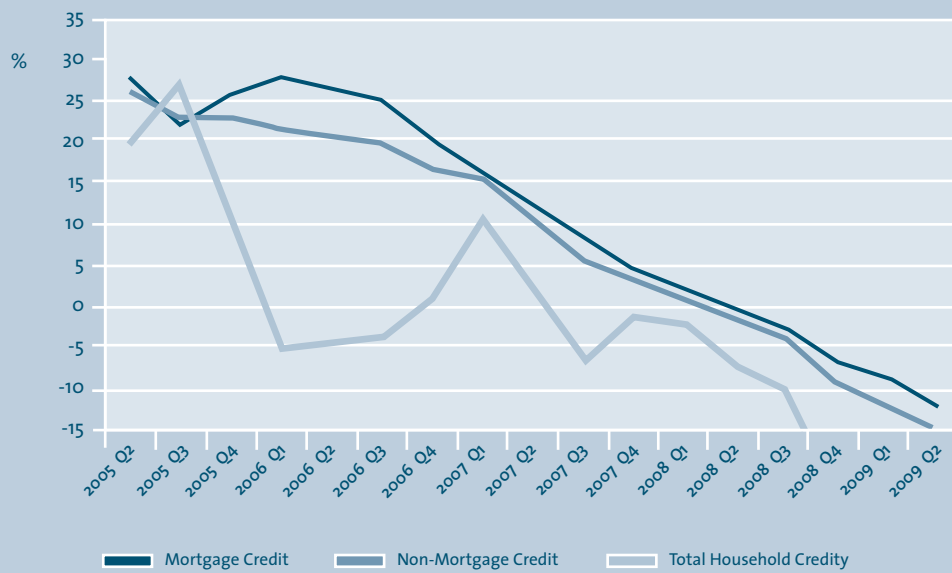


Figure 2 Household Credit Year-on-Year Change, Mortgage and Non-Mortgage



Source: Sectoral Developments in Private Sector Credit, June 2009, Central Bank and Financial Services Authority of Ireland

Figure 3 Credit Supply and Demand: SMEs

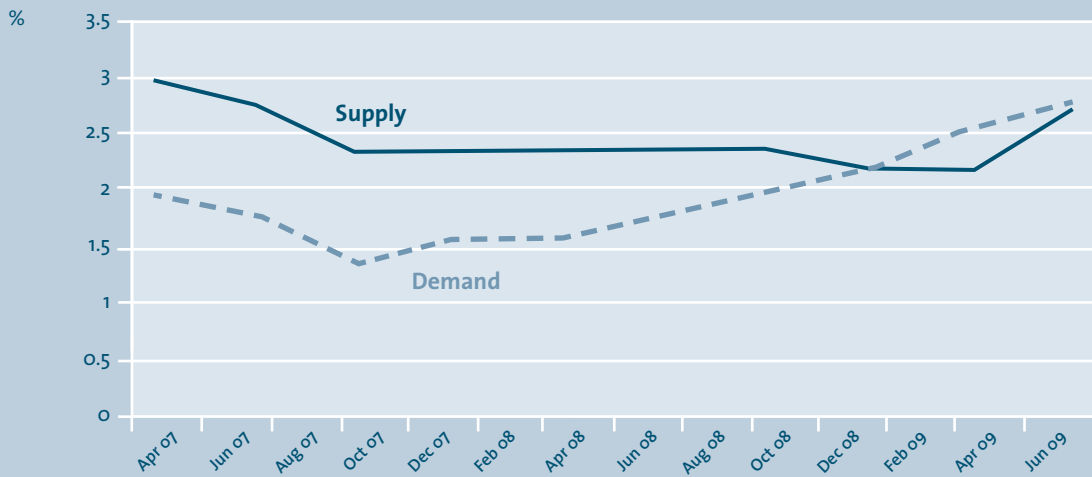
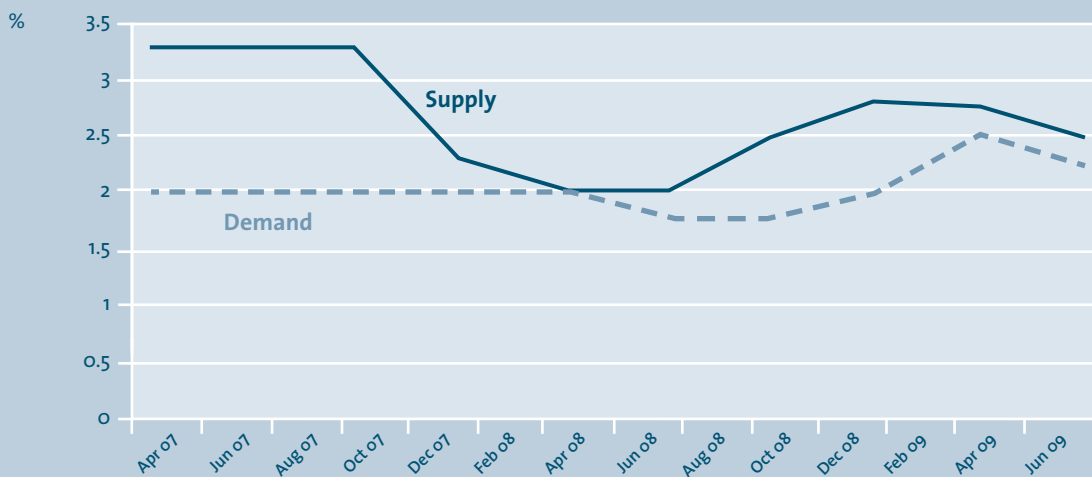


Figure 4 Credit Supply and Demand: House Purchase



Source Euro Area Bank Lending Survey, July 2009.

These two surveys together confirm that aggregate stocks and flows of credit continue to decline in the Irish economy. A causal factor is the impact of recession on the demand for credit on the part of both enterprises and households. In addition, with falling prices, real interest rates are higher than nominal rates.

However, it is also clear that tighter lending on the part of banks is also contributing. It is important that banks cooperate as fully as possible in keeping alive businesses during the current recession which, otherwise, have sound business models and good prospects, and that they resume lending into the Irish economy once there is a growing demand for credit. This implies that the reasons why banks may be reluctant be kept in focus and addressed.

The first of these is their need to recapitalise in the wake of having to absorb losses on their property-related lending. The greater the write-down on these loans, the more the banks must restore their capital to meet regulatory requirements, retain the trust of depositors and creditors and avoid management behaviour that becomes either too conservative or too reckless (Honohan, 2009). Banks that must give priority to increasing their capital are more likely to use funds and cash (from whatever source) for that purpose rather than to increase lending.

A second factor that militates against banks resuming lending on the scale required in the aftermath of a property collapse is their high loan-to-deposit ratios. These rose to unsustainable levels because of the banks' heavy recourse to borrowing on wholesale money markets. They loaned funds for long-term property-related developments, far in excess of their deposits, by borrowing short term funds on wholesale money markets which they believed they would be able to rollover indefinitely. They can reduce their high loan-to-deposit ratios through a combination of increasing deposits and shrinking their loan books. There is now strong competition to attract deposits, though low ECB interest rates and falling disposable household income are working against this objective. Non-Irish banks face even stronger pressures to reduce lending into the Irish economy than Irish banks. This is because their loan-to-deposit ratios on their Irish operations are higher, while they also face expectations, if not pressures, to extend lending in their home markets as a priority, particularly if they have been the beneficiaries of government support in their home market (McConnell, 2009).

A.2.4 The NAMA Project

By far the most significant Irish policy measure taken in response to the banking crisis is the creation of the National Assets Management Agency. Draft legislation on how NAMA would function was published for public consultation. Inevitably, the core decision to take the NAMA route was revisited during this wider consultation. To some extent, a trade-off became apparent between the value of continuing with resolute action in pursuit of a clear strategy and the value of reopening the original strategic choice so as to gain wider cross-party and popular support. The government underlined the advantage of taking swift action based on a body of evidence even when not all technical issues have been settled. Others emphasised the advantage of moving more slowly, garnering wider popular support and gradually seeking to reduce the number of uncertainties.

The public consultation on how NAMA should proceed has been active. Significant issues were raised. Among these were the idea that the banks should share some of the risk concerning the improvement in the Irish property market; and that the mechanisms for achieving this should include more than a levy which NAMA could invoke at the end of its life if it became clear that property prices were not going to recover sufficiently to justify the terms on which it first acquired the loans. In addition, the potential of NAMA to contribute to the achievement of public policy objectives in land management, social housing, public transport planning and other areas, has come into sharper focus. Less consensus was generated on how the loans which NAMA acquires should be priced, but the intricacies involved became more widely appreciated.

The vigorous debate on NAMA does not necessarily militate against the achievement of financially sound banks that operate sustainable, welfare-enhancing business models and enjoy the confidence of the Irish public. The broad contours of the discussion are briefly summarised below. Within financial institutions, the bodies that regulate and supervise them and NAMA itself, insights and concerns from the debate need to be internalised and acted on if the final objective is to be achieved.

As explained, NAMA is to replace property-related loans on bank balance sheets with government-guaranteed bonds. The proposal is to pay €7bn (or 15 per cent) above the estimated current market value of the loans on the basis that the land and properties that are collateral to the loans have a higher 'long-term economic value'⁵.

Government expects that several effects will result from this approach. It expects that this will reduce the scale of the banks' capital losses and, thus, lessen their need to recapitalise and the likelihood that they will require further State investment. It expects this approach to help to restore the banks as going private concerns and reduce the likelihood of further nationalisations. Government believes that, over a ten year period, NAMA will cover its costs; it estimates that Irish property and land prices need to recover over ten years to be 45 per cent below their 2006 peak values (in real terms) for NAMA to be profitable. They are currently 50 per cent below these values. In short, in the Government's view, paying the banks part of the excess of long-term economic value over current prices is an efficient strategy for keeping the need for further State equity investment to a minimum, boosting the value of the equity stakes the State has already acquired and, above all, bringing closer the time when the banks resume their normal functions as credit providers to the economy.

Some of the implications for the banks are relatively clear. Loans on which the interest payments have become highly uncertain or are already being rolled over (€9bn of their current €77bn book value, or 17 per cent, is rolled over interest), and for which collateral in the form of land and property is down by 50 per cent from its peak value, will be replaced by government IOUs on which the interest stream is guaranteed and whose redemption value on maturity guarantees them that a significant part of their original loans to property developers will be recouped. Only 5 per cent of the bonds are to be subordinated making their value to the banks conditional on recovery in property and land market prices. Furthermore, should

⁵ The validity of the concept of 'long-term economic value' is itself part of the debate on NAMA.

they so choose, the banks can use these NAMA bonds as collateral with the ECB to borrow cash. This borrowed cash could improve their liquidity and is available, in theory at least, to lend on into the Irish economy. In addition, the fact that the banks borrow the cash from the ECB for less than the interest they receive on the bonds (the government is to pay 0.5 per cent above the ECB rate) provides a small boost to their profit margins. It is true that the bonds the banks receive will be some 30 per cent below the book-value of their loans.⁶ As a result, their assets will shrink (though by less than 30 per cent on a risk-weighted basis), and they will record a significant book-keeping loss that will erode their capital and oblige them to seek fresh sources of capital. They may seek to replenish their capital from asset sales, rights issues or other means. If they have to seek further equity investment from the State, this will come at the price of ceding further control and direction and bring them close to being nationalised concerns.

