



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta
National Economic & Social Council

Ireland's Five-Part Crisis: An Integrated National Response

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Abbreviations

AIB Allied Irish Bank	EU European Union	NPRF National Pension Reserve Fund
BOI Bank of Ireland	FÁS Training and Employment Authority	NTMA National Treasury Management Agency
CDS Credit Default Swaps	HICP Harmonised Index of Consumer Prices	ODA Overseas Development Aid
CPI Consumer Price Index	IDA Irish Development Authority	OECD Organisation for Economic Cooperation and Development
CSO Central Statistics Office	IFSC Irish Financial Services Centre	PCW Programme for Competitiveness and Work
CWO Community Welfare Officer	GDP Gross Domestic Product	PESP Programme for Economic and Social Progress
DES Department of Education and Science	GGB General Government Balance	PNR Programme for National Recovery
DETE Department of Enterprise Trade and Employment	GNP Gross National Product	PRSI Pay Related Social Insurance
DSFA Department of Social and Family Affairs	JA Jobseekers Allowance	SGP Stability and Growth Pact
ECB European Central Bank	JB Jobseekers Benefit	SWA Social Welfare Allowance
EMS European Monetary System	LR Live Register	VTOS Vocational Training Opportunities Scheme
EMU European Monetary Union	NESDO National Economic and Social Development Office	
ERM Exchange Rate Mechanism	NDC Notional Defined Contribution	
ESRI Economic and Social Research Institute	NDP National Development Plan	
	NGO Non Governmental Organisation	

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Ireland needs to formulate an integrated national response to the current crisis that is widely understood, can command support and, most importantly, engage the ability and energy of the Irish people.

The current national crisis has five closely-related parts: banking, fiscal, economic, social and reputational. It is important to understand what has happened in each area and why it has happened so quickly. The crisis poses profound challenges to many existing theories and models, at both the national and international level. The high degree of uncertainty—particularly about the impact of conventional policy measures—provides further reasons for constructive, collective discussion of the problems and their solution. Countries capable of conducting such a dialogue and implementing a coherent and agreed response quickly are likely to come through current difficulties better than those which do not.

Existing Shared Understanding

The severe current crisis can be seen, in part, as the manifestation of a range of risks, each one of which was separately identified at a given moment in the past. What was not envisaged was that these risks would materialise simultaneously and in a mutually reinforcing way. The crisis is also a manifestation of risks that were not identified. Prime among these is the dramatic collapse of the model of international finance and financial regulation that developed in the past 20 years. Furthermore, Ireland's exposure to these risks and capacity to cope with them is significantly shaped by its own *national* policy frameworks, institutions and processes. It seems clear that features of Ireland's approach to economic and social development, policy implementation, regulation, management of public expenditure, wage coordination and bargaining have not sufficiently protected the economy and society against even some of the risks that had been identified.

What is Our Ambition?

International assessments now being made about Ireland can be dis-spiriting. Yet the kinds of difficulties Ireland is now experiencing have been shared, at various times, by states and societies that recovered and went on to record impressive social and economic achievements (e.g., Sweden, Denmark, Finland and the Netherlands). We can learn, in particular, from their commitment to innovation, radical reform of the public sector and social solidarity. To do so we must recreate our common purpose. This common purpose must include a willingness to fund public systems and a relentless insistence that public bodies respond to the changing and diverse needs of individuals, families, neighbourhoods, enterprises and sectors. Ireland's future economy will be different, but that is all the more reason to retain and develop our ambition to have a smart economy and a developmental welfare state, even in an uncertain world.

Key Elements in the Story So Far

Lost Competitiveness: Over a long period of high growth, driven first by exports and latterly by construction, Ireland's price and cost level rose significantly. This made Ireland expensive, for people and for businesses. With the collapse in construction and fall in employment, the consequences of this high price level for job creation, and the competitiveness that drives it, assumes a higher profile. It is imperative to reinvigorate exports in the coming years.

Property Bubble: Since approximately 2004, Ireland developed one of the worst property bubbles the world has seen in recent years. Up to 2004, fundamental supply and demand factors went a considerable way towards explaining why houses continued to sell despite their high prices; thereafter, expectations of future house price increases themselves began to drive current house prices. Banks played a huge role in this by borrowing money cheaply on international markets on a short-term basis and lending it on a long-term basis to builders, developers and house-purchasers. Many people with major responsibilities in Irish banking institutions and the Irish regulatory system did not acknowledge or act when warning indicators flashed red.

Global Imbalances: At the world level, some countries have consistently run large current account deficits, principally the US, and others large current account surpluses, principally China and the oil-exporting countries. Much of the net foreign currency receipts of the largest surplus countries were loaned back to the advanced countries, which contributed to an apparent 'savings glut' that drove down medium- and long-term interest rates. Cheap credit, in turn, provided a favourable context for a degradation of credit standards and a wave of financial 'innovation'. Disastrously for the world, much of this innovation was in US sub-prime lending. In September 2008, what had started as a crisis in mortgage lending to the US sub-prime market a year earlier became a full-blown global financial crisis.

In Ireland, until Autumn, 2008, there were grounds for hoping that a substantial housing-market correction, which began towards the end of 2006, and strategies to renew the economy's competitiveness by focusing on knowledge and innovation, would enable the country to enter a new phase of more moderate but soundly-based growth without major dislocation. But the global financial crisis precipitated the credit crunch which spilled over into the real economy. Ireland is now experiencing the vulnerability of its economic openness (without which, of course, the rapid expansion and higher living standards since 1993 would not have happened).

A collapse in construction and fall-off in exports have triggered a decline in employment and consumer spending. The slump in tax-rich activities (housing and domestic demand in general) has caused a spectacular drop in tax revenue. With tax revenues falling sharply and public expenditure proving much more difficult to keep from growing let alone reduce, Ireland's fiscal deficit has soared and is currently the highest, and one of the most intractable, in the EU.

Ireland's membership of the European Union and euro area powerfully influence the set of measures available to pull the country through the current crisis, for the better. At the same time, the severity of the financial and economic crisis has exposed several forms of institutional incompleteness in economic governance in the euro area and the wider EU. Ireland has an interest in appropriate policy and

institutional development and must play a full part in helping to design the way forward for the EU.

The pressure of events has forced the Irish government to react to various aspects of the unfolding crisis. We should not berate ourselves, or each other, over the fact that these reactions to fast-moving events do not yet constitute our full, considered, integrated and agreed response. Equally, while government and some other actors have had to react to events, other processes have proved slow in responding.

Limitations of Partial and Sequential Responses

The current crisis has five dimensions tightly tied up with each other:

- ◆ Banking crisis
- ◆ Public finance crisis;
- ◆ Economic crisis;
- ◆ Social crisis
- ◆ Reputational crisis

It is possible to devise a set of further reactions to each of these crises. But, our analysis strongly suggests that a series of partial and sequential measures, some of which are undoubtedly necessary, will not be sufficient and effective:

1. Technically, action on each of the crises requires specific supportive and coordinated actions on several of the others;
2. 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;
3. 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, it is now necessary to formulate an integrated national response to the five-part crisis. One counter argument might be that it is too late to seek an integrated and agreed response. If account is taken of the scale and the possible duration of the crisis, we see that this view is probably mistaken. We could look back ruefully in five years and see that we were mistaken to think that the die was cast in March 2009.

An effective Irish response would have a number of characteristics. It would address all five dimensions. It would be based on social solidarity and a positive perspective on Ireland's future prosperity. It would combine high-level coherence with maximum engagement and local problem solving. It would take short-term measures that have a long-term logic.

Stabilising the Banking System

Problems in financial institutions have confronted Government with an urgent challenge to which it had to react. The priority is to reestablish a sound financial

system capable of meeting the full needs of Ireland's economy and society. The policy response to the banking crisis must also address:

- ◆ The need to ensure that recent policy measures provide protection to the increasing number of households with mortgage arrears;
- ◆ The need to ensure that recent 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.

The Challenges of the Public Finances

The Government has set the objective of bringing the deficit of GGB below 3.0 per cent in 2013. The correct combination of expenditure reductions, tax increases and increased borrowing needs to be assessed not only on how it narrows the gap between expenditure and revenue, but also on how it is likely to impact on the other dimensions of Ireland's challenge: the economic crisis, the social crisis and the country's reputation. A medium-term strategy to restore balance to the public finances will require an increase in the tax share of GNP—from its 2009 level—if a satisfactory level of provision of services and benefits is to be achieved. Changes to the tax system should not be considered solely in terms of revenue, but also in the light of principles of tax reform.

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. The expenditure reductions and tax increases to date have left many 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.

Restoring Ireland's Economic Competitiveness

The severity of the *economic* crisis is evidenced in company closures, job losses and short-time working. A coordinated national approach to income determination is critical at this time; it must take account of the unusual depth of the economic crisis and of important new developments, such as falling prices and the incidence of debt problems among both firms and households. It must recognise that, over the coming years, Ireland's economy has to return to being driven by exports rather than domestic demand. To achieve this, economic recovery will be characterised by a fall in Ireland's price level and cost structure, relative to our trading partners.

Consequently, a difficult set of overlapping and competing objectives and factors confronts those involved in finding a coordinated and integrated response to the crisis. These include:

- ◆ Employment—particularly the threat of further unemployment;
- ◆ Ireland’s loss of competitiveness over the past seven years;
- ◆ The pressures on certain enterprises created by the recent fall in sterling;
- ◆ The evolution of prices, including policy instruments that influence input costs to business, professional fees and rents;
- ◆ The level of domestic demand;
- ◆ The state of the public finances, which are directly affected by public sector pay developments and indirectly influenced by wider unemployment, economic and income developments;
- ◆ The burden of mortgage debt, particularly on those who become unemployed; and
- ◆ Social solidarity, encompassing the whole of Irish society, not just those whose incomes are determined in collective bargaining.

In addition, a coordinated approach to incomes—and other adjustments in the private sector (in prices, cost and employment)—must be accompanied by action on the other four crises, particularly, stabilisation of the banking system, retargeting of the NDP to support employment and enterprise, enhanced activation measures to support those who lose their jobs, and measures to repair Ireland’s reputation.

Responding to the Social Challenge

The current crisis is already having significant social consequences. It is critical to insulate the most vulnerable from the worst effects of the recession and not to ease up on, or postpone, the reforms and strategies that are in place to tackle existing social deficits. It is also imperative to adopt new measures that protect those now experiencing loss of employment, income, savings and pensions. Practical measures are needed that 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 unfortunate to be 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 will ensure 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. The Council urges 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.

Paradoxically, the economic recession and collapse of private construction provides an opportunity to address some outstanding housing issues in particular social housing, rental accommodation, sustainable communities and active land management. Social policy initiatives would be unsustainable and ineffective if they are not accompanied by measures to address the public finance crisis and the economic crisis.

Restoring Ireland's Reputation

Ireland's small size, location and model of economic development make it highly vulnerable to any loss of influence or status in the EU or, worse still, if there were to be a return to a less rules-based international system. Ireland now faces a reputational crisis, for several reasons:

- ◆ The uncertainty about Ireland's willingness to participate in major developments in the EU and its commitment to EU membership;
- ◆ The perception that Ireland's public finances are vulnerable to default because of a combination of low growth, contingent liabilities to the banking system and the increasing ratio of debt to GDP;
- ◆ The perception that Ireland has, along with a number of other countries, had a lax and ineffective system of regulation of the financial sector;
- ◆ The perception that Ireland's response to the banking crisis may not include sufficient change in governance, personnel and governance arrangements;

These perceptions make themselves felt in various ways, notably the increase in yields on Irish government bonds, as bond markets demand higher spreads to hold what are seen as riskier assets, and the low market valuation of Irish banks.