The principal attraction to the State of the NAMA approach is that it could remove the principal grounds for mistrusting the soundness of the Irish banks. The substitution of NAMA bonds for property-related loans is expected to make depositing with, lending to, or investing in, the Irish banks less risky. It is hoped that they will be able to source funds once again on wholesale money markets, attract retail and corporate deposits and concentrate on profitable lending outside of the construction and property sectors.

Major challenges remain for the State in ensuring that NAMA is successful. It adds significantly to the level of State indebtedness, probably more than alternative routes, though such alternatives have not been subjected to the same scrutiny as NAMA. There remains the challenges of ensuring that the boost to banks' liquidity and financial soundness will lead to an improvement of credit conditions for the corporate (principally SMEs) and household sectors in Ireland. That will require both genuine reciprocity on the part of the banks and a recovery in the demand for credit within Irish economy. The successful management and administration of NAMA—valuing the individual loans (establishing their 'long-term economic value' independently from interested views), dealing with developers in a rigorous but fair and impartial manner, selling land and properties at the right time, balancing the need to ensure State debt is repaid with appropriate support for public policy objectives in social housing, strengthening the corporate governance arrangements within the NTMA (under whom NAMA is to operate), etc.—will require high levels of expertise and supervision in the public interest. Given its existing policy commitments, it seems likely that Government will want to refer to sustainable development principles in managing the NAMA portfolio. The National Spatial Strategy identifies principles for consolidation and development of urban areas and identifies a set of sustainability tests to be applied in assessing development proposals (DEHLG 2002).

⁶ From the time the loans were first made, their book value has been reduced by the degree of write-off which the banks have practiced but augmented by the significant rolling over of interest which has taken place.

A.3 The Fiscal Crisis

The recession has resulted in a pronounced deterioration in Ireland's public finances. Between 2007 and 2009 exchequer tax revenue is estimated to fall by €12.8 billion while total expenditure is estimated to rise by €11.1 billion, resulting in a major deficit in the public finances. In July 2009 the ESRI projected a general government deficit of €20.1 billion or 12.2 per cent of GDP. The exchequer deficit, which among other things also includes exchequer spending on bank recapitalisation, was projected by the ESRI to be €25.7 billion. This represents an exceptionally high level of borrowing and exceeds, for example, total current expenditure on health and education. The crisis in the public finances has meant a sharp increase in tax revenue allocated to paying national debt interest: this expenditure has risen from 3.8 per cent of exchequer tax revenue in 2008 to 9.4 per cent in 2009 and will continue to rise sharply in the years ahead. In the mid-1980s expenditure on debt interest was in the region of 30 per cent of exchequer tax revenue.

In its report of March 2009, the Council expressed its support for the target of reducing the government deficit to 3 per cent of GDP by 2013. The Council argued that action on the public finances needed to be assessed not only in relation to its impact on the deficit 'but also on how it is likely to impact on other key dimensions of Ireland's challenge: the economic crisis, the social crisis and the country's reputation' (NESC, 2009: 49).

A.3.1 Action Taken and Progress Made on the Public Finances

Since July 2008 major steps have been taken to address the crisis in the public finances. These are summarised in the box below. Action on the public finances has involved both substantial spending reductions and tax increases. Discretionary reductions of €4.9 billion were announced from July 2008 to the April 2009 Supplementary Budget and these have been primarily reductions in current spending. Tax increases of €5.6 billion were also announced, with a strong reliance on increased income tax and levies. The measures announced to date accumulate to in excess of 6 per cent of GDP.

Action on the public finances has been taken against the background of a deteriorating economic situation. In January a target deficit of 9.5 per cent of GDP was adopted for 2009. As economic data emerged, it soon became clear that this target would not be achieved without further large corrective action and concern was expressed that attempting to adhere to this target would be damaging. In the April 2009 Supplementary Budget a new target for the deficit of 10.75 per cent of GDP was adopted for 2009. Substantial budgetary measures were adopted in the April budget with a view to meeting this target (see box below).

Major Actions Taken on the Public Finances since July 2008

July 2008: Expenditure reductions announced with current value of €440 million and full year value of €1 billion. These include payroll savings of €260 million and cuts in areas such as advertising, public relations and procurement.

October 2008 Budget: €2 billion tax increases of which income tax accounted for €980 million, VAT €227 million and capital gains tax €160 million. Gross voted current expenditure was budgeted to increase by 3.6 per cent and voted capital spending to fall by 8.4 per cent.

February 2009: Expenditure reductions were announced of almost €2.1 billion comprising €1.79 current and €0.3 capital. The largest element was the pension levy on public servants with a gross value of €1.4 billion. Other savings included a reduction in overseas development aid of €95 million, reduction in professional fees of €80 million and general administrative reductions of €140 million. In addition, the postponement of the next scheduled pay increase under Towards 2016 in September 2009 was announced which will generate full-year savings of €1 billion in 2010.

April 2009 Supplementary Budget: Tax increases with a full year value of €3.6 billion, of which income tax, the health levy and PRSI contributed €2.8 billion. Current expenditure savings of €1.2 billion and capital expenditure savings of €576 million were announced. The major current expenditure reductions were as follows: social welfare (€400 million), replacement of early childcare supplement with provision for early childhood education (€180 million) and payroll savings of €300 million.

Cumulative announcements: July 2008 – April 2009:

Tax increases: €5.6

Expenditure reductions: €4.9 billion and €1 billion from postponement of proposed pay increases under Towards 2016

Total measures: €10.5 billion or 6.3 per cent of GDP.

All figures quoted refer to full year savings.

Public expenditure has continued to grow notwithstanding the reductions in many areas that have been put in place to date. This is due to the influence of other factors on spending, including the rise in unemployment and other demand-driven spending, as well as increased interest payments. Total current expenditure in 2009 is projected to increase by €5.1 billion (8.9 per cent), while exchequer tax revenue is projected to fall by €6.4 billion (-15.6 per cent). Gross voted current expenditure, which excludes debt service and covers expenditure on services and benefits, is projected to increase by €3.2 billion (an increase of 6 per cent) in 2009 while voted capital spending is projected to fall by €1.7 billion (-18.9 per cent).⁷

It is clear that major action has been taken to limit the growth in the deficit in the public finances. A key question to be considered is the extent to which the actions taken and further unavoidable retrenchment is consistent with addressing the other dimensions of Ireland's crisis (i.e. economic, social and reputational) and the other principles outlined by the Council above.

In July 2009 the report of the Special Group on Public Service Numbers and Expenditure Programmes, chaired by Colm McCarthy, published its report.⁸ The McCarthy report identified expenditure savings of €5.3 billion (primarily current spending). Its recommendations covered social welfare and other payments, public service employment and other non-pay expenditure. The Group highlighted the public service pay and pensions bill (although core pay rates were not within its terms of reference) as key issues in expenditure management. It recommended a reduction in public service staff of over 17,000 and called for rationalisation of many state agencies and other bodies.

The McCarthy proposals are very wide ranging. The major savings proposed are, however, concentrated in three departments: Social and Family Affairs (€1.8 billion, 35 per cent of all savings), Health (€1.2 billion, 23 per cent) and Education (€0.7 billion, 14 per cent). Taken together these three departments, which account for 80 per cent of current spending, represent 72 per cent of total savings proposed. The next biggest savings proposed are in Agriculture (€0.3 billion, 6 per cent). These four departments cover close to 80 per cent of all the proposed savings. The staff reductions are even more concentrated, with three quarters of the planned staff reductions allocated to health and education, which, of course, represent almost three quarters of overall staffing (excluding local authorities).

⁷ Figures in this paragraph are based on the April 2009 supplementary budget, the January 2009 Addendum to the Irish Stability Programme Update and the Revised Estimates to the Public Services, 2009.

⁸ Hereafter referred to as the McCarthy report.

Table 1 McCarthy Report: Proposed Savings

	€million	% of total	Staff	% of total
Social & Family Affairs	1,848	34.8	0	0.0
Health	1,230	23.2	6,168	35.5
Education	746	14.0	6,930	39.9
Agriculture	305	5.7	1,140	6.6
Sub-total	4,129	77.8	14,238	82.0
All other depts.	1,181	22.2	3,120	18.0
Total	5,310	100.0	17,358	100.0

Source *Report of the Special Group on Public Service Numbers and Expenditure Programmes*, Volume 1, Dublin: Government Publications (percentages have been rounded up).

The Commission on Taxation published its report in September 2009. The work of the Commission on Taxation was guided by a set of general principles: equity, flexibility, tax neutrality, simplicity, an evidence-based approach and pragmatism. As in the 1980s Commission on Taxation and the Council's advice over several decades, many of the current Commission proposals involve widening the tax base. The advantage of a broad tax base is that it minimises the tax rates required to achieve any given level of revenue. In adopting this approach, the Commission sought to position the tax system to support economic activity. The Commission also emphasised the desirability of designing the tax system in such a way as to minimize the volatility of tax revenue.

The Commission on Taxation did not recommend an increase in the overall level of taxation. Their general view was that revenue raised from its proposed measures should be used to reduce the tax burden in other areas. As such, its recommendations would not directly contribute to the reduction of the deficit. However, its wide ranging recommendations would make the tax structure more efficient and thereby contribute to the long term sustainability of the public finances and the economy. Whatever level of taxation is considered appropriate, the approach of the Commission on Taxation can contribute to shaping the structure of the chosen level of taxation.

A.3.2 The Public Finance Challenge

Correction of the Public Finances

The State at present is undertaking a very high level of borrowing to bridge the gap between expenditure and revenue. Following the April 2009 Supplementary Budget, the official projection was of a general government deficit of €18.4 billion or 10.75 per cent of GDP in 2009. Since then current expenditure has been close to the profile planned in the April budget but tax revenue has lagged projections. The ESRI projections for the deficit have been referred to above: a general government deficit of €20.1 billion (12.2 per cent of GDP) and an exchequer deficit of €25.7 billion (15.6 per cent of GDP). Ireland entered the current crisis with a relatively low public debt level. However, large deficits quickly produce large increases in public debt, before taking account of the banking crisis. Rising debt further accentuates the challenge of correcting the public finances, given the dynamic of rising interest payments. An ESRI report estimated that the general government debt to GDP ratio at the end of 2009 would be 57.5 per cent of GDP. The net debt ratio, which deducts the assets of the National Pension Reserve Fund (NPRF) and other financial assets, was estimated to be 34.2 per cent of GDP (Bergin *et al.*, 2009). These figures exclude the impact of NAMA. The treatment of NAMA in the public accounts is still being considered by Eurostat.

An economic recovery can be expected to contribute to reducing the deficit. This is one of the benefits from adopting measures that maximise the ability of the Irish economy to participate in any global economic recovery. The scale of the additional challenge to correct the public finances will depend on the extent and nature of Ireland's recovery. In the April 2009 Budget, the Department of Finance projected a continuing decline in GNP in 2010 (-2.8 per cent) and a return to growth in 2011 (2.5 per cent GNP growth), with growth averaging close to 4 per cent in the following two years. For 2010 and 2011, the April 2009 budget sets out the intention of introducing budgetary measures with a full year value of €4.75 billion in each of these years. An indicative allocation of these measures across tax and expenditure was included in the April budget statement, as shown in the table below, but this allocation remains to be decided. The projections presented in the April budget indicate that further budgetary measures would be needed in subsequent years in order to meet the Government's target of reducing the deficit to 3 per cent of GDP by 2013. These projections indicate a possible adjustment path to this target involving further measures of a cumulative €7 billion in the years 2012 and 2013.

**Table 2 Additional Annual Measures as Planned in Budget 2009
(Full year value)**

	2010	2011
Taxation	€2,500m	€2,100m
Current Expenditure	€1,500m	€1,500m
Capital Expenditure	€750m	€1,000m
Total	€4,750m	€4,600m

Source: Department of Finance (2009), 'Macroeconomic and Fiscal Framework 2009-2013'.

The ESRI has published recovery scenarios for the economy and the public finances. In a scenario based on an early global recovery in 2010, there would be a return to strong growth in the Irish economy from 2011, with GNP growth in the region of 5 to 6 per cent in the years to 2015. The planned budgetary measures for 2010 (as announced in the 2009 Budget) are incorporated in this scenario with a neutral fiscal policy pursued in subsequent years. This would result in a projected fall in the deficit to 3.3 per cent of GDP by 2015. The ESRI also presents an alternative scenario of prolonged recession in which the global economic recession persists into 2012. This, in turn, would delay economic recovery in Ireland and slow the adjustment of the Irish public finances. In this scenario, the same public finance assumptions would result in a deficit of around 5 per cent of GDP by 2015.

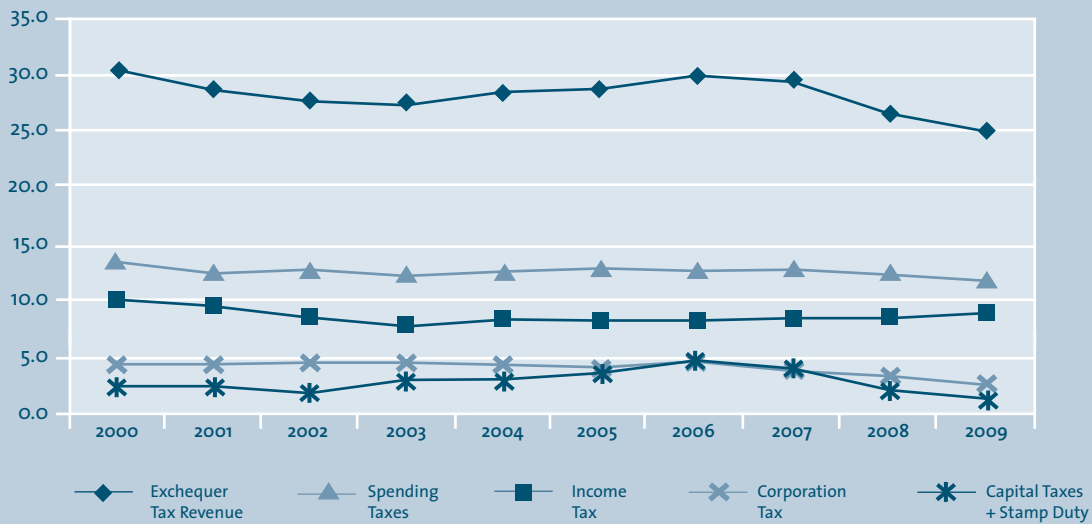
There is uncertainty at this stage as to how much additional budgetary action will be needed in future years to address the deficit. For 2010, however, automatic correction is not expected so that substantial budgetary measures will be required for 2010 to reduce the deficit as indicated in the April 2009 budget.

There are significant policy choices to be made on the measures used to correct the deficit. In the first instance there is a choice in the balance between expenditure and tax. Within expenditure, there are choices as to balance across measures with regard to services, employment, public service reform, pay rates and capital expenditure. For 2009, the allocation of expenditure across major categories of voted current spending is approximately as follows: pay and pensions (€19.8 billion, 35 per cent), social welfare (€21 billion, 37 per cent) and all other expenditure (€15.8 billion, 28 per cent). In addition, there is exchequer capital spending of €11.2 billion and central fund expenditure (debt service and EU contributions) of €5.9 billion.

In the years prior to the economic crisis, the tax share of GNP became increasingly reliant on stamp duties and capital taxes. The share of these taxes in GNP increased by just almost percentage points between 2002 and 2006 (see Figure 5). Since 2006 the exchequer tax share of GNP has fallen by over five percentage points. This sharp fall has been caused by a reversal of the earlier rise in the share from stamp duty and capital taxes (a fall of 3.3 percentage points) as well as a sharp fall in corporation tax revenue (a fall of 1.7 percentage points); spending taxes also fell by 0.8 percentage points. The income tax share has increased in this period.

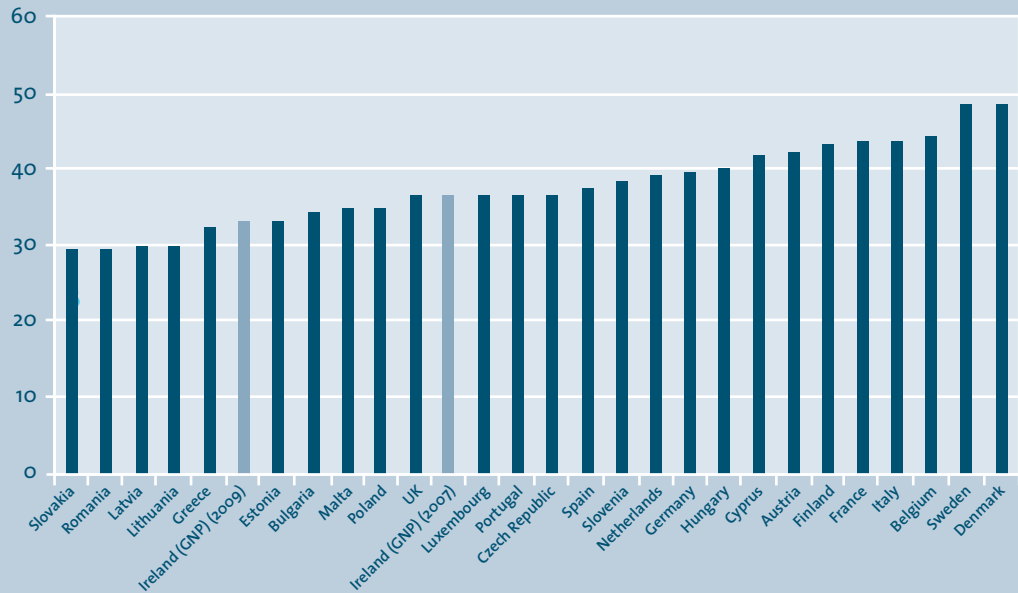
The increased reliance on capital taxes during the boom left the public finances vulnerable to recession. Revenue from capital taxes can be expected to increase in an economic recovery, but it would not be feasible or desirable to return to the same degree of reliance on the type of capital taxes that were a feature of final years of the economic boom.

Figure 5 Exchequer Taxes as a Percentage of GNP



Source Based on Department of Finance data, provided by the Commission on Taxation. Capital taxes refer to capital gains and capital acquisitions tax. Spending taxes refer to VAT and excise duties. Non-exchequer taxes (including PRSI and local authority rates) are not included.

Figure 6 Tax Share of GDP/GNP



Source Eurostat (2009), Taxation Trends in the European Union. The GNP-based figures for Ireland are NESG calculations.

In 2007 the tax share of GDP (defined comprehensively to include PRSI) in Ireland was estimated by the European Commission to be 31.2 per cent of GDP, equivalent to 36.7 per cent of GNP.⁹ If the GNP measure is used, this placed Ireland three percentage points below the GDP-weighted average for the EU (27).¹⁰ The major long-standing factor in Ireland's below-average share of tax in GDP/GNP is below average social security contribution. It is estimated by the European Commission that since 2007 Ireland's tax share has fallen to 27.7 per cent of GDP (33.0 per cent of GNP) in 2009, which represents an exceptionally large fall in tax revenue. The fall in Ireland's tax revenue share of GDP/GNP over the past two years, despite increases in income tax, is due to the decline in revenue from corporation tax, capital taxes, stamp duty and spending taxes. When the 2009 figure is used for Ireland in Figure 6 above, it would appear that Ireland's tax share of GNP is now among the lowest in the EU (27). There is scope for the tax share of GNP in Ireland to rise without making Ireland a 'high tax' country. Some rise in the tax share of GNP can be expected to occur with economic recovery but, in view of the reliance on exceptional revenue induced by the housing boom, not all of the fall in tax share is likely to be reversed automatically.

9 Neither GDP nor GNP is an ideal measure of the total tax burden in Ireland. The disadvantage of GDP is that it includes profits of multinationals that are not part of the tax base insofar as most taxes are concerned. However, the limitation of using the tax/GNP measures is that this includes corporate taxes on multinationals while these profits are not part of GNP. Hence the tax/GNP measure overstates the real level of the tax burden for Ireland.

10 The GDP-weighted average for the tax/GDP share for the EU (27) in 2007 was 39.8 per cent. The arithmetic average was 37.5 per cent.

While Ireland's tax share of GDP/GNP has fallen, the share of general government expenditure in GDP/GNP has increased dramatically. It is estimated by the European Commission that Ireland's expenditure/GDP share increased from 35.7 per cent of GDP in 2007 to 45.8 per cent in 2009. The gap between Ireland's expenditure share of GDP and the EU (27) average (50.1 per cent of GDP) has narrowed considerably and on a GNP basis general government expenditure in Ireland (54.6 per cent of GNP) now exceeds the EU (27) average.

The discussion so far has not considered the impact of action to address the banking crisis on the public finances. Additional interest costs will arise from the bonds issued to buy loans from banks and a substantial increase in the national debt. On the other hand, interest income will arise on the loans taken over by NAMA. In addition, some revenue will arise from capital repayments or from asset recovery that can be used for repayment of bonds. Significant expenditure could be incurred in capitalisation of banks but over time this could also yield significant revenue. The net impact cannot be determined at this stage.

While further correction of the public finances is essential, it is not sufficient. An even bigger challenge is to address the public finances in a manner that is consistent with tackling the economic, social and reputational dimensions of Ireland's crisis. Action on the public finances needs to be guided by a vision of what is desirable for Ireland's economy, society and environment. In its March 2009 report, the Council's identified a number of principles, cited in Chapter 2 of the main report.