There is a close connection between a country's international reputation and the credibility and effectiveness of its domestic governance arrangements. For example, Ireland needs to persuade its 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. In the modern world, sovereignty is status within the regimes that govern international life; international reputation is linked to the ability of a society to act collectively, recover and reinvent its economy.

Towards An Integrated National Response

An integrated policy approach that simultaneously addresses the banking, fiscal, economic, social and reputational dimensions of the current crisis is, the Council believes, the one with the best chance of succeeding. There are advantages in engaging economic and social organisations in framing and implementing such an integrated, national response to the crisis. This is true. But it is not the general advantages of policy consultation and joint policy framing that is the first reason for seeking an integrated approach. Rather it is the analysis of the crisis as having five inter-related dimensions that warrants the integrated response. An effective integrated response must, of course, be able to depend on wide societal ownership of the need to respond to all five dimensions of the crisis. Framing a shared analysis and understanding of the crisis is only a first step in creating such wider ownership.

1

Introduction

1.1 The Focus

This paper focuses on Ireland's response to the current crisis. The Council seeks to assist government in developing an integrated response to the current crisis. This requires:

- (a) An accurate characterisation of the position in which Ireland finds itself in February 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 addresses the various dimensions of the crisis and can engage the Irish people in this critical struggle for survival of our economy, society, reputation and independence.

1.2 Where Does Ireland Belong? What is Our Ambition?

Events are moving so fast in the international economy that it can be hard to get one's bearings. In this profound crisis countries are comparing themselves with each other, are being ranked by rating agencies and are examining themselves. While these comparisons can be dispiriting in Ireland at present—and we certainly have things to learn from others—they should not dampen Ireland's ambition for its economy or its society.

We say this for two reasons. First, the grouping of countries, and even the comparison of countries can be misleading and can conceal as much as it reveals. Second, the kind of difficulties Ireland is currently experiencing have been shared, at various times, by states and societies that recovered and went on to impressive social and economic achievements. Furthermore, several of those societies have structural similarities to Ireland and they are ones we have long been interested in learning from.

In this fast-moving crisis countries are being categorized in various ways. One is to identify a set of eurozone countries—Greece, Spain, Portugal, Italy and Ireland—that are experiencing severe public finance problems in the current international recession and financial crisis. Indeed, in all these countries the yield on their government bonds has risen significantly in recent months reflecting the perception that their public finances are at increased risk. Another grouping is the more recent EU member states—Hungary, Latvia, Lithuania, Estonia, Bulgaria and Romania—that are having a particularly bad time in the current international recession and financial crisis. While such categorisations are inevitable to some degree, they may not be that helpful for policy learning and societal aspirations. For example, Spain, like Ireland, is suffering the contraction of a large construction industry after a building boom and, largely because of this, both countries face a severe public finance deficit. The similarity glosses over significant differences—in areas such as the banking regulation, labour market policy and the development of high-technology manufacturing and high-value services. These differences are as important as the similarities if our focus is policy learning, the foundations of economic dynamism and the ambitions of society. Indeed, the European Union is structured and organised not on the basis of categorical groupings of member states, but on the basis of policy areas—some highly coordinated, some loosely coupled—in which member states can do fine-grained benchmarking and learning. Ireland's active participation in this learning—and our willingness to learn different things from diverse countries—is critical in finding our way forward.

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. Like Ireland, all these countries have displayed strong growth of high-value manufacturing and services, have a profile in high-technology industries, are successful at job creation, and have enduring systems of social partnership in which diverse interests resolve differences and agree on the need for stability, competitiveness and the complementary nature of economic and social policy. They have, at different times, experienced occasional sharp economic reversals. Indeed, in several cases their economic crises have included the collapse of an asset price bubble, a banking crisis and a sudden fiscal imbalance.

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 of these countries—that have achieved enduring prosperity and high levels of inclusion and solidarity—is that they 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 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 a real sense, both these characteristics mesh with Ireland's policy developments and ambitions of the past four decades. To reverse Ireland's lagging economic development we built institutions and policies—such as the IDA, the education system and our participation in Europe—to actively engage with the most advanced international firms and to address a succession of problems that constrain economic development in a small peripheral European country. To find a stable economic and social framework we then adopted policies and built institutions—such as social partnership and our participation in European monetary union—to achieve a consistent combination of macroeconomic, distributional and structural policies. In recent years, we have seen that to truly reach our ambitions we need now to connect these economic and social projects, policies and institutions. This found expression in the idea of a developmental welfare state, linked to, and appropriate for Ireland's economy and economic development institutions.

The profound current crisis might be seen by some as a reason to abandon these ambitions. The international evidence—for example from Sweden, Denmark, Finland, the Netherlands and other countries—is that this need not be so. To maintain our ambitions, we must recreate our common purpose. As in the countries listed, this common purpose must be expressed through a willingness to fund public systems and a relentless insistence that public bodies respond to the changing and diverse needs of individuals, families, neighbourhoods, enterprises and sectors. If the future economy is different, and it will be, this will pose less of challenge to the developmental welfare state we are beginning to build than it would to a traditional one, or to an underdeveloped one.

The Council believes that the actions Ireland takes in the next two years will, in large measure, determine whether we rebuild our common purpose and apply it to realising our economic and social ambitions, even in an uncertain world.

1.3 Where is Ireland Now: Near the End or at the Beginning?

In this paper, we argue 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.

The analysis in Chapter 2 shows that these five crises have their origin in a complex set of global, international, European and national imbalances and events. 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.

The pressure of events has forced the Irish government to react to various aspects of the unfolding crisis. The sudden contraction of expected revenue in mid 2008 prompted Government to move the budget forward from December to October. The deepening of the international credit crunch, following the collapse of Lehman Brothers, forced government to introduce bank guarantees on the night of September 30th, 2008. The early budget included introduction of the income levy at 1, 2 and 3 per cent on different levels of income. A range of other Irish policy reactions to the crisis are summarised in Table 1, categorised by the five dimensions listed above. To this list could be added the proposals and programmes of a range of organisations within Ireland. Between actual reactions and alternative proposals we observe a disparate catalogue of actions and ideas. A key question is how to progress from reactivity to response.

In summary, this paper advances six main arguments:

1. Our understanding of the crisis, and of the relative contributions of global and national factors, is evolving. As revised forecasts suggest that more and more countries will experience a large contraction of output in 2009, we increasingly appreciate that Ireland is in the midst of an historically significant, global, economic crisis.
2. 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. We should not berate ourselves over the fact that these reactions to fast-moving events do not yet constitute our full, considered, integrated and agreed response. Equally, while government and some other actors have had to react to events, other processes have proved slow in responding.
3. There are five dimensions to Ireland's current 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.
4. It is possible to devise a set of further reactions to the banking crisis, the fiscal crisis, the economic crisis, the social crisis and the reputational crisis. But, our analysis strongly suggests that this series of partial and piecemeal measures, some of which are undoubtedly necessary, will not be sufficient and effective.
5. This lack of effectiveness is likely for three related reasons:
 - Technically, action on each of the crises requires specific supportive and coordinated actions on several of the others;
 - 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; and
 - 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.

6. Consequently, it is now necessary to formulate an integrated national response to the five crises.

The goal of this paper is to develop the case for the six propositions outlined above.

While the paper argues that action on each of the five crises depends on action on the other four, it is not suggested that only measures which deliver on more than one front should be considered. Despite the inter-dependence between policies, some are effective in addressing certain problems and others at addressing other problems. This is why we identify five distinct, but related, crises. Each sphere and crisis requires to be analysed correctly. For example, while a fair sharing of burdens is critical to overall success, the policies that can ensure a sense of fairness (such as taxation and holding financiers to account) will not, in general, be very effective in addressing the economic crisis of firm closures and unemployment. In this sense, the paper seeks to draw on the Council's particular contribution to Irish policy—the willingness and ability of diverse actors to engage in honest, joint, deliberation and analysis of evidence and explanations.

Consequently, the specific argument of this paper is not that there are advantages in engaging economic and social organisations in framing and implementing an integrated national response to the crisis. This may be true. But the essential argument of this paper is that there is an analysis and understanding of the five distinct, but related, crises that suggests that Ireland needs an integrated, and clearly articulated, national response over the coming years. It is not the existence of diverse economic and social organisations, in itself—or some general advantages of policy consultation or joint policy framing—that is invoked in support of an integrated approach. If anything, it is the reverse. The analysis of the crises and the necessary elements of an integrated response is cited as a reason to frame an integrated response, as far as possible, in engagement with a range of Irish organizations. It is the shared analysis and understanding that warrants the integrated response, not the joint engagement that warrants an agreed response.

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. Framing a shared analysis and understanding is only a first step in creating such wide ownership.

Table 1.1 Policy Reactions to the Unfolding Five Part Crisis

Banking Crisis	<ul style="list-style-type: none"> ◆ Guarantee arrangement to safeguard all deposits (Sept 2009) ◆ Decision to re-capitalise Anglo Irish Bank, AIB and BOI (Dec 2009) ◆ Nationalisation of Anglo Irish Bank (Jan 2009) ◆ Recapitalisation of AIB (€3.5bn) and BOI (€3.5bn) (Feb 2009) ◆ Central Banking Commission (March 2009)
Fiscal Crisis	<ul style="list-style-type: none"> ◆ 3% reduction in public sector pay roll bill for 2009 (July 2008) Budget 2009 (October 2008) <ul style="list-style-type: none"> — Income Levy (0% up to €18,304; 1% up to €101,000; 2% up to €250,000 and 3% over €250,000) — Supports to business: tax, R&D, stamp duty, capital gains, farm taxation — Charge on second homes ◆ Ministerial pay cut (October 2008) ◆ Set target to eliminate current budget deficit and reduce general government deficit to below 3% by 2013 (Jan 2009) ◆ Special Group to review public service numbers and expenditure programmes (Dec 2009) ◆ ‘Draft Framework’ agreed by Government and the Social Partners (Jan 2009) ◆ Financial Emergency Measures (Feb 2009) <ul style="list-style-type: none"> — Pension levy; Farm Waste Payments; Professional Fees and services; Early childcare Supplement; ODA; General Administration ◆ Decision to introduce further measures to ensure deficit is limited to 9.5 per cent of GDP in 2009 (March 2009).
Economic Crisis	<ul style="list-style-type: none"> ◆ Investment <ul style="list-style-type: none"> — Maintain commitment to capital investment, spending on science and research (Oct 08) — Economic renewal programme: Ireland’s Smart Economy (Dec 2008) — Enterprise Stabilisation Fund with initial funding of €100m (March 2009) ◆ Jobs <ul style="list-style-type: none"> — Prioritising projects that generate more jobs: €150 million re-allocated towards schools infrastructure and home insulation and energy efficiency measures (Feb 2009) — Mid-West Region Task Force (Feb 2009)

- ◆ Costs
 - No increase in corporation tax and new measures to support R&D (Oct 2008)
 - Energy regulator to work with the energy companies to reduce prices (Feb 2009)
- ◆ Credit
 - Banks required to provide at least 10% more capacity for lending to small and medium-sized enterprises in 2009. (Dec 2008)
 - Banks introduce €100m fund to support energy efficient investments (Dec 2008)
 - Statutory Code on lending to business with effect from March 13th (Feb 2009)