Process

The task of designing and implementing a suitable package of measures to correct the public finances while meeting other objectives is a clearly a complex one. This task is undertaken by government departments with political guidance. The important McCarthy report represents an additional source of advice that can influence this process. The approach adopted by the McCarthy group was as follows. Each government department was invited to submit an evaluation paper to the Group which would outline exchequer money received, outputs and public service impacts produced and possible options for reducing expenditure. At the same time, the Department of Finance vote sections (which monitor spending) were also invited to prepare evaluation papers with recommendations for reducing expenditure. Both sets of papers were considered by the Special Group who then conducted meetings with the management teams of each department. This process yielded proposals for major spending reductions. In Chapter 3 of the main report, the Council highlights the importance of now finding a process that can take forward the project of fiscal adjustment, taking appropriate account of the social and economic dimensions of the crisis. In doing this, several dimensions are worth considering. These include the degree of centralised control, the expertise of front line service staff, the degree of devolution of responsibility to harness the benefits of local flexibility, and whether the process is likely to overcome the problems that have dogged the management of public expenditure in Ireland for some time.

The McCarthy report found that the public service was insufficiently focussed on how public resources are allocated, how efficiently they are spent and what results are being achieved. There are numerous examples throughout the report of opportunities to reduce spending without adversely affecting services.¹¹ In addition to recommendations to reduce spending, the McCarthy report also made several proposals which it believed would secure ongoing improvements in the management of public expenditure:

- ◆ Public service performance charters for new spending proposals setting out the business case, resources needed and output/impact indicators required to measure success.
- ◆ Cost benefit analysis of all significant expenditure proposals should be undertaken and published. Capital projects above €30 million should be subject to 'look back' evaluations to check realised costs and benefits against the original proposals.
- ◆ Sunset clauses for all spending programmes whereby programmes would be wound down after period unless there was evidence of clear positive results.
- ◆ Use of cash limits for grant schemes.
- ◆ Annual estimates should be published on programme basis consistent with annual output statements.
- ◆ Development of improved competency to evaluate and challenge programmes and enhanced integration of policy reviews into the resource allocation process.
- ◆ A stronger role for the Comptroller and Auditor General (C & AG) to include auditing of output statements in respect of outputs delivered and the efficiency and effectiveness of delivery. A similar recommendation was also recently made in an international peer review of the C & AG office.

An earlier NESC (2002) study also found weaknesses in the management of public expenditure. A key conclusion was that the system of public expenditure management should have greater strategic focus. This study identified the need for a stronger link between strategic priorities and expenditure allocations and to encourage spending departments to take a more strategic focus outside their own immediate areas. The need to develop a stronger evaluation culture was highlighted, including making greater use of evaluation in decision making. It has recently been argued by Boyle (2009) that the key weakness in evaluation is now on the demand side: notwithstanding rhetorical support, he argues that the practical demand for evaluation is quite low, as illustrated for example in the lack of interest by Oireachtas committees in the findings of value for money or policy review.

¹¹ Examples of such spending include the following. Numbers in brackets refer to page numbers in the McCarthy report. In addition to basic public service pensions there are 'added years' arrangements in parts of the public service; for example, a high court judge, who might typically be appointed to the bench at 50 years of age is entitled to a full pension at age 65, an effective 25 years added service (Volume 1: 7). In regard to services provided under the General Medical Service (GMS) the McCarthy report found that the 'representative bodies enjoy a veto-like power over the introduction of new services or expansion of existing services' (Volume 2: 139). It recommended phasing out of existing GMS contracts and their replacement with new contracts. In relation to hospital beds it pointed to the potential for a major reduction in acute hospital beds if integrated health care were implemented (Volume 2: 139).

In its March 2009 report the Council emphasised the desirability of placing more emphasis on output and outcome indicators in the management of public expenditure. Drawing on evidence in NESDO (2009), it was noted that many public sector organisations at the delivery end — and even more so voluntary organisations that are contracted by statutory bodies — are already undertaking in-depth review of their own practise, achievements and failures. This can yield real benefits in term of improving the effectiveness of services. Where this is happening, the Council argued, it requires changes in the central government department or agency to be able usefully absorb such rich information. Where it is not happening, the Council argued, ‘the centre should impose the obligation that it begins right away’ (NESC, 2009: 96).

In making spending adjustments over the coming months and years, a balance will need to be struck between inevitable increase in central control, on the one hand, and the real benefits of well-designed devolution, on the other. These have been identified by NESC (2009) and, in greater depth, in the NESDO Futures Ireland study (NESDO, 2009). The case for a devolved approach was summarised by the Council as follows:

A problem-solving partnership-based approach which enables organizations overcome the enormous challenges they now face and which creates more local ownership of the problem and the solutions is essential. Local ownership of the problem and the solutions should be enabled by allowing, in so far as it is possible, the devolution of responsibility and decision-making to the local level. For example in identifying savings, public sector organisations should be empowered to advance their own proposals and be encouraged to engage with all staff in their own organisations to come up with viable proposals within agreed budgetary parameters (NESC, 2009: 96).

It is also worth considering institutional reforms that could enhance the formulation of fiscal policy, with a view to ensuring its sustainability beyond the current crisis. This could include mechanisms for expert critique of fiscal policy proposals in the policy process. In recent years Sweden has established a fiscal policy council comprised of experts that assesses the extent to which the objectives of policy are being achieved.

A.3.3 Conclusion

Major action has been taken to address the crisis in Ireland’s public finances; discretionary fiscal measures announced since July 2008 accumulate to in excess of 6 per cent of GDP. Despite this, there continues to be a huge gap in the public finances with the likely level of exchequer borrowing in 2009 in the region of €25 billion. It is vital that timely action is taken to reduce the deficit. Beyond addressing the current crisis it seems important to introduce structural and institutional reforms to improve the formulation of fiscal policy and management of public expenditure.

A.4 The Economic Crisis

This section looks at some of the actions taken to address the economic and competitiveness crisis and the challenges now facing the Irish economy. Following a discussion of recent actions, it examines recent economic developments, employment, business performance and competitiveness. Table 3 lists the main actions taken since March 2009.

**Table 3 Economy/ Competitiveness: Actions Taken
March – September 2009**

Enterprise Stabilisation Fund (€100m) (March 2009)
Employment Subsidy Scheme(€250m) (August 2009)
Technology Actions to Support the Smart Economy (August 2009)
Review of Lending to SMEs – Mazars Report (June 2009)
Work Placement Programme (2000 places) and Short-time Working Training Programme (277 places) (May 2009)
High Level Action Group on Green Enterprise (May 2009)
Establishment of 7 Industry Led Competency Centres – (May 2009)
Credit Supply Clearing Group (May 2009)
Announcement of increased activation and training places 128,000 (April 2009)
Irish Economic Summit Farmleigh – Diaspora (September 2009)

A.4.1. Action Taken on the Economic Crisis

Actions taken to address the crisis in employment have focused on efforts to support those becoming unemployed and measures to keep people in employment. The former are dealt with in Section A.5 on the social dimension of the crisis. However, it is likely that much more needs to be done to support those losing their jobs. For example, just 1,371 additional places have been created in FAS Training and Employment courses since July 2008.

In relation to supporting those in jobs there are two principal schemes. First, the Enterprise Stabilisation Fund, announced in March 2009, provides total funding of €100m to enterprises that are experiencing difficulties. The funding is provided primarily through preference shares, repayable after 5 years and typically at a 3 per cent coupon rate. The key criterion is that the business must have been in a viable position before the beginning of the current crisis. Funding is provided to businesses that are judged to have a viable medium-term future and an ability to increase exports as the world economy improves. The funding is provided for specific projects. Second, the Employment Subsidy Scheme, announced in August 2009, provides funding of €250m, €60 million of which is allocated for 2009. Similar criteria apply in terms of export focus and recent performance. The key difference is that funding is provided not for projects but to subsidise employees' wages. The maximum subsidy for an employee is €9,100 over 15 months. The subsidy reduces over the 15 month term from €200 per week to €50 per week in the final quarter. The maximum subsidy for any company is €500,000, but this may be reduced depending on the level of grants previously received. The closing date for applications was September 4th 2009. Applications were received from around 700 companies.

It is not yet clear how business has responded to these schemes and the extent to which the schemes are achieving their objectives. In addition, given the scale of the job losses it seems likely that other initiatives and ways of supporting and creating new employment will be explored by government, business and trade unions.

A key challenge is finding ways to support more exporting firms, import competing firms, entrepreneurs and local enterprises and 'export nurseries'. It would be important in this context to analyse the full range of supports available to support business development and to look at ways that resources might be re-directed to respond to the crisis.

There are also long-standing factors. The Government has maintained its commitment to research and development. A key strand of activity in terms of supporting economic renewal in Ireland is the Government's strategy *Building Ireland's Smart Economy* launched in December 2008. An Innovation Taskforce has been established (July 2009) to make this strategy a reality. A key part of the taskforce's remit is how to position Ireland as an international innovation hub.

A.4.2 Recent Economic Developments

The annual decline in the Irish economy for 2009 is expected to be one of the largest in the OECD in 2009. The average Irish economic forecast as published by DKM in September 2009 was for a fall in GNP of 9.3 per cent and in GDP of 8.3 per cent in 2009. For 2010, the average forecasts were for declines of 2.9 per cent for GNP and 2 per cent for GDP. The unusually severe decline in the Irish economy is due to the sharp fall in domestic demand. Total exports have performed surprisingly well in this crisis although there has been a sharp fall in traditional exports and some high-tech goods exports (see below). Nevertheless, much of the manufacturing sector has been severely affected by the recession.

All types of domestic demand will fall in 2009. Private consumption is the largest component of domestic demand and the average DKM forecast for 2009 is a fall of 8 per cent in this component of demand. The decline in consumer spending is due both to the fall in employment and a substantial increase in personal savings. The level of personal savings had fallen to a low of 3.2 per cent of personal disposable income in 2007, but is projected by the ESRI to be over 10 per cent in 2009 and 2010. Investment is showing a steep fall in 2009; the average DKM projection is for a fall in investment of over 30 per cent in 2009 followed by a further fall in almost 16 per cent in 2010. The ESRI expects housing completions to fall by over 60 per cent in 2009 (to 20,000 units) and a further fall of over 37 per cent in 2010 (to 12,500).

Annual growth rates can be misleading in understanding turning points in the economy (White, 2009). This is because annual rates are strongly influenced by what are known as 'carryover' effects. It was estimated in the ESRI *Quarterly Economic Commentary* (Summer, 2009) that if there were no further declines in the economy after the first quarter of 2009, the declines that had already taken place would imply an annual fall in GDP of 5.8 per cent and in GNP of 8.5 per cent. Carryover effects are also a significant factor in forecasts for 2010.

The most recent evidence from the quarterly national accounts shows that the pace of economic decline is slowing and it could be the case that the economy is approaching a stabilisation point. In the first quarter of 2009 the quarterly decline in GNP was 5.6 per cent, a very steep fall. In the second quarter, the fall was much lower at 0.5 per cent. GDP fell by 2.3 per cent in the first quarter and was stable in the second quarter. A notable feature of the second quarter national accounts is a modest recovery in real consumer spending (0.5 per cent), following the very sharp fall of over 5 per cent in the first quarter. The real volume of exports of goods and services in the second quarter was broadly unchanged; there is huge diversity across different export sectors, as discussed below. Real investment spending also increased in the second quarter. This was due to increased investment in machinery; building and construction continued to decline in the second quarter and this is expected to continue into next year.