Social Crisis

- ◆ Exemptions from new income levy for those on lower incomes (Oct 2008)
- ◆ Rule changes to ease pressures on defined contribution and benefit pension schemes (Dec 2009)
- ◆ Recapitalised banks to provide additional 30 per cent capacity for lending to first-time buyers in 2009 (Dec 2008)
- ◆ Statutory Code of Conduct on Mortgage Arrears with effect from Feb 27th (Feb 2009)
- ◆ Increasing the capacity to deal with those becoming unemployed and providing advice (Feb 2009)
- ◆ Welfare forms available on line (Feb 2009)
- ◆ New system of allowance and expenses adopted by Oireachtas (Feb 2009)
- ◆ Decision to review the Mortgage Interest Supplement (Jan 2009)

Reputational Crisis

- ◆ Independent Committee to examine remuneration and bonuses in banking sector (Dec 2008)
- ◆ Agreement at European Council on elements of national & EU action on the Lisbon Treaty (11/12 Dec 08).
- ◆ Government appointees to bank boards (Dec 2008)
- ◆ Task Force on Public Sector Reform (Jan 2009)
- ◆ 'Draft Framework' agreed by Government and the Social Partners (Jan 2009)
- ◆ Agreement with European partners on concerns of the Irish people on Treaty of Lisbon (Dec 2008)
- ◆ €2bn Public Expenditure Savings for 2009 (Feb 2009)
- ◆ Resignations by some senior regulators and senior bank personnel (Feb 2009)
- ◆ Statutory Codes of Conduct for Banking (Feb 2009)

1.4 Structure of the Report

Chapter 2 describes the main features of Ireland's economic crisis and identifies the reasons for such a rapid deterioration in output, revenue, employment and wealth. Note is made of the uncertain international environment within which Ireland must frame and implement its response. The chapter discusses the ways in which the crisis poses profound challenges to the European Union.

Chapter 3 summarises a number of aspects of the Council's existing analysis and understanding that are relevant in current circumstances. It draws attention to the Council's recognition of a number of the risks and vulnerabilities inherent in Ireland's economic and social development. A detailed supporting Appendix, A, summarises the Council's discussion, at various times since 1986, of the mechanisms of adjustment that are necessary and appropriate in a small country within the euro zone. The chapter and supporting appendix discuss the degree to which the current five-part crisis can be seen as a manifestation of risks identified by the Council. It can certainly be seen as a manifestation of some of the international risks inherent in Ireland's economic position: 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. Of course, the current crisis involves the simultaneous materialisation of a number of the negative scenarios analysed earlier, and it was not envisaged that these would occur together. But it is also clear that the crisis is a manifestation of a number of risks that were not identified. Prime among these is the dramatic collapse of the model of international finance and financial regulation that developed in the past 20 years, as we discuss in Chapter 2. This, combined with the deep global recession and Irish crisis, have created an unprecedented economic context. Finally, 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. It seems clear that features of Ireland's approach to economic and social development, policy implementation, regulation, coordination and bargaining have not sufficiently protected the economy and society against some of the vulnerabilities identified in earlier studies.

Chapter 4 identifies a number of characteristics of an effective Irish response to the crisis. These range from the need for the response to address all five dimensions of the crisis, to the importance of taking short-term measures that have a long-term logic. Among the most important is that an effective national response would combine high-level coherence with maximum engagement and local problem solving. The chapter concludes with the assertion that Ireland now needs an integrated, and clearly articulated, response for the coming years and this must combine retrenchment with fairness and reform.

Chapter 5 seeks to further explain and defend the six core arguments stated above. It argues that it is possible to devise a series of further reactions to the banking and credit crisis, the fiscal crisis, the economic crisis, the social crisis and the reputational crisis. Focusing on each crisis in turn, it identifies the kinds of issues that need to be resolved and some of the measures that are likely to be necessary. In each case, it is argued that the measures necessary to address one crisis, viewed narrowly, require the support of actions on the other crises. Three general reasons keep arising. First, the narrowly-focused actions are, in a number of cases, unlikely to succeed in solving the narrow-defined problem they are aimed at. Second, actions focused narrowly on any one of the five crises will be hard to communicate and implement because of problems and tensions created by the other four crises. Third, Ireland needs to formulate an integrated national response that is widely understood, can command support and, most importantly, can engage the ability and energy of the Irish people. Further partial and sequential measures, many of which are undoubtedly necessary, will not be sufficient and effective, for the reasons summarised above.

One counter argument might be that it too late to seek an integrated and agreed response. If account is taken of the scale and possible duration of the crisis, we see that this view is probably mistaken. We could look back ruefully in five years and see that we were mistaken to believe that the die was cast in March 2009.

The paper takes a step back from many of the specific policy recommendations that are warranted. Ideas and options on several policy areas—fiscal policy, the labour market and activation, pensions policy and public sector reform—are presented in Appendix B. While many of the most critical and urgent policy areas are confined to this appendix, it is important, at this stage, to separate the overall analysis and argument from discussion of specific policy proposals or options. Appendix C provides supporting material in relation to technology revolutions and financial capital and Appendix D provides an overview of partnership and policy responses in other countries.

2

Describing and Understanding the Crisis

2.1 Introduction

There are a number of interacting dimensions to the current crisis facing the Irish economy. Section 2.2 describes some of the most salient features to the crisis, detailing the sharp decline in output, the impact on the labour market, the effects on public revenues and the emergence of some new economic phenomena. Section 2.3 seeks to provide an overall understanding of why Ireland's economic fortunes have so dramatically reversed, focusing in turn on the impact of a period of prolonged high growth on the economy's competitiveness, Ireland's banks and financial regulatory system, and the nature of the global financial and economic crisis. Section 2.4 reflects on what facing the future now entails.

2.2 Describing the Crisis

2.2.1 A Sharp Decline in Output

There has been a rapid and steep fall-off in economic growth. The swing from GDP growth of 6 per cent in 2007 to a contraction of 1.8 per cent in 2008, with a further contraction of at least 4 to 5 per cent forecast for 2009¹, is unprecedented in its speed and depth. What has happened in the two years 2007 and 2008 alone already surpasses previous Irish downturns; real GDP growth dropped by 7.8 percentage points (Table 2.1). It took six years from 1978 to 1983 for GDP to fall by a similar amount, and growth just entered negative territory in the trough (-0.7 per cent in 1983).

With the sole exception of Iceland, the downturn in the Irish economy in 2007 and 2008 was the most severe of any experienced by an OECD member state (*OECD Economic Outlook*, December 2008). Ireland also had the unfortunate distinction of being the first euro area economy to record a recession (two consecutive quarters of negative economic growth)

¹ Department of Finance and European Commission January 2009 forecasts respectively. By March 2009, some private sector economists were anticipating more.

Table 2.1 Irish Economic Downturns Compared

	1972-'75	1978-'83	2000-'03	2007-'09
	GDP, Annual Volume Change			
	%	%	%	%
Peak	6.9	7.2	9.2	6.0
	5.6	4.2	5.8	-1.8
	2.6	2.9	6.4	-5.0 (f)
	1.4	2.5	4.5	
		1.5		
Trough		-0.7		
Swing	5.5	7.9	4.7	11.0

The reason for Ireland's particularly severe downturn is that a substantial housing market correction and sharp deceleration of export growth have occurred together. Residential construction peaked at almost 90,000 units in 2006 and a correction, in both house prices and supply, began towards the end of that year. The decline has accelerated —as few as 22,500 houses may be completed in 2009²—and spread to commercial and retail construction, particularly after the international credit crunch in September 2008 exposed the huge involvement of the country's banks in borrowing short-term funds on international money markets to fund property investments and purchases (discussed further below).

As domestic investment in construction has plunged, the growth rate of Ireland's exports has also dramatically slowed, pulled down by the worsening international recession. Growth of 6.8 per cent in exports of goods and services in 2007 fell to 1.2 per cent in 2008 and is anticipated to become a fall of between -0.7 per cent (*Central Bank, Quarterly Bulletin*, January 2009) and -2.6 per cent (*European Commission, Interim Forecast*, January 2009) in 2009. This decline in exports partly reflects the significant declines taking place in the GDP of Ireland's main trading partners in 2009: the European Commission forecasts a decline of 2.8 per cent in the UK, 1.6 per cent in the US and 1.9 per cent in the euro area. In addition, a significant depreciation of sterling against the euro has occurred, compounding the difficulties facing Ireland's indigenous exporting companies in particular.

2. Central Bank Quarterly Bulletin, January 2009.

Initial expectations that the financial turmoil that began in the US in 2007 would confine itself to the Anglo-Saxon economies (where relatively short-term developments in shareholder value are considered to have greater weight in boardroom decisions), and that any impacts on the real economy would be largely confined to the advanced economies, have been progressively confounded. Into 2009, the profound interdependence of finance and production, and of advanced and emerging economies, is painfully evident. Across Asia, and for big and small countries in the EU, exports plunged in the last quarter of 2008 leading to some phenomenally bleak forecasts for some economies in 2009 should the same trends continue (e.g., a contraction in GDP in 2009 of 12.7 per cent in Japan and of 9 per cent in Germany; China's exports plunged 17.5 per cent in January 2009 on the same month a year previously).

Even without a major contraction in construction activity, the Irish economy would be facing a very challenging outlook because of this dramatic slowdown in world trade. Occurring together, the fall-off in construction and bleak global trading conditions create an economic 'emergency' today that is comparable to some of the most difficult decades faced by the State since its independence.

2.2.2 Consumer Spending and Saving

The onset of recession has led to a fall in consumer spending. Consumer spending began to fall in the second quarter of 2008 and declined by over 1 per cent in both the second and third quarters. The retail sales component of consumer spending has shown a particularly sharp drop with a fall of 4.5 per cent in 2008. The decline accelerated over the year and the final quarter saw an annual drop in sales of 8 per cent. In addition to the fall in spending, the trend in retail sales is affected by the rise in cross-border shopping³. In the year to November 2008, the decline in retail sales in Ireland (-7.3 per cent) was almost three times the average decline for the euro area (-2.6 per cent)⁴. There were some other EU (15) countries that had similarly large falls in retail sales over the year to November 2008: Italy (-5.6 per cent), Denmark (-6.1 per cent) and Spain (-7.9 per cent).

The emergence of recession and the fall in employment would be expected to result in a fall in spending. The decline in consumer spending, however, is more pronounced than can be explained by changes in current income. The ESRI (*Quarterly Economic Commentary, QEC, Winter 2008*) has estimated that there was a substantial increase in the savings ratio from 3.8 per cent of personal income in 2007 to 5.7 per cent in 2008. A further increase to 8.6 per cent is projected for 2009.

There are a number of possible explanations as to why consumer spending is falling by more than would be warranted by changes in income. The most significant factor is likely to be the widespread uncertainty across the economy, in particular fear of possible job losses. Another negative influence is the fall in wealth, including pensions. This creates a need for increased savings to rebuild provision for retirement. The prospect of future tax increases or earnings reductions could also be restraining spending. A credible plan to tackle Ireland's economic crisis has the potential to limit the decline in consumer spending.

3. Retail sales refers to sales within the Irish state while Irish consumer spending is an estimate of consumer spending by Irish residents anywhere in the world.

4. Comparisons with euro countries are based on retail sales excluding motor trades and bars.

2.2.3 A Sharp Fall in Employment and Increase in Unemployment

Total employment began falling during 2008. It was down 4.1 per cent (a drop of 86,900) by the fourth quarter of 2008 on a year earlier (it had grown by 3.2 per cent in the year to the fourth quarter of 2007).⁵ The largest decline was in the construction sector (-45,900) with large falls also recorded in the wholesale and retail trade (-18,200), other production industries (-11,600) and hotels and restaurants (-10,500). The decline in male employment, at 5.7 per cent, was nearly three times that in female employment (-2.0 per cent); some 70 per cent of the male jobs lost were in construction. The decline in employment held by nationals from the new EU member states was also particularly sharp, down by 10 per cent as against a fall of -3.8 per cent for Irish nationals. A sharper fall in total employment is expected for 2009, with the ESRI projecting a fall of 5.5 per cent (116,000) and the Central Bank one of 4.6 per cent.

Over the course of 2008, the standardized monthly unemployment rate rose from 4.9 per cent to 8.3 per cent. By December 2008, the seasonally adjusted Live Register (LR) was up 70 per cent on a year earlier at 293,500 people. By February 2009, it had climbed further to over 350,000, up almost 88 per cent on a year earlier, while the unemployment rate increased to 10.4 per cent, entering double-digit territory for the first time since October 1997.

The fall in employment and increase in unemployment are taking place across the territory of the State, but some regions and areas are being affected disproportionately. The numbers on the Live Register in the Mid-East Region (the commuting counties of Meath, Kildare and Wicklow surrounding Dublin) recorded an 87 per cent increase in 2008, and the Midlands Region a 76 per cent increase (the increase nationally was 70 per cent). In smaller local areas with a particularly high reliance on construction employment, cost-sensitive manufacturing operations, tourism or retail, Live Register numbers have doubled.

2.2.4 A Dramatic Drop in Revenue

The sharp decline in economic growth *and* the fact that it has been pulled down largely by a slump in tax-rich activities (housing and domestic demand in general) has caused a spectacular drop in tax revenue. Exchequer tax revenue (excluding PRSI) fell by €6.5 billion during 2008 and was €8 billion below what had been projected at the start of the year. The shift in the composition of tax revenue away from income tax in earlier years substantially increased the scale of the decline. It was estimated by Honohan (2009a) that, if corporation tax, stamp duties and capital gains tax had retained their combined 1987 share of total tax revenue, the fall in revenue in 2008 would have been much lower, at 8 per cent instead of 14 per cent. There will be a further sharp decline in revenue during 2009; the first two months of the year have shown a fall in revenue of €1.8 billion or 24 per cent compared to the corresponding months in 2008.

5. This paragraph is largely based on CSO (2009), Quarterly National Household Survey, Quarter 4 2008.

Public expenditure has continued to increase. Between 2007 and 2009, net current expenditure increased by around €8 billion (an increase of around 20 per cent in nominal terms), before taking into account the recently announced cuts of €2 billion. The increase in current expenditure has been consistent with budgetary projections; in fact, the outturn for net current expenditure in 2008 was slightly below the initial projection. Following reductions in 2009, the level of net capital expenditure in 2009 is close to its 2007 level in nominal terms.

Largely because of the dramatic drop in tax revenue, Ireland's public finances have deteriorated rapidly. In the absence of policy changes, the Department of Finance estimated in January 2009 that the deficit, as measured by the general government balance (GGB), could be 10.5 per cent of GDP in 2009, with double digit deficits being sustained out to 2013. Since then, savings measures have been announced with a full year value of €2 billion, but there has been a further deterioration in the revenue outlook. It was announced in March 2009 that additional measures will be introduced to limit the GGB to 9.5 per cent of GDP 2009. By comparison, the *average* euro area government budget deficit is forecast to rise substantially, but from 1.7 per cent in 2008 to 4.0 per cent in 2009; the 2009 forecast for Ireland and into 2010 on the basis of unchanged policies is by far the worst anticipated for any EU member state (European Commission, Interim Forecast, January 2009). The Government intends to reduce the 2009 deficit to 9.5 per cent of GDP. Even when this is achieved, over 16 per cent of the State's current running costs will be met by borrowing in 2009. The debt/GDP ratio rose to 41 per cent at the end of 2008 compared to 25 per cent at the end of 2007. However, this is exclusive of around €20 billion cash held by the NTMA (more than 10 per cent of GDP). In addition, an account is taken of the assets of the National Pension Reserve Fund (NPRF) and the Social Insurance Fund, the net debt to GDP ratio at the end of 2008 was around 20 per cent of GDP.

2.2.5 Relatively new Economic Phenomena

A Fall in Prices

Following several years of relatively high inflation, Irish inflation has fallen sharply and there is now the prospect of a fall in prices. The December Quarterly Economic Commentary (QEC) of the ESRI forecast a fall in the CPI for 2009 of 2 per cent and a rise in the alternative inflation measure (harmonised index of consumer prices, HICP) of just 0.5 per cent, with the primary difference between these forecasts due to mortgage interest rates. Inflation has fallen much more than analysts and policy makers had expected earlier; the summer 2008 QEC projected CPI inflation of 2.7 per cent. Furthermore, the strength of the euro against sterling has not yet been reflected in consumer prices. Importers are typically engaged in long term price contracts so there is a delay in passing on exchange rate movements to prices. The current weakness of sterling along with further falls in interest rates and rents raises the possibility of a considerable fall in the level of the CPI in 2009. According to Fitz Gerald (2009a), the CPI is likely to fall by at least 3 per cent in 2009 and possibly by 5 per cent. If wages were to fall, this would further reduce the CPI.

Changing Composition of Wealth

The sharp declines in the values of property, equities and pension funds have all contributed to substantial reductions in the wealth of Irish households and depleted nest eggs for many retired people. Because of their exposure to Irish equities which have been particularly severely affected, it is estimated that Irish-managed pension funds declined by an average of 35 per cent in 2008 (Moloney and Whelan 2008); there are now large deficits in many private pension funds. By the end of 2008, house prices were down a cumulative 15 per cent on their peak in February 2007 and showed little sign of having bottomed out; a minority of home owners now have negative equity. Overall, it is likely that the proportionate decrease in private wealth in Ireland will be higher than elsewhere.

The fall in wealth has a negative effect on confidence in the short-term; its long-term impact will not be clear for some time but the scale of the recent contraction in wealth is likely to have significant long term effects. The contraction of wealth is, also, unevenly distributed. There are, of course, some positive dimensions to the fall in asset values. The price of Irish property, and land and commercial rents had risen to unsustainable levels and become a burden on individuals trying to buy houses and on business in general. The fall in property and land values will help to restore lost competitiveness. Typically, asset prices declines are followed by recovery.

One component of household wealth not directly impacted by the collapse in share and house prices is the value of deposits and financial securities. Table 2.2 provides an overview of the financial assets and liabilities of Irish households (it thus includes householders' mortgages but not the value of their houses). In 2007, Irish households held currency, deposits and financial securities to the value of almost €100bn. How households use these assets over the coming months and years may be a vital component in the Irish recovery. A key factor may be the overall confidence people have in the future of the Irish economy.

The Table shows how growth in mortgages (i.e., 'long term loans') have dominated the growth in Irish households' financial liabilities, but also that the same households increased investment in pensions and insurance policies as well as their deposits and holdings of financial securities. The overall picture is not one of particularly imprudent behavior and augurs well that, if given sufficient information and a strong sense of vision, Irish households will act responsibly during the current crisis also.

Sovereign Credit Risk

An implication of the reputational dimension to Ireland's economic crisis has been a sharp increase in the premium payable on Irish government bonds. The interest yield on ten-year Irish government bonds is 2.5 percentage points higher than corresponding German bonds and marginally higher than the yield on Greek bonds. There is a related large premium on Irish credit default swaps (CDS); these are financial instruments that can be used to insure against defaults on bonds. Speculation in the CDS market can add to the premium on Irish bonds and thereby worsen the public finances by making it more expensive to refinance debt. The high level of cash reserves (around €20 billion at the start of the year) provides a short term buffer from the need to raise finance on the bond markets in the immediate future. Notwithstanding difficult market conditions, the National Treasury Management Agency (NTMA) successfully launched two bonds in the first

Table 2.2
Financial Assets and Liabilities of Irish Households (€ bn)

	2001	2007
Assets		
Currency, deposits, securities	55.9	99.1
Shares	59.1	79.1
Insurance and pension	64.4	126.6
Total Assets	180.4	308.2
Liabilities		
Short term loans	14.6	11.8
Long term loans	44.0	173.9
Total Liabilities	60.4	190
Net Financial Assets	120.0	117.3

Source CSO Institutional Sector Accounts 2001-2007, December 2008

Note Totals contain minor additional items.

two months of 2009. With these bonds the NTMA raised a total of €10 billion or 40 per cent of the expected funding requirement for 2009. The issue of how to address Ireland's reputational crisis is discussed in Section 5 below.

Availability of credit

The growth of credit to the private sector has slowed markedly over the past two years, while in the final quarter of 2008 the level of credit to the non-financial private sector (business and personal lending) contracted by over €3 billion. The contraction of credit occurred across most sectors of the economy. The results of European Central Bank (ECB) credit surveys show that the contraction in credit is due both to weaker demand and a more restrictive approach by lenders.

A decline in the supply of credit is a global problem. Given the recession, it is rational for banks to adopt a more cautious approach, as borrowers' prospects have deteriorated. However, the decline in credit can itself be a factor in a weaker economy. Bebchuk and Goldstein (2008) have pointed to a potential coordination problem with credit: because of the impact of bank lending on the level of demand in the economy, the risk of one bank getting repaid depends on the willingness of other banks to lend. Hence the economy: 'may get stuck in an inefficient credit freeze in which banks expect other banks to avoid lending, and given these expectations rationally choose to hoard their capital to avoid the expected losses from lending when other banks to not' (Bebchuk and Goldstein, 2008).

Another factor that could be restricting credit availability in Ireland is a desire by banks to reduce their high loan-to-deposit ratios and associated reliance on wholesale money markets. Honohan (2009b) has pointed out that a rush to reduce this ratio could be disastrous for the country's ability to ride out the global recession.

As part of the recapitalisation of the two main banks, these banks have made commitments to increase lending capacity to small and medium enterprises by 10 per cent and to provide an additional 30 per cent lending capacity to first-time buyers in 2009. Compliance with this commitment will be monitored by the Financial Regulator.

2.3 Understanding the Crisis

The current Irish crisis can be understood as a combination of the following elements:

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

Views on the relative significance of these three causes of Ireland's current crisis differ. Indeed, it seems likely that our judgement on their relative roles will continue to change, as events unfold and as more knowledge is gained on the depth of the crisis in other small European member states. Here we discuss how each helps us to understand the crisis.