The fall in domestic demand has resulted in imports falling by more than exports. This has led to a sharp reduction in the balance of payments deficit. In 2008 the deficit on the current account of the balance payments exceeded 6 per cent of GNP, while for 2009 the ESRI projects a deficit of less than 1 per cent, and a surplus in 2010. The small deficit in the balance of payments is an indicator of the economic sustainability of the Irish economy—notwithstanding a very large government deficit. In international terms the country is moving rapidly to a situation in which it is paying its way. The large government deficit is mostly offset by a surplus of saving over investment in the private sector.

There is potential for the Irish economy to gain considerably from global recovery, although the weakness of domestic demand means that Ireland's recovery is expected to lag any global upturn. Analysis in the last ESRI Medium Term Economic Review (Fitz Gerald *et al.*, 2008) showed that the impact of growth in global demand today is considerably higher than it was in 1990. It was estimated that a 1 per cent shock to world demand in 1990 would raise Irish GNP by 0.85 percentage points above what it would be (by 1994), while a comparable shock to demand in 2006 would raise Irish GNP by 1.32 percentage points. This is due to structural changes in the Irish economy that have made it more integrated into the global economy. In particular, the increased significance of international services is a major additional link between the Irish economy and global markets. Almost one third of the impact of a rise in global GNP on the Irish economy would now come through international services, compared to just 12.3 per cent in 1990. Manufacturing is still the largest channel of influence and almost 57 per cent of the impact would come through this sector, down from 68 per cent in 1990. Tourism would now account for 11 per cent of the impact on the Irish economy of a global rise in demand.

A.4.3 Employment and Unemployment

In Ireland the impact of the recession is most dramatically evident in the fall in employment and the rise in unemployment. Total employment fell by almost 175,000, or 8.2 per cent, in the year to the second quarter of 2009 (see Table 4). The decline in full-time employment was even higher at 190,000 or 11 per cent. The steepest decline was in construction, with a fall in employment of over 35 per cent (86,700), while employment in manufacturing fell by 10 per cent (29,200) and in agriculture by 15 per cent (17,700). Employment in services fell by around 3 per cent, but within this there was huge variation. Employment in professional and business services fell substantially, but there were gains in employment across other service sectors. These included the sectors in which public employment dominates (health, education and public administration), but also financial services, transport, information & communications.

In an international comparative perspective, Ireland's labour market has been harder hit by the current crisis than most other OECD countries. By the end of July 2009, Ireland had the second-highest unemployment rate after Spain and its unemployment rate had risen by more than in any other OECD country since December 2007 (OECD, 2009).

The quarterly employment trends show that the pace of decline in employment is slowing. The highest fall in employment was in the first quarter of 2009, with a fall in total employment of 3.4 per cent (seasonally adjusted). The fall in the second quarter was roughly half this rate at 1.8 per cent. Again the sharpest fall was in construction (12.9 per cent). Total services employment was broadly stable (assisted by gains in health and public administration) and there were also gains in three private services sectors (transport, hotels and restaurants and financial services).

The rate of unemployment in September 2009 was 12.6 per cent. In September 2009, 429,400 people were on the Live Register, up from 245,800 in the September 2008. There are some signs that the pace of unemployment growth is easing, with a seasonally-adjusted monthly increase in the Live Register in September 2009 of 600 people. The number of redundancies has fallen each month since May of this year. Nonetheless, absolute numbers remain high, with 5,914 redundancies in August compared to 3,147 in August 2008.

Table 4 Employment Trends by Sector

	Annual % Change, Second Quarter 2009	Annual Change in '000s, Second Quarter 2009	Quarterly Change in '000s, Second Quarter 2009	Quarterly % Change, Employment, Quarter 2009	Second Quarter 2009 (000s)
Agriculture etc	-15.3	-17.7	-4.3	-4.2	97.8
Manufacturing	-10.1	-29.2	-7.5	-2.8	259.9
Construction	-35.4	-86.7	-23.5	-12.9	158.0
Wholesale and retail trade	-9.7	-30.0	-4.1	-1.4	279.8
Transport and storage	1.8	1.7	1.1	1.2	94.2
Hotels and restaurants	-4.3	-5.4	1.4	1.2	119.6
Information and communications	3.4	2.4	-0.2	-0.3	72.2
Financial services	3.2	3.4	2.9	2.8	108.3
Professional services	-12.2	-14.2	-2.5	-2.4	102.5
Administrative services	-13.5	-10.3	-0.4	-0.6	66.1
Public admin and defence	4.9	5.1	1.0	0.9	108.2
Education	2.7	3.9	-1.4	-0.9	148.0
Health	3.2	7.1	5.5	2.5	228.6
Other services	-5.7	-6.1	-1.5	-1.5	100.1
All services	-2.9	-42.4	1.8	0.1	1,427.6
Total	-8.2	-174.2	-36.3	-1.8	1,944.9

Source: CSO (2009), *Quarterly National Household Survey, Second Quarter*.

A.4.4 Business Performance

Turning to business performance in the crisis there are some positive signs, though headline figures are masking some important underlying difficulties.

The fall in Ireland's exports has been considerably lower than that experienced by Ireland's trading partners. In the *OECD Economic Outlook* of June 2009, Ireland's exports were projected to fall by 10.4 per cent in 2009. This was the seventh lowest fall among 30 OECD countries and well below the average fall of 16.5 per cent. The OECD also projected that Ireland's exports would fall by less than the decline in Ireland's export markets.¹² Other economic forecasters are more optimistic about Ireland's export performance in 2009. The average fall in exports projected in the DKM survey of forecasts is 4.7 per cent. Emerging data suggests that the outcome will be better than forecast; in the first half of 2009 the real annual decline in exports was 2.8 per cent, while the value of export revenue was broadly unchanged.

¹² Export performance is defined as the gap between growth of export volumes and the growth of export markets for goods and services. The OECD estimated that Ireland's export performance would be an increase of 4.8 per cent in 2009; i.e. Ireland's exports were projected to fall by 4.8 percentage points less than the fall in export markets.

The relatively strong total export performance is driven by pharmaceuticals, medical equipment and some services exports. Merchandise exports rose 2.5 per cent in value terms year-on-year in the first half of 2009. Table 5 outlines the relative performance of Irish export sectors and shows the growing dependence on 'chemicals and related products.' In the period January to June 2009, this sector accounted for 58 per cent of goods exports, up from 52 per cent in the same period the previous year. However, the strong performance of this sector masks some very dramatic declines in other sectors, in particular food (-12 per cent), office machinery (-27 per cent) and electrical machinery (-28 per cent).

Table 6 provides an overview of the data in relation to exports of services. The overall level of exports has performed well, with levels in the second quarter of 2009 down just 2 per cent on the same quarter in 2008. When one considers that services include financial services and insurance, and that these are a significant component (22 per cent in 2008) of Irish service exports, then this is a good performance. Business services, which accounted for 31 per cent of service exports in 2008, continue to perform strongly; exports increased 4 per cent over the same period in 2008. Business services include merchanting (sales of goods that do not enter the country), operational leasing, and other services such as market research, R&D, architectural and engineering and management services. However, the figures do illustrate that there are sectors which are experiencing very difficult trading conditions, in particular financial services, insurance and tourism.

Table 5 Merchandise Exports from Ireland 2008 to 2009 (€million)

	Jan - June 2008	Jan - June 2009	% change
Food and Live Animals	3,486	3,060	-12
Beverages and Tobacco	526	459	-13
Crude materials - except fuel	698	415	-40
Mineral fuels	425	320	-25
Animal and veg oil	22	9	-59
Chemicals and Related Products	22,368	25,659	15
Metal articles, wood products etc	870	614	-29
Machinery and transport goods	9,389	7,283	-22
Misc Manufactured Articles	4,215	4,595	9
Commodities not elsewhere	932	1,383	48
Unclassified	316	525	66
Total Merchandise Exports	43,245	44,321	2

Source CSO (2009). External Trade June 2009 Provisional Details. September 24th 2009.

Table 6 Service Exports from Ireland 2008 and 2009 (€million)

	Q2 2008	Q2 2009	% change
Transport	808	808	0
Tourism and Travel (Tourism Receipts)	1161	1019	-12
Communications	127	117	-8
Insurance	2103	1751	-17
Financial Services	1757	1621	-8
Computer Services	5968	5919	-1
Royalties/ Licences	156	293	88
Business Services	5181	5373	4
Other Services	91	127	40
Total Service Exports	17353	17029	-2

Source: CSO (2009). Balance of International Payments, Quarter 1 2009, June 30th 2009.

The trends in goods exports are reflected in manufacturing output growth. The annual change in total manufacturing output in the second quarter of 2009 was a fall of 2 per cent. This represents a strong performance in view of the global and domestic economic environment. There is, however, a marked divergence in performance within the manufacturing sector. In the 'modern' manufacturing sector output in the second quarter grew by at an annual rate of 10 per cent, while in the 'traditional' sector it fell sharply by over 14 per cent. The output growth in the 'modern' sector was mostly due to chemicals. Computers and electrical equipment showed sharp declines in output. The fall in output in 'traditional' manufacturing is exceptionally high. Even this rate of decline understates the underlying decline across most 'traditional' manufacturing sectors, as 'traditional' manufacturing is boosted by the category 'other foods' which includes cola concentrate. The annual fall in output in five sub-sectors within 'traditional' manufacturing exceeded 40 per cent in the second quarter of 2009. The decline in employment in manufacturing, of over 29,000 over the year to the second quarter of 2009, is almost double the entire decline in employment over the period from 2000 to 2007 (a fall of 15,000). The manufacturing sector is being affected both by difficulties in exporting and the sharp fall in construction demand.

The international environment for investment remains extremely challenging. Nonetheless, foreign direct investment into Ireland increased by 22 per cent in 2008, and according to the IDA, the outlook for 2009 remains positive. This is a very positive factor and suggests that despite the crisis Ireland remains an attractive location. IDA continues to target high-end manufacturing activities and services and many of the recent investments highlight Ireland's attractiveness as a location for activities such as R&D centres and operational/supply chain hubs.

We note below that Ireland's competitiveness, as measured by the World Economic Forum, has declined in 2009. However, the report also notes some of the ongoing strengths of the Irish economy: 'FDI and technology transfer' (ranking 1); 'sophistication of firms operations and strategy' (18); 'quality of scientific research institutions' (16); 'university–industry collaboration' (13); 'transparency of government policy making' (13); 'quality of the educational system' (8) and 'inflation' (8) (WEF 2009). It is also important to note that Ireland has scored reasonably well in recent surveys of innovation. In a summary index compiled by the European Commission Ireland scored above the EU average. Irish firms outperform the EU average in the proportion of turnover derived from '*new to the market*' innovations (European Innovation Scoreboard, 2008). However, Irish firms are less likely than their EU counterparts to be involved in creation of new products, services or processes. The innovative performance of service firms is significantly weaker than manufacturing firms. In addition, studies of entrepreneurship find that Ireland performs well in relation to other countries (Global Entrepreneurship Monitor, 2009). However, insufficient numbers of these start-ups develop into viable indigenous businesses with strong export potential.

A.4.5 Cost Competitiveness

Irish cost competitiveness is improving, albeit slowly. There is evidence that costs are reducing. The HICP fell at an annual rate of 2.4 per cent in August and the corresponding fall in the CPI was 5.9 per cent. The fall in consumer prices over the past year (to August 2009) in Ireland is the largest in the euro area.

There are mixed signals emerging in relation to earnings and pay and this requires further analysis. While weekly earnings are decreasing in some sectors (most notably in the financial sector), hourly rates may be holding up in others. Between the first quarter in 2008 and first quarter in 2009, hourly labour costs in the industrial sector rose by 9 per cent. At time of writing, 2009 earnings data were not available for construction, retail, wholesale or hospitality, which accounted for 75 per cent of all jobs lost in the year to the first quarter of 2009. When available in October, data relating to these sectors will help to give a clearer picture on earnings trends.

Forecasts earlier this year by the European Commission predicted that unit labour costs across the euro-area would increase by 3.4 per cent in 2009. It predicted that during the same period Irish unit labour costs would decrease by 4 per cent, providing a strong boost to Irish competitiveness. The emerging data would not suggest that a relative adjustment of this scale is occurring. In the first quarter of this year, average weekly earnings for the average industrial worker increased by 1.4 per cent relative to the first quarter in 2008. This was lower than the rate of increase in other European countries: across the euro-area wages and salaries grew by 3.4 per cent compared with first quarter in 2008; and the second quarter was 3.9 per cent higher (Eurostat, 2009). There is also potential for productivity growth in Ireland to be somewhat stronger than the euro average this year, which would contribute to lower unit wage costs.

In an analysis of possible recovery scenarios for Ireland, Bergin *et al.* (2009) examined how wages might adjust in the current crisis and a subsequent recovery. Based on a standard model of wage formation, it was suggested that nominal wages would fall by a cumulative 6 per cent over the period 2009-2011 in the context of a global recovery. It was acknowledged, however, that such nominal wage falls have not been experienced before in Ireland. It was estimated that for every one percentage point that wages were above the forecast level, the long term impact on unemployment would be to raise it by 0.6 percentage points.

Non-pay costs remain stubbornly high. The prices of some services have increased over the last year. Over the 12 months since August 2008, the cost of education and health increased by 3.9 and 2.7 per cent respectively. Transport costs increased over the three months to August, but had decreased since August 2008. The National Competitiveness Council (NCC) has shown that significant service costs facing business—in particular electricity, broadband, waste disposal, professional and legal services—remain very high in comparison to other countries. Ireland remains an expensive location for renting industrial property (second most expensive out of 16 countries) and for the construction of industrial and office units. Ireland was third most expensive out of 13 countries for the construction of industrial units and fourth most expensive for office units. There was a large fall in office rents of 25 per cent in 2008 and Ireland's relative position has improved on this measure (NCC, 2009). Other costs facing employees and others, such as childcare, remain among the highest in Europe (OECD, 2007).

The euro/sterling exchange rate has fluctuated considerably over the last 12 months (www.ecb.int). In September 2008 the euro was worth around £0.8. The euro weakened considerably until the end of 2008, finishing the year at close to parity with sterling (€1=£0.95). This created very significant pressures for businesses dealing with the UK. In 2009 the euro has continued to fluctuate against sterling. It fell back to £0.89 by the end of February, strengthened again in March but fell to £0.85 at the end of June. However, since the summer of 2009 the euro has strengthened considerably again. At the end of September the euro was worth £0.91. As was evident in the early part of 2009, this creates very significant challenges for Irish exporters and those competing with imports from the UK.

The euro has also fluctuated against the dollar. The euro weakened against the dollar through the early part of 2009, to reach \$1.26 at the beginning of March. Since then it has strengthened and at the end of September of this year the dollar was valued at \$1.46.

Finally, Ireland's competitiveness, as measured by the World Economic Forum, has declined over the past year. Ireland is now ranked 25th, down three places on 2008. The report noted that the biggest problem facing businesses was access to finance: 25 per cent of firms ranked this as its main problem resulting in a ranking of 64 for Ireland (WEF, 2009). Section A.2 on banking discusses the issue of credit availability. The other factors linked with decline in the overall index were 'government surplus/deficit' (ranking 125); 'soundness of banks' (121); 'flexibility of wage determination' (127) and the 'quality of infrastructure' (65).

The evidence suggests that while there is some cost competitiveness improvement it is modest. As pointed out in Section A.2 there is an economic need to achieve

stabilisation in the banking system. Access to credit is still a critical barrier to economic growth. Government and its agencies will undoubtedly be anxious to look beyond stabilisation to consider the way finance is provided to business, including for start-ups/entrepreneurs.

A.5 The Social Crisis

A.5.1 Introduction

Economic history (our own and that of other countries) warns us that the social impacts of housing collapses and recession can be the most damaging and the longest lasting. As 2009 has worn on, more has been learned about the impacts of the current crisis on jobs and unemployment, about the demands placed on our employment services and training and educational systems, and about the pressures coming on welfare spending, social services and housing supports.

A.5.2 Job Loss and Unemployment

The discussion of the economic crisis above presented the most recent figures on the pace of job loss and the pace of unemployment growth, each still occurring but at a slackening rate (Table 7). When occupational groups rather than economic sectors are examined, it becomes clear that job loss, which has occurred for every group over the year to June 2009, was on a particularly large scale in occupations associated with lower skill levels. Employment levels of craft workers and operatives, for example, were lower by 25 per cent and 19 per cent respectively, but by low single figures for managers, professionals and technical workers. In the first six months of 2009, the pace of job losses appears to have eased; employment levels among higher skilled occupational groups stabilised or even showed a slight increase (managers).

Table 7 Employment Levels by Broad Occupational Group, 2008-2009

Occupational Group	2008 000s	2009 000s	2008-09 %	Q1-Q2, 09 %
Managers	332.2	323.2	-3	2
Professional	250.2	246.0	-2	0
Technical	193.8	192.3	-1	-1
Clerical	257.6	246.8	-4	-1
Craft	282.1	210.6	-25	-9
Personal	246.1	242.0	-2	-1
Sales	184.8	171.1	-7	0
Operatives	173.1	140.2	-19	-6
Other	193.0	166.2	-14	4
Total	2,112.8	1,938.5	-8	-1

The number employed in part-time work increased by 15,900, a trend also evident in average hours worked which fell by 2.5 per cent over the year (QNHS Q2, 2009). Patterns in part-time work may reflect increased flexibility in the labour market in the face of the downturn (for example, one third of the increase in part-time employment is among people who describe themselves as underemployed). However, it is also the case these figures may reflect a stop-gap measure between full-time employment and layoffs (Quarterly Economic Commentary, 2009).

In the second quarter of 2009, those in the 15-19 and the 20-24 year age groups experienced the highest rates of unemployment at 36.4 per cent and 23 per cent, followed by 13.4 per cent for those in the 25-24 and 9.9 per cent for the 35-44 year age groups. However, the increase in the year in the numbers unemployed was greatest for 25-34 year age group at 50,300, compared with 29,800 for those aged 35-44, and 25,400 for the 20-24 age group. The 15-19 year age group experienced increased unemployment of 7,800 persons.

Employment fell across all regions, with the highest percentage decreases in Border (-9.9 per cent) and South-East (-9.7 per cent) regions. Employment in Dublin decreased by 8.9 per cent over the year (QNHS Q2, 2009).

It is important to consider that recent employment experience of nationals and non-nationals. Between 2004 and 2007, nationals of the EU Accession States, accounted for 57 per cent of the extra jobs created (NESC, 2008: 9). They have been particularly impacted by the downturn. Their employment fell by 25 per cent, as against 6 per cent for Irish nationals, in the twelve months to June 2009, while unemployment among them increased by 140 per cent (113 per cent for Irish nationals). There is evidence from several sources (Live Register, issuance of PPS numbers, claimants of Job Seeker's Benefit/Allowance, net migration estimates) that the numbers of EU 12 nationals who remain unemployed in Ireland may have peaked in Spring 2009, and that more are returning to their home countries. The fact that EU citizenship ensures no barrier to re-entry is noted as a significant reason for their mobility, and is credited with having introduced a significant degree of flexibility into several national labour markets across the EU (Kahanec and Zimmerman 2009).

A.5.3 OECD Review of Activation Policies in Ireland

An in-depth study of Ireland's activation policies was published in January 2009 (Grubb *et al.*, 2009). While the purpose and context in which it was undertaken were not related to the economic crisis, several aspects of Ireland's activation policies which it finds noteworthy cast a penetrating light on the preparedness and capacity of Ireland's active labour market policies to deal with the collapse in employment and surge in unemployment which have occurred. For example, it noted the degree of fragmentation in Ireland's public employment service (PES), with sometimes overlapping and uncoordinated roles between FÁS, the LES, the LDSIP and the DSFA. It concluded that, even embracing all the bodies involved, Ireland's PES appeared understaffed and that the proportion of staff time devoted to implementing an activation agenda was low. It observed that the referral strategy operated jointly by DSFA and FÁS centred largely on a once-off contact and had little follow-through or long-term results for clients. It noted that, even for the most disadvantaged job-seekers, no public or other type of organisation in Ireland

took responsibility to be the employer of last resort and that this undermined the willingness and purpose of continuing engagement with ALMPs on the part of the most disadvantaged. It found that the ratio of unemployment benefit recipients to labour force survey unemployed in Ireland was the highest in the OECD in the early 2000s.¹³ On a more macro-level, it reflected that Ireland had come through a most remarkable period of employment growth without reducing its overall dependency rate on social welfare, and that it had improved real payment rates more than its activation measures (NESC, 2005).

The principal author of the OECD study (Grubb, 2009) reflected that recession is not a reason or a time to delay restructuring Ireland's PES and ALMPs. To some extent this is happening; for example, staff are being redeployed to frontline PES activities, the LES is being included for the first time in the implementation of the referral strategy, procedural reforms are speeding up the processing of claims for Job Seeker's Benefit, benefits are being made easier to retain when people seek to return to education, etc. In its report of March 2009, the Council drew on the lessons of the late 1980s and early 1990s—concerning the scarring effects of long-term unemployment and how a generation can be lost to the economy and to satisfactory participation in society—to urge imaginative and 'smart' innovation in this area (NESC, 2009: 56-57) and to suggest a Job and Skills Summit as a way of accelerating it.