2.3.1 The Declining Competitiveness of Ireland's economy

From approximately 2001 onwards, a profound shift in what was driving the Irish economy took place, the full implications of which did not—and could not have been expected to—register with most of the Irish public at the time. On the surface, the 'good times' appeared to continue. Real growth in GDP averaged 5.6 per cent over the seven years, 2001-2007. This was a significant drop from the 9 per cent recorded between 1994 and 2000, but still sufficient to maintain Ireland's economy as one of the fastest growing in the OECD world, generating steady net employment growth and revenue buoyancy. Beneath the surface, however, the construction industry took over from the traded sector the role of driving the economy. Export growth in volume terms fell from an annual (and truly exceptional) average of over 17 per cent between 1994 and 2000, to under 3 per cent between 2001 and 2007. But Irish living standards were not affected by this sharp drop in the performance of exports (and there was, correspondingly, less pressure to analyse why it occurred and to address its implications), because a surge in domestic construction gathered pace after 2001, particularly in house-building. Construction peaked at 24.5 per cent of GNP in 2006 (DKM, 2008), by which time the level of Irish house-building was as remarkable internationally as the growth rate of Irish manufacturing exports had been in the late 1990s.

The shift from export-led growth to construction-driven growth had a dramatic effect in changing the composition of Ireland's current account on the balance of payments. It had been in near balance between 1998 and 2004, with a substantial trade surplus being more or less offset by the royalties, license fees, dividends, etc., paid to multinational parent companies abroad. After 2004, however, the current account balance deteriorated sharply to record a deficit of 6.4 per cent of GDP in 2007 and 6.5 per cent in 2008. This occurred because of the way the surge in house-building was financed; banks and other mortgage providers in Ireland began, effectively, to 'import' funds on a large scale (borrowed on international markets) in order to provide mortgages to house buyers and loans to builders and developers. Borrowing on this large scale to boost domestic savings and invest in a rapidly growing economy need not be a problem, if the investments are productive. The conditions that make investment in the different types of construction 'productive', however, can be poorly understood (see 2.3.2 below).

A further major feature of the last fourteen years during which growth has been high is that Ireland's price level, relative to elsewhere in the EU, rose significantly. From being just below the average for the EU-15 in 1996, it was 14 per cent higher in 2001 and 19 per cent higher by 2007.⁶ Expressed in another way, Ireland moved from being the 6th cheapest EU-15 country in which to live and carry on business in 1996, to being the 4th most expensive in 2001 and the second most expensive (after Denmark) by 2007. A convincing detailed analysis of how and why this has happened remains work in progress. But it is probable that the rapid growth of the Irish economy, movements in the relative value of the euro, infrastructural deficits, weak competition in some sectors (e.g., professional services), small scale, high indirect taxes, low productivity in some services (including public services) and the actual levels of wages/salaries in some segments of the labour market have all played their part. It is also possible that the much less dramatic increase in the relative cost of living in Ireland in the first half of the current decade, compared to the second half of the 1990s, is linked to the large immigration from the states which joined the EU in 2004 and subdued wage growth — at least in the parts of the economy that migrant workers entered in significant numbers.

While a convincing analysis has yet to be done, Ireland's high price level assumes a higher profile as it becomes imperative to reinvigorate exports once again; rents, business services, utilities, wages and other Irish inputs to exporting companies have become more expensive at a pace which productivity advances simply could not compensate for (and for which, of course, the policy instrument of devaluation was also not available). The annual competitiveness reports of the National Competitiveness Council benchmark a range of Irish costs against other countries and cities. The most recently published of these reports (NCC, 2009), shows that key non-pay costs in Ireland compare poorly to other countries, including property costs, utilities (electricity, waste and mobile telecommunications), and a range of business services (accountancy, IT and legal services). Within Ireland, costs are typically highest in Dublin.

6. Comparative price levels (in this instance of final consumption by private households including indirect taxes) equalise the purchasing power of different national currencies and allow countries to be ranked as relatively expensive/cheap. They are available and updated on the Eurostat website.

Wages also cannot be left out of the picture. Wage growth in Ireland has been considerably faster than in Ireland's trading partners during the current decade, notwithstanding the slowdown in real wage growth in Ireland since 2006. The measure 'unit labour costs in common currency terms' incorporate the effects of both wage and productivity growth in Ireland relative to Ireland's trading partners as well as exchange rate movements. For the manufacturing sector, unit labour costs in common currency terms in Ireland have fallen relative to Ireland's trading partners. Much of this was due to the exceptionally high value-added chemicals sector. For the economy as a whole, unit wage costs in common currency terms were 32.4 per cent higher in 2007 than at the start of the decade relative to Ireland's main trading partners (Central Bank, 2008: 46).

While the ambition has been clearly stated to base the productivity and competitiveness of the economy on the ability to apply knowledge and to innovate, rather than on low costs, a significant number of workplaces and businesses have not yet developed sufficient capabilities in these areas and remain vulnerable to cost competition, and they are being squeezed. The combination of the euro's rise against sterling and the dollar and rapidly rising Irish costs saw Ireland's real exchange rate increase by 25 per cent between 2001 and 2007, whereas it had fallen by 7 per cent over the preceding seven years, 1994-2000.

Restoring competitiveness in a way that is equitable will require a multidimensional approach. This is addressed in Chapter 5 below.

2.3.2 The Property Bubble, Ireland's Financial Institutions and Regulatory System

A part of the above story of how domestic demand took over from net exports the role of driving the economy is not unusual. It could appear to describe a normal process in which the extreme competitiveness of an export sector is gradually reined back and the latter is forced to share more of its gains with the non-traded sector with which, after all, it shares the same 'social space'. But the rate of expansion of Ireland's construction sector, and the scale it attained, came to reflect much more than the preference of Irish people to increase home ownership and enjoy larger homes on foot of a stronger economy. While fundamental factors initially drove higher levels of demand for houses (rising incomes, a growing population in the age group at which household formation most occurs, falling real interest rates, immigration, etc.), and slow progress was made in tackling some intractable supply constraints (principally land management and planning), houses continued to sell despite their prices being higher than they needed to be. However, once again, a transition occurred which is clearer in retrospect than at the moment it happened; expectations of future house price increases themselves began to drive current house prices. Money, sourced cheaply by financial institutions on international markets, was used to build/buy already expensive houses because the lenders, builders and end-purchasers all shared the expectation that the value of the houses in question would continue to rise.

This type of ‘irrational exuberance’ or collective hubris cannot be ascribed to any unique Irish cultural trait or institutional feature. Periods of dramatically strong economic growth are frequently followed by an asset bubble as expectations of capital appreciation of the asset type in question (usually property and/or equities) develop a self-fulfilling momentum that delinks its price level from underlying economic fundamentals. It only requires that a new group of investors continually appears who believe that some upside remains in the market for the most recent investors to make money. These ‘animal spirits’ to which Keynes drew attention in studying the 1920s and which later economists have studied with the help of social psychology (Shiller, 2008; Akerlof and Shiller, 2009) are no respecter of nationality or sophistication of economic development, but have appeared in advanced and emerging economies from Northern Europe to Latin America. At the same time, it is deeply disappointing that Ireland’s fourteen years of strong growth led to ‘the steepest and longest of the several national property bubbles around the world in the late 1990s and early 2000s’ (Honohan, 2009b).

Significant indicators flashed red long before the international credit crunch exposed the level of hubris which had infected Irish financial institutions. For example:

- ◆ house prices were seen to be departing from their long-term relationship with incomes and rents from the late 1990s onwards (the price-to-income and price-to-rent ratios began to climb);
- ◆ despite their high prices, houses remained an attractive buy because low interest rates and expected capital gains made taking on the required mortgage a good investment (the user cost of housing was declining);
- ◆ the sustainable level of residential investment, of some 10 per cent of GNP, was surpassed from 2001 onwards;
- ◆ the annual growth in the balance sheet of some banks frequently passed the 20 per cent rate considered to signal looming problems (Anglo Irish Bank averaged an annual 36 per cent growth rate between 1998 and 2007);
- ◆ in the 2006 Census, 15 per cent of the housing stock was found to be vacant;
- ◆ Irish financial institutions began to source increasing volumes of funds on the interbank market in order to lend on to developers and house-buyers (cheaply and with no exchange risk) —by the end of 2005, the net import of funds by these institutions for such purposes amounted to 41 per cent of GDP, a rise from 10 per cent just two years earlier (Honohan, 2006);
- ◆ the levels and structure of the remuneration of chief executives became delinked from any demonstrable economic purpose and from prevailing norms in the rest of Irish society.

It is sobering how the mass psychology of the property bubble kept many people who held major responsibilities in Irish banking institutions and the Irish regulatory system from acknowledging such warning signals as these and seeking to steer the institutions away from disaster. On the contrary, long after it was wise, Irish banks continued to lend on a large scale for the development and purchase of already highly-priced commercial and residential property in Ireland and the UK, in an effort to make up for their late entry and small market shares. Honohan (2009) even concludes that a distinct change of behaviour seems to have occurred in these formerly-conservative institutions. Note, for example, that a Government statement in February 11th 2009 observed that 'The Irish Financial Institutions have little or no exposure to the sort of complex financial instruments which are weighing on the balance sheets of many banks internationally'. Honohan argues that their vigorous sourcing of wholesale funds on international money markets 'may have begun to drive house inflation from about 2003 onwards' (Honohan 2009b).

It is also clear that the regulation and supervision of Irish financial institutions was ineffectual. A strong preference to operate a principles-based rather than rules-based regulatory regime was abused by the senior management of at least one major institution and may explain why significant instruments available to the Irish Financial Services Regulatory Authority —such as its ability to insist on prudent loan-to-income or loan-to-property ratios, higher risk weightings for property lending, higher capital ratios, more diversified loan books and key personnel being 'fit and proper persons' —were not used. The light approach to financial regulation may have been motivated by a desire to present Ireland, and in particular the IFSC, as an attractive place from which to export innovative financial services.

There are parallels between the Irish crisis and historic and current financial crises elsewhere. Reinhart and Rogoff (2008 and 2009) provide a survey of financial crises across many countries. Their work can remind us that Ireland is not unique, but also underlines the extreme seriousness of what has happened. In one study (2009), they focus on a set of five severe financial crises in developed countries (Spain 1977, Norway 1987, Finland 1991, Sweden 1991, and Japan 1992), as well as on famous crises in emerging markets (the Asia crisis of 1997-98, Columbia 1998, and Argentina 2001). They show that financial crises are typically preceded by asset price inflation, rising leverage and large sustained current account deficits and that the aftermath of severe crises share three characteristics. First, there are sharp falls in asset prices. The average fall in real house prices in severe financial crises was 35 per cent, while the average fall in equities was over 55 per cent. Second, there are sharp falls in output and employment. The average fall in output from peak to trough was over 9 per cent and unemployment on average rose by seven percentage points. Third, the real value of government debt rises sharply; the average real increase in debt was 86 per cent. The major driver of the increase in debt tends to be the fall in revenue rather than the cost of bank bailouts. The effects on asset prices, output and employment are deep and lasting, but these recessions do end. On average output declined for two years, while the rise in unemployment extends for five years.

They also ask whether the current problems will be more or less difficult to resolve than the historic episodes. On the one hand, they point to greater willingness of central banks to intervene in the current crises. On the other hand, previous episodes were confined to individual countries or groups of countries, while the current problems are global. This makes it more difficult for countries to resolve the crisis through export growth.

2.3.3 Structural weaknesses in the current globalisation process

What has been described above is, so far, a largely Irish story. An economy whose potential for growth was significantly underestimated up to the mid-1990s, grew prodigiously for a period of some 14 years. But in the process, saw international competitiveness decline and a major property bubble develop. Until Autumn, 2008, there were grounds for hoping that a substantial housing-market correction (which began towards the end of 2006), and strategies to renew the economy's competitiveness by focusing on knowledge and innovation, would enable the Irish economy to enter a new phase of more moderate but soundly-based growth without major dislocation (Fitz Gerald *et al*, 2008; NES, 2008; OECD, 2008).

In September 2008, however, what had started as a crisis in mortgage lending to the US sub-prime market a year earlier became a full-blown global financial crisis, triggered by the collapse of Lehman Brothers that month. Global capital markets froze. Ireland's economy, government and society found itself immediately exposed because of the borrowing and lending practices of its banks; literally overnight, they were no longer able to roll-over large volumes of short-term borrowing which they had loaned long-term for property-related transactions. As the global financial crisis has spilled over into the real economy, Ireland is experiencing new downsides to the increased openness and specialization of its economy (without which, of course, its rapid expansion and generation of higher living standards since 1993 would not have happened). Retrenchment in global manufacturing chains, the unraveling of international financial integration and new protectionist pressures questioning the benefits of free trade, particularly in services, if they become established, could significantly alter the Irish economy's growth trajectory.

In the meantime Ireland has no real alternative route to high employment and high living standards than through internationalising its economy; but this is consistent with acknowledging major weaknesses in current global trading relationships, financial flows and their governance. In fact, awareness of the vulnerability of any small, open economy and of the desirability of radical reform in global economic governance should permeate all policy-making in Ireland.

Compelling and broadly-agreed accounts have begun to emerge of the causes of the current global crisis (e.g., Wolf, 2009; Turner, 2009; Haldane, 2009). They point to the strengthened interaction between global macro-imbalances, on the one hand, and global financial 'innovations', on the other, since the mid-1990s. In brief outline, some countries have consistently run large current account deficits (principally the US on the world stage) and others large current account surpluses (principally China and the oil-exporting countries). Instead of these proving ultimately self-correcting through currency realignments, major surplus countries (principally China) have preferred to retain large external reserves and not see their currencies appreciate. Much of the net foreign currency receipts of the largest surplus countries, instead,

were loaned back to the advanced countries, which contributed to an apparent 'savings glut' that drove down medium- and long-term interest rates. Cheap credit, in turn, provided a propitious context for a 'degradation of credit standards' (Turner 2009) and a wave of financial 'innovation' as investment banks in particular tried to satisfy the thirst for higher yields by offering investors new products that claimed to diversify and spread the high risks of, for example, US sub-prime lending.

Addressing macro-imbalances

The US can no longer function as the engine of growth for the global economy which means its trading partners can no longer rely on US domestic demand for their export growth. As US households and corporate sector cut down on their borrowing, huge US fiscal deficits will provide only a partial and temporary replacement. A key question, then, is the extent to which other countries will replace the loss of US demand. Large countries whose development models have relied principally on competitively-priced manufacturing exports (Germany, China, Japan, and Korea) will find it culturally and institutionally difficult to boost their levels of domestic demand sufficiently to compensate for the decline in their exports. Yet, in simple terms, 'without more Chinese consumption to balance more American savings, the deflationary impact of the (current) crisis (will) be prolonged' (Turner, 2009).

Restructuring global finance

International financial institutions are still highly reluctant to engage in medium-term transactions with each other because of their inability to gauge which among them bear significant levels of exposure to bad debts, principally those originating in the US. Considerable efforts and coordinated action by central banks and governments to provide liquidity, guarantee debt, and inject capital into banks have still not managed to restore confidence. The benefits of financial liberalisation are, in fact, much more contested than for trade liberalisation, including among economists. As Wolf notes, 'while almost all economists concur on the benefits of free trade, the same is decidedly not true for liberal finance' (2009: 2). Empirical research suggests that financial openness and growth are positively correlated in mature economies but negatively so in developing economies. What is considered to make the difference is that robust institutions, sound macroeconomic policy, deep financial markets, and high-quality financial sector regulation and supervision are more likely to be found in the former than in the latter. An important conclusion is that if 'important welfare gains from financial liberalization (are to accrue) in the long run the sequencing of reforms (needs to be) properly scheduled' (ECB, 2009: 90)

2.4 Facing the Challenges in the European Context

2.4.1 A Crisis for Ireland within a Challenge for Europe

Our analysis has identifies the complex combination of global, European and national factors that have shaped the current crisis. In this section we discuss the European dimension of Ireland's crisis and identify a number of ways in which the crisis poses challenges to the European Union.

2.4.2 The European and International Context of Ireland's Five Part Crisis

There is a strong sense Ireland is experiencing a crisis that was not adequately foreseen. The Central Bank and Financial Services' Regulatory Authority's *Financial Stability Report 2007*, the ESRI's *Medium-Term Review 2008-2015*, NESC's *The Irish Economy in the Early 21st Century* and, most recently, the Department of Finance's *Stability Programme Update 2008* are examples of otherwise good data and analyses carried out in 2008 that did not—and, perhaps, could not—foresee the combination of events that have produced the current situation. The major downward adjustment of the domestic housing sector was inevitable; that an international financial crisis should metamorphose into a global recession at the same time was not. Up to and including 2007, Ireland's export-led and increasingly services-orientated economic model benefited hugely—some would say 'disproportionately'—from the increase in world trade and the boom in financial services. Since 2008, it has, correspondingly, more to lose now that both are ended. As the world economy slows, and the global financial services industry undergoes major downsizing and radical surgery, it has become clearer that Ireland's economy is facing 'a genuine adjustment on a large scale and not just some cyclical downswing followed by a rapid recovery' (Dumas, 2009).

The measures Ireland now takes in response to its five-part crisis must take account of (i) the possibility that the required repairs and reforms of the international financial system may take years rather than months to be properly focussed and implemented; (ii) the depressed state of the global economy generally and the depth and duration of the economic slowdowns occurring in our main trading partners in particular. In short, further deterioration in the international environment cannot be discounted: 'The travails of the financial sector are a long way from being settled yet. The recession has hardly begun' (*The Times*, London, 19 January 2009). A third vital dimension of Ireland's current context is membership of the European Union and the euro area⁷.

2.4.3 The Euro Area and European Union Context

Ireland's membership of the European Union and euro area powerfully influence the set of measures available to Ireland to pull the country through the current crisis; it has also significantly shaped the form the crisis has taken. In several key areas, an understanding of the opportunities and constraints, of the advantages and obligations, that arise from EU and euro area membership are indispensable to identifying correctly the national measures that must be taken.

7. Appendix D reports partnership and policy responses in a number of European countries.

As noted above, sterling's fluctuating value against the euro has contributed to Ireland's problem of cost competitiveness, balance of payments and employment loss. Despite this difficulty, membership of the euro has to be considered as preferable to managing an independent currency at the present time. If Ireland had remained outside the euro, foreign lenders would have wanted a higher interest rate to compensate for the exchange risk they were undertaking. The experience of other EU countries outside the euro (Sweden in the early 1990s; the UK and Hungary in recent years), however, suggests that Ireland would still have undertaken increased private foreign borrowing in the years 2002 to 2007. It is likely that higher Irish interest rates, which would have prevailed if Ireland had remained outside the euro, would have had relatively little impact on Ireland's property boom because the expectation of asset price appreciation had so gripped investors (Lane, 2009). Consequently, the currency depreciation (or perhaps collapse) that would, almost certainly have taken place during 2008 would have greatly increased the burden of private foreign borrowing on Irish households and firms. For example, this is the current situation of Hungary. But for the euro, it is probable that Ireland's currency crisis—today largely confined to sterling's depreciation against the euro—would be dominating the already complex and disturbing context in which the country finds itself.

The obligations of the Stability and Growth Pact (SGP) are a further feature of our European context. The SGP went through its first real test during the economic downturn of 2001-03 when Germany and France breached the 3 per cent limit for government deficits and the Commission suspended, rather than applied, the Excessive Deficit Procedure. It was significantly reformed in 2005 to give more leeway to member states to act in exceptional circumstances. Ireland, at the time, appreciated how the scope for government to borrow and invest in a rapidly growing economy was implicitly increased and not as constrained as before to public investment levels that could be financed out of current surpluses. However, a continuing concern with the SGP is that its provisions still do not provide clear incentives for member states to build up sufficient buffers in good times that allow them pursue stronger counter-cyclical policies in bad times without recourse to heavy borrowing (European Commission, 2008). Fiscal management in Ireland and other countries (e.g., Spain) would have benefited if reform in this direction had been part of the 2005 package. Across the EU, there is a shared concern to understand better, identify earlier and act sooner when cyclical upswings generate revenue buoyancy, policy makers come to believe a structural increase has taken place in available resources and long-term expenditure plans are based on revenue streams that are volatile (op. cit., 251-256). Ireland, as the member state which has most consistently underestimated both revenue buoyancy and expenditure growth (ECB, 2008), needs the SGP to be further improved, not that it be weakened or discarded.

At present, the SGP's 3 per cent reference value for government deficits is not a binding constraint on Ireland's route out of its current situation. In addition, Ireland's low debt-GDP ratio allows some scope for several years of significant borrowing. Naturally, the Excessive Deficit Procedure has been triggered and the Commission has expressed the desire to know in greater detail how Ireland's General Government Balance will be kept to -9.5 per cent in 2009 and -9.0 per cent in 2010, before being reduced to -6.5 per cent in 2011 and -4.7 per cent in 2012, and, finally, brought below -3.0 per cent in 2013. At present, the market valuation of government bonds is more pressing than the SGP. As noted, at present Ireland is seen as a country whose level of borrowing is beginning to run close to its ability to repay. This is a situation which Ireland and the European Union face together and not one with which the latter is confronting the former.

The Lisbon Strategy for advancing structural reforms that respect the interdependence between economic and social policy is also integral to the context within which Ireland confronts the present crisis. Currency devaluation is not possible in the euro area and kept to narrow limits across the EU (except for the UK and Sweden who have formal opt outs from ERM II). This means that Ireland's options for ensuring that businesses in Ireland provide goods and services at least as efficiently and profitably as elsewhere in the EU hinge on supply side factors —skills, management, technology and design, logistics, costs, wage levels, infrastructure, etc.— and that any significant barriers businesses face in these areas compared to those prevailing elsewhere in the EU will have consequences. Simply put, it would become easier to supply Ireland from elsewhere in the EU than the reverse. The EU does not want economic activity steadily concentrating in the most competitive regions while the least competitive regions are increasingly abandoned by all businesses that have the option of relocating. On the contrary, it is committed to keeping regional imbalances within defined limits; it currently relies on the Lisbon Strategy and the Structural Funds as the principal routes for ensuring the productive capabilities of all regions are brought up to, and retained at, levels where carrying on business across the EU from within each of them is viable.

If Ireland has allowed a period of strong domestic demand to increase difficulties for its exporting sectors, the role — and desirability — of a strong export performance in also boosting domestic demand should not be lost sight of and was a welcome feature of Ireland's strong employment growth until recently (NESC, 2008: 141-143). Fiscal stimuli may be largely ineffective in economies as small and open as that of Ireland. However, they retain considerable significance in larger EU member states; where domestic demand does not pick up in response to strong current account surpluses, macro-imbalances internal to the EU, with parallels to that described above for the global economy begin to develop. The rewards to successful implementation of the Lisbon Strategy will increase as the EU is better able to co-ordinate its member states' macroeconomic strategies.