It has become clearer that this further innovation in Ireland's PES and ALMPs might be considered on *complementary fronts*. Specific groups have come into sharper focus and some new measures, even if tentative and on a small scale, have been taken that particularly benefit one or more groups and may have potential for further development:

- ◆ *People still at work but whose employment is under threat or who are having their working hours reduced* (liable to benefit particularly from the Employment Subsidy Scheme, the Enterprise Stabilisation Scheme, and the introduction of a Pilot Scheme for Short-Time Workers);
- ◆ *The 'class of 2009', i.e., the cohorts finishing their education and training when prospects are so poor* (FÁS has moved effectively to support apprentices being made redundant, the Work Placement Scheme provides work experience for new graduates in particular);
- ◆ *The short-term unemployed who have good prospects of rerouting themselves relatively quickly to new jobs* (The speedier processing of claims for Job Seeker's Benefit has been significant here. It is to be noted that a significant level of churn continues to take place on the Live Register);¹⁴

¹³ Another window onto the same reality is the traditional warning that the Live Register is not a good measure of unemployment. Its average, for example, over the three months April to June 2009 was 50 per cent higher than the QNHS estimate of unemployment in that quarter.

¹⁴ The curtailment of the entitlement period for Job Seeker's Benefit to 12 months from 15 (and to 9 months for people with less than 260 PRSI contributions) might be seen as a curious measure in the context of severely depressed labour demand. It has produced some short-term savings and may have encouraged some non-nationals to return to their home countries more quickly. However, it would seem to have added to bottlenecks in the more costly processing of applications for Job Seeker's Assistance, where processing times have lengthened not shortened. It has also accelerated some people's arrival into the world of means-testing.

- ◆ *The recently unemployed with characteristics that suggest they are likely to drift into long-term unemployment unless they receive timely and intensive support (the DSFA is becoming more capable of identifying them through ‘profiling’¹⁵, changes are being made to ensure that access to the Back to Education Allowance does not first require becoming long-term unemployed);*
- ◆ *People with disabilities, lone parents with little formal education and the already long-term unemployed who found it difficult to access and retain employment even in the ‘good years’;¹⁶ and*
- ◆ *Non-Irish nationals who face such poor prospects in their home countries that remaining part of Ireland’s labour force is their choice (third country nationals on work permits who are made redundant have had the time they can search for a new job extended to six months).*

Overall, an increase in the supply and suitability of educational and training places, and their increased take-up, continues to be the single most important line of response to the deterioration in the labour market, quantitatively and in strategic terms. Increased provision by FÁS of training programmes in particular demand, of PLC courses by VECs, of outreach and in-house courses by ITs and other Colleges, and of third level opportunities for mature students by the Universities are all taking place. The Supplementary Budget (April 2009) made provision for an additional 6,910 places in the education sector (2980 full-time and 2430 part-time places at third-level places, and an extra 1500 PLC places) and for 14,000 additional places on short-time FAS courses in response to the higher unemployment. While this approach to turning a crisis into opportunity for many individuals is wholly consistent with Ireland’s long-term economic strategy in general and the National Skills Strategy in particular, it remains difficult to evaluate the overall adequacy and impact of the supply response to date. The increase in demand for education and training in the wake of rising unemployment is still, in places, clearly outstripping the increase in supply (e.g., in 2009, there were 60,000 applications for 32,000 available PLC places) while, in other cases, courses remain undersubscribed.

The preference of a significant proportion of the newly unemployed for shorter, modular programmes over longer courses has been noted by providers and is influencing their response. In assessing the timeliness and effectiveness of initiatives, a number of issues are coming to the fore—principally, the extent to which the composition of the supply response and its regional provision meet demand, and the extent to which financial impediments and eligibility rules are blocking people from accessing courses. There is a widespread desire among education and training providers of every type for an overview, leadership and effective coordination in ensuring resources are deployed to maximum effect in response to the current crisis and that best practice is speedily identified and disseminated.

¹⁵ It will use personal information on those entering the Live Register to identify, in particular, those who are older, with poor literacy or numerical skills and a longer history of unemployment in order to refer them to training and education providers.

¹⁶ By June 2009, there were over 14,000 young people (under 25) on the Live Register for over a year (2,300 of them for more than 3 years). While they constitute a tiny proportion of the overall LR (3.4 per cent), the fact that, at a young age, people are yet classified and treated as long-term unemployed is a poor reflection on Ireland’s welfare state. A significant new measure introduced in May will see 18 and 19 year olds receive the equivalent of the full rate of Job Seeker’s Allowance (JA) (€204.30 a week) only if they are engaged in training, education or on CE. Otherwise, they will receive a lower JA payment of €100 a week. In the Netherlands, for example, as of July 2009, even this is no longer tolerated. They have introduced legislation obliging public authorities to link work, education or a combination of both with income support to all unemployed young people (under 27).

The deterioration in the labour market, in the lives of many households and individuals, is being compounded by falling disposable incomes and retrenchments in some areas of current public social spending. The extent to which financial difficulties and hardship are increasing should not be discounted if, as is possible, the proportion of the population estimated to be 'at risk of poverty' is seen to have fallen when the next EU-SILC appears. It would not be surprising if median disposable income, the benchmark by which it is assessed, will transpire to have fallen by more than the lowest household incomes.

A.5.4 The Social Welfare Budget

Spending on social welfare has been pushed higher by the surge in unemployment. The Department of Finance estimate that each additional 1,000 people on the Live Register increases spending on Job Seeker's Benefit (JB) and Assistance (JA) by €11.77m (2009 payment rates) and generates further costs of €1.4m on supplementary payments such as rent allowance and mortgage interest subsidies. The Department of Social and Family Affairs estimate that spending on JB and JA alone in 2009 will have risen by 120 per cent on 2008 to €4.6bn and that it will absorb 22 per cent of its total spending (up from 12 per cent in 2008).

This is part of the context within which debate on the possible role of welfare rates in fiscal correction is more openly debated. The withdrawal of the Christmas bonus has already entailed some reduction in social welfare incomes. Certain factors are prompting discussion of further measures: the large share of the social welfare budget in overall current public spending; the fact that not all social welfare goes into low-income households; a falling HICP is increasing the real value of social welfare payments; that the possibility of lower net earnings in certain sectors may cause replacement rates to increase for some social welfare recipients, principally those with dependants. Other factors are likely to be taken into account also: the degree of improvement in the position of social welfare recipients was one of the achievements of Ireland's boom years; evidence that it is not the level of the payments which is critical but the extent to which they are poorly backed by or integrated with activation measures (recall the OECD observation that payment levels and the intensity of activation need to proceed in tandem);¹⁷ the absence of evidence that a low welfare payment, of itself, is an effective form of activation; and a large number of welfare recipients do not have dependants and, therefore, do not enjoy high replacement rates. Indeed, Irish policymakers will note recent OECD evidence that in response to the current crisis, 'around half of OECD countries have moved to increase the incomes of job losers by increasing the generosity of unemployment benefits or extending covering to those previously excluded' (OECD, 2009) (admittedly these are probably countries with stronger public finances than Ireland).

Overall, in approaching budgetary decisions in this area, policy makers will be unlikely to estimate possible savings in a static or short-term context, preferring to rely on the most reasonable estimate possible of net savings over a longer period and across the distinct, but interrelated, areas of public social spending, defined broadly.

¹⁷ This does not imply that replacement rates cannot be insignificant (see Callan et al. 2006).

In recent years, Irish policy and public discussion has identified important directions for reform and signalled increased ambition to achieve higher levels of social and economic participation for social groups (notably people with disabilities and lone parents) where outcomes lag significantly the standards set by other small European countries. While the intensity and timetable for implementing the National Disability Strategy and the reform of the One Parent Family Payment, for example, may have to alter to reflect the temporarily disabled condition of the State itself, there is concern to re-affirm these strategic intentions and direction of policy development.

A.5.5 Public Services and Publicly Funded Services

Budgetary constraints and associated cutbacks, principally in the 2009 Budget and 2009 Supplementary Budget, have impacted on the provision of certain public services and publicly-funded services.¹⁸ ESRI analysis has considered the distributional impact of the recent budgetary changes in tax and social welfare and concludes that the effects on household incomes have been progressive (taken most from highest incomes and protected the lowest). This is a welcome development. However, the broader impact of a reduction in, or reduced access to, public services also needs to be considered. In the medium to long-term, the extent to which changes in access to publicly-funded services (withdrawal of a service, longer waiting times, increased co-payments, etc.) might undermine the living standards of particular groups despite the relatively light impact on them of tax and social welfare changes is important to monitor. It is easy for reductions in provision of public services to have the greatest impact on the most vulnerable groups. Specifying aspects of programmatic change that will save significant costs needs to be complemented with a clear picture of which social groups will be most affected and of their differential capacities to absorb the changes in service provision and access. The abolition of the Early Childcare Supplement, and its replacement with a universal free preschool arrangement for 3 and 4 year olds, is one example of a short term measure with a longer term logic. It remains to be seen whether the design of the scheme and its implementation are effective.

While there may be some efficiency gains to be achieved across the public sector which will have a zero or minimal impact on the provision of public services,¹⁹ the scale of the fiscal adjustment necessary make it likely that budgetary constraints will impact on the provision of and access to some public services and publically funded services. The dilemma for social decision-making then is how best to allocate scarcer resources given the legitimate, but competing, needs across a range of social and publicly-funded services. The provision of and access to certain services may also impact on the behaviour of individuals and their labour market choices. Consequently, public service resource allocation will want to

¹⁸ Education and health both attracted increases in their overall budget allocation under the 2009 Budget. However while certain areas (such as capital investments in education; the cancer control programme, suicide prevention and therapy services for children in health) benefited from this increased allocation, other areas experienced reductions. Adult education is one example. Co-payments and increased payment for accessing certain services were also introduced in education and health. In education, annual fees for post-primary transport were increased (€300 per annum) in the 2009 budget and the book grant scheme for the disadvantaged was removed from most schools at a saving of 75 million. A&E charges were increased for those presenting without a GP's letter from €66 to €100 euro, while there was a €10 increase in the drugs payment scheme. Eligibility for the medical card was not raised and for those over 70 who do not qualify under a means-test an annual cash grant of €400 euro will be paid (where gross weekly income is below €650 for singles and €1300 for a couple).

¹⁹ As evidenced in recent developments in the pharmacy sector, the state, as a buyer of services, has the opportunity to seek better value and increased efficiency which will, in turn, enhance core services and work in the national interest.

be informed by a systematic approach aligned with wider economic and social policy goals. Decision-making will want to be supported by appropriate appraisal mechanisms, mindful that using a resource in a particular way denies its use elsewhere and a reduction in costs in one area may in fact result in increased costs elsewhere in the system.

A.5.6 Escalating Social Problems and the Crisis

Should unemployment remain high and prove long-lasting, the experience of the late 1980s and early 1990s teaches us that part of its pernicious side-effects can be escalating social problems in addition to the erosion of workplace skills. Deteriorating health, the undermining of family relationships and growing poverty, for example, became evident in that earlier period. Experience seems to highlight the advantages of taking prompt action to prevent individuals and households beginning the slide into poverty and hopelessness. Three specific areas, which have been monitored and studied in recent months, can serve as examples of where consideration may want to be given to early intervention in an effort to prevent much more deep-seated and costly social problems developing. These areas are the treatment of mortgage holders under stress, of people leaving private rented accommodation, and of people in debt.