Finally, EU membership requires that state rescue packages—for financial institutions and specific sectors—do not damage the Internal Market. Sensitivity about this was one reason for initial anxiety in other EU countries regarding Ireland's Bank Guarantee, introduced on 30th September 2008. Since then, there has been wider EU focus on emergency measures by member states to protect what are considered core financial or industrial infrastructure. Clearly, such measures have the potential to damage the Internal Market. It is likely that smaller EU member states would suffer more than larger ones. Once again, Ireland's interests and those of the EU as a whole are significantly aligned on this issue.

2.4.4 The Crisis Poses Challenges to the European Union

The severity of the financial and economic crisis has exposed several forms of institutional incompleteness in economic governance in the euro area and wider EU:

- ◆ First, the September 2008 credit crunch exposed weaknesses in the coordination of financial regulators and supervisors across the EU;
- ◆ Second, as governments, both in and outside the euro, have had recourse to higher borrowing to finance deficits, the ECB and European Commission have been re-active rather than pro-active in responding to the currency threats posed within the ERM and the credit risks posed within EMU;
- ◆ Third, as the level of economic activity has fallen, the European Council and European Commission have struggled to encourage, coordinate and implement member states' fiscal stimuli in a timely, effective and adequate fashion;
- ◆ Fourth, the crisis has brought to the surface the tensions that can arise in having a deeply integrated internal market—with free movement of goods, services, capital and labour—with separate currencies, such as sterling, still free to move dramatically (see Section 5.6 below);
- ◆ Fifth, the crisis has again revealed the fact—much discussed in earlier decades—that the EU is experimenting considerably in having a monetary union without a significant degree of fiscal union;
- ◆ Sixth, the differential impact of the global financial and economic crisis on member states has shown the extent of the terrain still to be covered in implementing the Lisbon Strategy and, in the new member states in particular, using the Structural Funds; and
- ◆ Seventh, the crisis has highlighted the importance of the EU, as the world's largest trading block, in designing and negotiating reforms in global financial and economic governance.

It seems likely that, as often in the past, crisis will prove to be the impetus that pushes forward institutional and policy developments in the EU. On each of the challenges to the EU listed above, Ireland has an interest in appropriate policy and institutional development and should play a full part in helping to design the way forward.

3

Relating the Crisis to Existing Council Understandings

3.1 Introduction

Despite the uniqueness of the current situation, in many respects the economic crisis of 2008-9 is a manifestation of risks that have been identified in NESC reports over the past two decades—although it was not imagined in any report that these risks would materialise simultaneously.

It was different contexts at different times that led the Council to become aware of and articulate specific risks, vulnerabilities and policy requirements arising as Ireland sought to develop a stronger economy and a more participatory society. The international environment, evolving sometimes in clear directions and sometimes unpredictably, has been a constant theme. Among the major issues which the Council studied, in the process becoming aware of characteristic risks and vulnerabilities attending Ireland's path to economic and social development, are strategies for industrial development, the fiscal crisis in the 1980s, the unemployment challenge, wage bargaining, the EU internal market, the ERM and European monetary integration, housing policy and Irish social policy. Section 3.2 briefly articulates the specific challenges which the Council agreed face the formation of sound economic and social policy in Ireland. Rather than interrupt the flow of this report, the more detailed account of these previous analyses is contained in Appendix A. Section 3.3 reflects briefly on the relevance of this body of NESC work to the current crisis.

3.2 Key Areas Where There is Existing Council Understanding

3.2.1 Interdependence

A central element of the Council's understanding of Ireland's economy and society has become that of interdependence. Initially, the focus was on different forms of economic interdependence—between the public and the private sectors, between the indigenous economy and the international economy, and between the economic and the political (NESC, 1996: 4). In recent years, especially since its 2005 report, *The Developmental Welfare State*, the analysis of interdependence has been extended to include interdependence between the economy and society, and the complementary relation between social and economic policy has become a central thrust of the Council's work.

3.2.2 Consistent policy, the scope of negotiated agreements and the nature of partnership

In its three-yearly Strategy reports over the last two decades, the Council adopted as a framework of analysis the examination of the challenges facing macroeconomic policy, distributive policy and supply side policies, in an attempt to ensure that the key forms of economic interdependence were being properly understood and allowed for. From the early 1990s onwards, the Council began to reflect on the potential advantages of social partnership agreements in helping the adoption and implementation of consistent policies. It examines the nature of, and conditions for, an effective system of social partnership in Ireland. It believes that the characterisation of social partnership adopted in 1996, and the later analysis of the problems which confront both bargaining and implementation, remain relevant in exploring the possibility of a partnership response to Ireland's current five-part crisis.

3.2.3 Incomes policy

The close relationships between the monetary regime, fiscal policy and wage bargaining have been a central theme of the Council's work and its policy recommendations over the last two decades. Ten years after adoption of the euro, it is easy to overlook the complex and, at times, difficult debates about how income developments in Ireland should be interpreted and managed as the country moved successively from having its currency linked to sterling, to floating the punt within the wide band of the ERM, to preparing for EMU by adopting the Maastricht criteria and to final membership of EMU on 1st January 1999. At different stages, NESCC analysed the evolution of Ireland's wage bargaining system, studied some of the advantages of coordinated wage settlement in the Irish context, and drew lessons from developments in wage bargaining across the EU in the context of the euro. A particularly important element in the Council understanding relevant to the current crisis concerns the mechanisms of economic adjustment in EMU (Section 3.3, Appendix A). It has also reflected at length on the links between wage growth and competitiveness and the need for reform in Ireland's system of public service pay determination.

3.2.4 Fiscal policy and public finance management

Over the past decade, the Council has proposed that fiscal policy should be conducted in accordance with the two core principles of sustainability and stabilisation. The latter implies that at a minimum, it is desirable that the public finances should not add to cyclical fluctuations in the economy and that, in general, when the economy is performing well, flexibility should be maintained in order to provide scope for some relaxation of fiscal policy in economic downturns. Another aspect of the Council's understanding is the need to significantly improve the management of public expenditure and it has given increased attention to the organisational changes required to improve implementation of public policy and value for money.

3.2.5 Vulnerabilities inherent in Ireland's growth as a regional economy

The Council's analysis and interpretation of Ireland's long-run economic development as that of a regional economy has led it to identify several specific vulnerabilities. These include enduring difficulties in measuring and predicting the Irish economy, and the challenge this poses to coordination; the particular problems that can arise from extensive growth (super-normal profits, rents and asset prices, inflation, the challenge of integrating people from abroad, patterns of spatial development that are unanticipated, and pressure on the environment, etc.); the extent to which policy errors can be punished severely, and even trigger extensive decline; the critical importance of effective international political and regulatory institutions, such as the EU, and of a rules-based international system that constrains the naked use of diplomatic and economic power; and the major role that developments in relative earnings within a currency union can play in fostering either economic expansion or contraction.

3.2.6 Social policy

As Ireland's economy grew stronger over the last two decades, the Council has paid increasing attention to the need to address social and economic goals jointly and the appropriate manner of doing so. It has reflected at length on weaknesses in Ireland's welfare state in providing people with the social supports they need in contemporary society and proposed a 'developmental welfare state' as a way of addressing social deficits. A life cycle approach has been proposed in building the developmental welfare state, focusing on the provision of services, income supports and innovative actions and activation for six cohorts of people. Adopting a life cycle approach in building the developmental welfare state requires an on-going reordering and restructuring in how government departments, service providers and NGOs work together.

3.2.7 Housing, land management and sustainable neighbourhoods

While the Council's understanding of the housing market did not anticipate the likelihood or full consequences of the collapse in construction that has occurred, it has a vision for sustainable development, land management and housing that is relevant to the current crisis. It identified five principles of sustainable housing and integrated development: sustainable urban densities; consolidated urban areas; compact urban satellites; rapid communication networks; and sustainable rural settlement. These help not only to understand what went wrong and what contributed to the creation of a property bubble, but can also serve to guide the response to this part of the crisis and help insure against its repetition.

3.2.8 Principles of taxation and tax reform

Finally, principles of taxation have played a central role in the Council's thinking from 1986 onwards. The theme of tax reform, and the application of the principles proposed by the Commission on Taxation, frequently figured prominently in NESC's three-yearly Strategy reports. The undoubted contribution that tax changes have to make to the resolution of the current crisis, and the opportunity for reform that the crisis itself presents, make it valuable to revisit these principles and proposals.

In short, the analyses of these themes which were agreed in previous NESC reports are relevant in understanding what caused Ireland's current five-part crisis. Indeed, the shared recognition of these vulnerabilities and associated policy challenges can be an asset in seeking an integrated and widely-supported response to the current crisis.

3.3 The Crisis as the Manifestation of Risks and Vulnerabilities

Consideration of these existing analyses and understandings, as evoked above and set out more fully in Appendix B, illustrates that the Council has been aware of a range of risks and vulnerabilities to which the Irish economy and Irish society is exposed. This has led NESC to outline the appropriate lines of policy to minimise the vulnerabilities and respond to specified adverse developments. The severe current crisis can be seen—at least in part—as the manifestation of a range of the risks which were identified, although it has to be said that NESC did not envisage that these would materialise simultaneously and in such a mutually-reinforcing way. Indeed, in this respect, it is necessary to distinguish between three classes of risk and vulnerability.

First, the current crisis can be seen as a manifestation of some of the international risks inherent in Ireland's economic position: 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. Prior analysis of these possibilities, mechanisms of adjustment and policy responses is relevant and valuable. This is so even though no previous study envisaged the simultaneous materialisation of negative scenarios that were conceptually distinct and which had invited analysis in specific circumstances. It was not envisaged that they would occur together.

Second, it is now clear that the crisis is also a manifestation of a number of risks that were not identified—or, when examined, were assessed as unlikely to materialise. Prime among these is the dramatic collapse of the model of international finance and financial regulation that developed in the past 20 years, as discussed in Section 2. Apart from its recent dramatic global collapse, the aspect of that model of finance that had greatest relevance to Ireland was the availability of, and recourse to, greatly increased private wholesale foreign borrowing to fund property-related borrowing within Ireland. When combined with other developments, discussed above, this put the main Irish financial institutions in greater danger than was recognised. These developments, combined with the deep global recession, have created the unprecedented economic context described in Chapter 2. The policy challenges of the resulting five-part crisis are discussed in Chapters 4 and 5.

Third, the Council's analysis also suggests 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. It now seems that certain 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 the national approaches that have been insufficiently informed by awareness of the vulnerabilities listed above are:

- ◆ The system of public expenditure management, especially methods of project appraisal, output and outcome measurement and accountability;
- ◆ A tendency to erode the tax base and make revenue vulnerable to the economic cycle;
- ◆ 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; and
- ◆ A range of features of national policy and partnership, as analysed by the Council in *NESC Strategy 2006* and by the OECD, that give rise to an 'implementation problem' with many dimensions.

While the scale and diversity of our current problems is quite remarkable, the fact that some aspects of the crisis are a materialisation of risks and vulnerabilities that we had identified, discussed and reached broad agreement on is important in finding a way forward.

4

The Characteristics of an Effective Irish Response

4.1 Summary

In the Council's view, an effective Irish response to the current crisis must have a number of characteristics. 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.

Here we briefly explain each of these requirements for an effective Irish response to the crisis.

4.2 Addresses all Five Dimensions of the Crisis

An effective response must address all five parts of the crisis: the banking crisis, the fiscal crisis, the economic crisis, the social crisis and the reputational crisis. In Chapter 5 we discuss each of these crises and possible policy responses in turn. As noted in Chapter 1, each of these crises requires careful analysis and Ireland's multi-annual response must be based on sound economic and social analysis. In stressing the importance of sound economic and social analysis, the Council acknowledges that, at both national and international level, the current 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. 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 occur.