Mortgage holders under stress

The percentage of the €1.4 billion worth of Irish residential mortgages in arrears for more than 90 days has doubled to 1.5 per cent, while 4 per cent of mortgages are in arrears for more than 30 days. Despite this increase in arrears, repossessions are relatively low. Under a 'code of conduct' lenders are obliged to wait a minimum of six months, and those availing of the State's recapitalisation scheme twelve months, before taking legal action. While court proceedings initiated by lenders against people in mortgage arrears on their principal home remain rare, there are more widespread pressures on mortgage holders. All face a rising real interest rate (the consequence of deflation) and the prospect that the next change in nominal rates will be upwards; for a significant number, their outstanding mortgages are growing as a proportion of their homes' value (the consequence of falling house prices), while some owe more than their homes are currently worth (negative equity). Some of those who bought homes or apartments near the top of the boom now find themselves living in unfinished estates with uncertainty surrounding the security and level of amenities in their neighbourhood.

People leaving private rented accommodation

There has been a welcome reduction in the level of private sector rents; by July 2009, they were down by almost 20 per cent on their 2007 levels.²⁰ For people seeking accommodation for the first time, this is unmitigated good news. For people seeking to change landlords or return home consequent on job-loss, an impediment appears to have grown in importance. Evidence suggests that the unjustified retention of deposits, invalid notice that accommodation should be vacated and illegal evictions have grown significantly. Threshold's most recent Annual Report observes that 'the economic downturn has generated more deposit disputes between landlords and tenants' and is exposing 'a culture ... where some landlords routinely refuse to

²⁰ The Daft.ie Rental Report, Q2 2009.

return deposits...(and) are more willing to claim breaches by tenants as a reason ... because many (of them) are themselves struggling and cannot afford to repay deposits' (Threshold Annual Report, 2008). Many of the tenants being treated in this way are non-nationals, up to 80 per cent of whom live in the private rental sector. In this context, policy makers may want to consider the swift implementation of a Deposit Protection Scheme (under consideration in the context of a review of the Residential Tenancies Act 2004).

People in debt

The growing level of unemployment in Ireland is occasioning higher levels of over-indebtedness and default in Irish society; debt enforcement proceedings in Irish courts have increased. The background is clear. During the boom years, personal credit became much more widely available, and was aggressively marketed. In 2004, the ratio of household debt to disposable income had reached 113 per cent, up from 48 per cent a decade earlier(1995); in the next six years it climbed by almost as much again to reach 176 per cent in 2009 (Law Reform Commission, 2009) (Law Reform Commission, 2009). Recent data from the Money Advice and Budgeting Service (MABS) and research from the Combat Poverty Agency (Stamp, 2009) confirm that borrowings incurred for lifestyle-related reasons explain part of this surge in indebtedness but that the most typical situation where people are in serious trouble because of debt continues to be that of a low income household lacking the money to afford essentials (with paying utility bills the most common essential on which they begin to fall behind). Whatever the situation that brings people into debt arrears, research points to the acute stress it engenders and the pointlessness of not distinguishing between those who cannot pay and those who refuse to pay. The Law Reform Commission believes that Ireland's system of debt enforcement needs to be reformed to acknowledge that the vast majority of people who fall into arrears with their contractual commitments do so because they are in financial difficulty, frequently brought about by changes in circumstances or adverse events, and that only a small minority of people refuse to pay their debts though they possess the means to do so. They advocate much less reliance on coercion and courts and a greater recourse to debt-counselling and advice, binding non-judicial debt settlement procedures and arrangements that ensure money for a basic standard of living debtors and their dependants.

Other areas have been heavily impacted by the financial crisis. For example, Irish pensions experienced real losses of 37 per cent in 2008. This is the worst investment performance across 30 OECD countries (OECD, 2009). While this is a source of serious anxiety for those who are approaching retirement age, there remains some uncertainty as to impact of this on actual payments to pensioners in the longer term. Private pensions and other investments provide a third of retirement incomes compared with the OECD average of less than 20 per cent.

A.6 The Reputational Crisis

The Council's March report outlined a number of factors that have had a damaging effect on Ireland's reputation, both domestically and internationally. These included the perception that Ireland's public finances were in a perilous position and were in danger of default; that Ireland had a lax system of financial regulation; that Ireland's reaction to the banking crisis might not establish a sufficient change in personnel and governance arrangements; and that Ireland's commitment to EU membership might be faltering.

NESC argued that these factors would manifest themselves as risks in a number of different ways. The most prominent risk would be an increase in yields on Irish government bonds, as bond markets demanded higher spreads to hold what are seen as riskier assets. A second would relate to the market valuation of banks. And a third risk might arise from commentary in the English-language media which might portray Ireland in a relatively unflattering light.

Turning to the money markets first, commentary is fairly unanimous that perceptions towards Ireland have improved in recent months. Increased confidence may have been partly prompted by the Finance Minister's tour of the financial markets of London, Paris and Frankfurt in May 2009 to emphasise Ireland's underlying strengths.

Demand for Irish bonds has usually been over-subscribed. The gap between the yield of ten-year German bonds relative to Irish ones has narrowed in recent months to a difference of about 1.4% compared to nearly 3% earlier this year. One money manager was quoted as stating that 'the fundamental questions whether Ireland will be able to stay in the euro or whether it will default on its debt no longer count' (Blomberg.com July 27th).

The share prices of both the main banks, Allied Irish Banks and Bank of Ireland, have increased since a low in March 2009 when both their share prices dropped to 12 cents. Over the month of September, the share prices of both banks have climbed above 3 euros as the introduction of the NAMA legislation reduced the likelihood of further state recapitalisation. Other changes in banking include the departure of senior staff at board level at five of the six Irish banks covered by the government's guarantee scheme. The Government has also committed itself to the 'orderly removal' of all non-executive directors of the banks participating in NAMA that were appointed prior to 2008. In addition, several transactions undertaken by Anglo Irish Bank are under investigation by the Garda Fraud Squad and the Director for Corporate Enforcement.

The Irish government have also pledged to reform the regulatory structures of Irish banks in a bid to 'restore the reputation of the country as a sound and secure centre of excellence in international financial services' (Dept. Of Finance Press Release, 18th June 2009). It has been proposed that the Central Bank and the Financial Services Regulatory Authority be merged into a single fully integrated regulatory institution, the Central Bank of Ireland Commission.

Two top-level posts will be established within the Central Bank of Ireland as *ex-officio* members of the Commission. A Head of Financial Supervision will report to the Commission on the regulatory and supervisory functions and objectives of the new structure. A Head of Central Banking will report on the performance of central banking functions (other than those that relate to the independent role of the Governor under the EC Treaty and Eurosystem and ECB structure).

The new Central Bank Commission will be chaired by the Governor of the Central Bank and will be responsible for both the supervision of individual firms and the stability of the financial system generally. Professor Patrick Honohan has been appointed as the next governor of the Central Bank. Honohan has suggested that:

much of the current global rethinking of regulatory design will not necessarily be particularly relevant to the Irish scene: the Irish problems relate to a very old-fashioned credit boom and not to financial innovation. The failure was one of insufficient scepticism on the part of the Regulator (Honohan, 2009).

But Honohan has also counselled against over-reaction:

the danger to be avoided now is that the Regulator might be inclined to impose requirements that discourage exactly the lending that is needed to protect the economy through the downturn and position it for a recovery (ibid).

Part of the rationale for this re-organisation of regulatory structures is to convince those abroad that Ireland is undertaking fundamental reforms to address some of the factors that brought on the recession in Ireland. Some international media commentary has concentrated on the recession rather than reforms. The *New York Times* highlighted the severe contraction in Irish GDP in 2009 as a cautionary tale for the world economy (19th April 2009). *The Economist* underlined the drop in domestic demand to speculate that the Irish economy is in 'free-fall' (17th July 2009). *The Economist* concluded that:

With Ireland's double-digit budget deficits leaving limited resources and capacity to focus on issues other than the ongoing fiscal and banking crises, economic policy is set to remain in crisis-management mode for the foreseeable future.

More recently, *The Economist* magazine has commended the Irish government for the introduction of legislation detailing how NAMA would operate: – 'at least, it gets something done' – and compared it favourably to efforts in other jurisdictions such as America and Germany (17th September 2009).

Neither of these sources refers to the assistance of the European Central Bank (ECB) which has played a crucial role in terms of providing liquidity to Irish banks. Irish-based institutions now account for almost 15 per cent of the total €900 billion of ECB loans into the European banking sector although this includes international lenders based in the Irish Financial Services Centre (*The Irish Times*, July 14th 2009). In its crisis report NESF foresaw this problem. It commented that 'the dominant role of the English language, combined with the fact that the UK is not a member of the eurozone, makes Ireland vulnerable to negative comment that does not reflect an understanding of, or sympathy for, the nature of the euro and its supporting institutions' (NESF 2009: 58).

The President of the European Central Bank spoke of Ireland's strengths in February 2009. He noted that the Irish government is acting resolutely to address this situation and was optimistic about Ireland. In addition he considered that measures have been taken or are under way to recover lost competitiveness and to exploit the country's comparative advantages in its high-tech, high-skills industries. He placed a strong emphasis on the need for Euro area governments and social partners to take account of the competitiveness and labour market conditions when setting wages. He believed that the open nature of the Irish economy with its associated flexibility and adaptability means that Ireland will be well placed to benefit greatly from the eventual recovery.

Ireland has also attracted comment from *The Financial Times*. In a recent editorial (10th August 2009), the paper acknowledged that Ireland was in the midst of a 'vicious downswing but counselled that it is 'not time to write off the Celtic Tiger'. According to the paper, Ireland still enjoys several enduring strengths such as a good tax regime, well-educated workers, a developed infrastructure and a capacity to attract waves of foreign investment. *The Financial Times* continued this relatively favourable response to Ireland in a feature article (30th August 2009). It noted the upswing in the mood of the international financial markets towards Ireland and the corrective action already undertaken by the government but considered that there was strong domestic opposition to reform plans. It quoted one government official as stating that:

Until people believe that the pain is being shared more equally – and perhaps one of these bankers or developers has to be put behind bars first – the government will always struggle to win popular backing for what they are doing.

Countering reputational risk should not be viewed as a zero-sum game between reassuring a domestic and international audience as the perceptions of both may be more linked than is usually thought. The Council previously underlined the 'close connection between a country's international reputation and the domestic credibility and effectiveness of its governance arrangements' (NESC, 2009: 60). If Ireland could produce a recovery plan that had broad domestic appeal, then this might help to convince overseas commentators about Ireland's longer-term future stability and viability. NESC earlier noted the converse outcome, namely that ratings agencies are inclined to downgrade a country if it displays a 'lack of ability to rebound' or an 'inability to fix the problem'. For the past twenty years, Ireland's progress has been associated internationally with the capacity of government and the social partners to reach multi-annual agreements, within the context of a shared analysis of economic and social challenges.

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