Given the international dimensions of the crisis—as described in Chapter 2—Ireland’s response must be attuned to international economic realities. In the short term, this involves recognition of the weak state of international demand, the weakness of sterling, a focus on the challenge of restoring Ireland’s competitiveness, the continuing problems in the financial system and the damage that has been done to Ireland’s international reputation. In both the short and medium term, the requirements of international credibility and the conditions for raising and servicing debt are critical. The unavoidable need to reverse Ireland’s balance of trade and capital flows is a central feature of the international economic reality. The world does not owe us a living and will be less likely to lend us one in the way that it did from around 2000 to 2007. This requires a restoration of competitiveness.

In the coming years, the speed and pattern of international recovery must be closely monitored and its implications for Irish policy identified. Although there remains great uncertainty, 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 economy which prevailed from 1990 to 2008. Yet it was in that economy that Ireland made its greatest convergence towards the levels of prosperity in Western Europe. This seems likely to have profound, as yet unknown, implications for Ireland. No economic or social organisation or interest within Ireland can safely absent itself from exploration of these implications.

4.3 Social Solidarity

An effective Irish response to the crisis must be seen to be fair. This has a number of dimensions that should be distinguished.

First, the package of responses must be seen as sharing the burden of adjustment fairly. It would be extremely unfair if national adjustment were made primarily through unemployment, and depriving people of essential and social care services. Rather fairness demands that those in a more secure economic position assume the larger part of the burden of adjustment.

Second, the economy and society that is to be achieved through sacrifice must be seen as fair⁸. Otherwise, it is hard to envisage individuals, families and organisations buying in to the national recovery effort. This is one reason why we argue below that Ireland’s response must combine retrenchment with reform. Again, it seems important to recognise the element of irreversibility, since it does not seem possible to return to the situation that existed in recent years and it will be impossible to enlist support by promising that current sacrifice might re-establish it.

8. The overall vision of a successful Irish society, articulated by NESC, is to be a dynamic economy and participatory society. Such a society incorporates a commitment to social justice, is based on economic development that is socially and environmentally sustainable, and which responds to the constantly evolving requirements of international competitiveness, understood as the necessary condition of continuing economic and social success. In successive reports the Council has spelled out its vision of a successful society and this has been adopted by government and the social partners.

Third, the infrastructure of social supports and social policy need to be maintained in the difficult years ahead. Although resources will undoubtedly be more scarce, the infrastructure of support and policy provides a foundation upon which the existing and new social problems can be addressed.

4.4 Consistent Policy Approach

An effective Irish response must be characterised by a consistent combination of macroeconomic, distributional and structural policies. Past economic problems can, in many cases, be attributed to adoption of inconsistent policy approaches (Appendix A). Ireland achieved much better economic performance once greater consistency was achieved. However, as noted in NESC's 2003 *Strategy Report*, the relationship between the three categories of policy changes over time. Consequently, it is necessary to periodically recast the relationship between macroeconomic policy, distributional policies, and structural or supply-side measures, and to review the content of policy within each of the three areas. The changing relation between macroeconomic, distributional and structural issues and policies has been analysed in each of the Council's three-yearly Strategy reports and, through that, has informed a succession of partnership programmes.

In the difficult economic period from the late 1970s to the late 1980s, the three existed in a vicious circle (NESC, 2003:173). During much of the subsequent period from 1987 to 2000, the three constituted more of a virtuous circle: positive aspects of macroeconomic, distributional and structural developments supported and reinforced one another. The long period of rapid growth from 1994 to 2000, however, brought the three elements into greater tension. Structural and supply-side bottlenecks and problems in service delivery impacted on inflation, the public finances, wage bargaining and the value of fixed incomes. At the same time, macroeconomic developments, particularly the weakness of the euro and pro-cyclical policy in Ireland, impacted on distribution, competitiveness and supply-side bottlenecks.

In mid 2008, the Council noted that there was a more complex set of relationships between macroeconomic, distributional and supply-side factors than has existed since the late 1980s. This created a number of temptations that, if followed, would yield a deeply inconsistent policy approach. Since mid year, these relationships have become profoundly more complex and difficult.

4.5 Based on a Positive Perspective on Ireland's Recovery

Notwithstanding the uncertainty and irreversibility noted above, Ireland's response to the five-part crisis has to be based on a positive perspective on Ireland's economic future. This might sound contradictory, but it is not. A positive perspective is necessary for two core reasons:

- ◆ To motivate wide engagement with the retrenchments and reforms that are now imperative;
- ◆ To guide us in which adjustments to make and which to avoid.

Despite the uncertainty and irreversibility, we can envision some necessary and desirable features of Ireland's recovery and future prosperity. These include:

- ◆ Adjusting the public finances so that Ireland can participate in, and fully benefit from, an international recovery;
- ◆ Re-establishing export-led growth;
- ◆ Strengthening indigenous resources for knowledge-based economic activity and innovation, including learning and problem solving in the workplace and greater economic and social use of Ireland's rural resources;
- ◆ Positioning Ireland to attract inward investment in high-value activities and participate in revived international networks of trade, investment, knowledge and migration; and
- ◆ Enhancing individual and social capabilities and social cohesion even through a severe downturn.

If these general elements of recovery and future prosperity are taken as known, they need to be pursued in the context of the uncertainty and change noted above.

It is important to recognise that this element of creation in the face of uncertainty is not entirely unprecedented for Ireland. In the past we analysed the economic and industrial models of more advanced countries in considerable detail, hoping and aiming to emulate them (NESC, 1983, 1992). We never quite succeeded in building similar structures; but made real strides by innovating and adapting, in close linkage with international business, technology and governance. But this meant that what we were creating was, in large measure, unknown to us (and others) even as we created it. Uncertainty on how Ireland will prosper is certainly greater now, but it is not entirely novel. Asking that someone or something dispel it for us entirely is asking the impossible.

However, there is a body of analysis, of long-term economic and technological development, that might provide some important pointers. Perez has for some time argued that the current crisis was inevitable (see for example Perez 2002). Based on detailed historical analysis of long run development cycles Perez argues that the transition from the 'installation phase' of a new technology, involves a 'turning point' during which a severe financial crisis will force greater regulation of speculative activity and bring finance back into the service of the real economy.

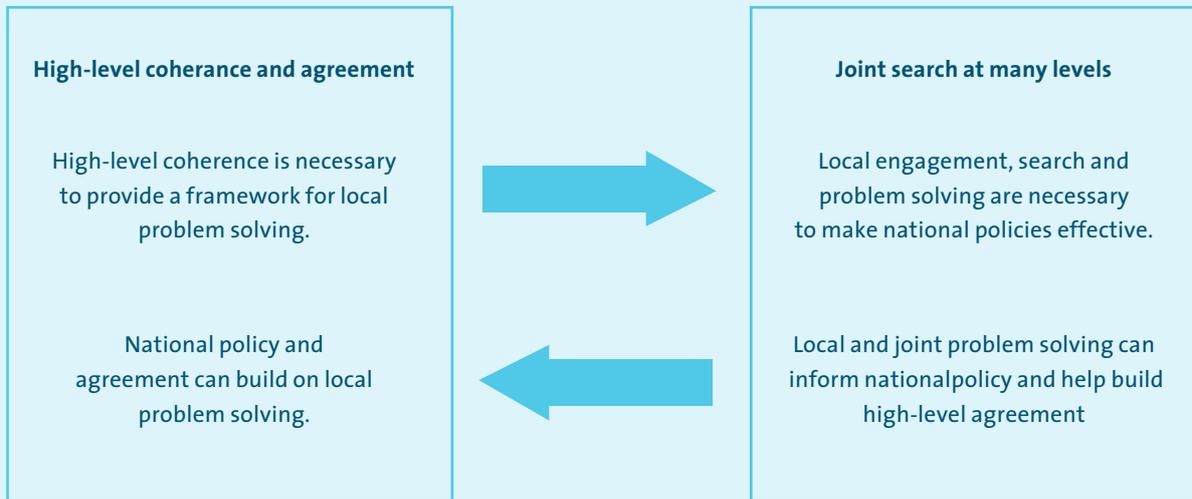
Perez suggests that the crisis of the kind currently underway internationally is the harbinger of the full deployment of the information and communication technologies (ICT), in ways that will create vast business, technical, environmental and social opportunities (Appendix C). She argues that at the end of this crisis more of the technologies associated with information and communication industry will be available to more people and at a much-reduced cost. Only those countries which have ensured that its society has the means to use these technologies — broadband and widely dispersed digital literacy and competency — can expect to be at the forefront of the return to growth in international economies. The key to growth, in what she calls the deployment phase, is entrepreneurial imagination to create new uses for technology. The key in this phase is social cohesion and finding *new uses* for technology, more than development of new software and applications, components, networks or systems. At the same time, Perez sees a need to increase basic discovery and scientific research in the emerging bio and nano technologies.

4.6 High-level Coherence with Maximum Engagement

A central argument of the Council is 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, 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). 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. This must involve public agencies, firms, social partners and, indeed, individual staff in a range of organisations.

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 further diminish Ireland's international reputation. But, to make matters worse, it is likely to also prevent or postpone lower-level engagement in the kind of problem solving which is urgently required. This argument, in the tradition of NESC analysis, emphasises the importance of using high-level agreement as a framework for local problem solving. This is depicted by the upper arrow running from left to right in Figure 4.1. A number of considerations suggest that there are further possibilities, hence the lower arrow, running from right to left in Figure 4.1.

Figure 4.1 Combining High-Level Agreement and Local Problem Solving



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. Such local problem solving on urgent current concerns of solvency, employment preservation and services—undertaken by the social partners, working with firms and public agencies—can help to strengthen high-level agreement. People and organisations that can adjust together to new realities at enterprise, agency or service level may find that this helps them in framing high-level parameters jointly.

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.

Appendix A, Section 1, notes the importance attached by the Council to interdependence between economy, society and the state and the inability to achieve valued outcomes—in areas such as employment, education or health—without the engagement of individuals, families and communities. The Council has argued that, although there is a demand for leadership and decisive action, the goals that people seek—such as greater employment or prosperity—are beyond the competence of any one sector of Irish life (including central government) to deliver (NESC, 2005).

Public policy and practice that is directed towards these issues must reflect this level of dependency and this will require significant changes in current practice. As the crisis deepens there is evidence that local problem solving behaviour—which combines social needs and economic opportunity—is engaging increasing numbers of people. There is growing popular and media interest with initiatives such as the Social Entrepreneurs Ireland organisation and the recently launched Ideas Campaign. The means of unlocking and supporting this potential is now critical.

Work within NESDO suggests that this type of creative grassroots capacity requires managers, leaders and policy makers to work in a more facilitative manner, as brokers capable of interpreting achievements, to help set challenging benchmarks and to create opportunities for mentoring. Extending this type of innovative capability into the mainstream will require reporting practices—of those at the delivery end and those in positions of authority—and rules and structures to change. These conclusions are based on an examination of a range of problem solving behaviours from people working across Irish society. It suggests that the capacity to operate in this way already exists in many parts of the Irish public sector, business and society: in schools, businesses, arts organisations, environmental organisations, hospitals and community organisations. However, it also suggests that new institutional forms are emerging, and more will need to, if we are to effectively combine high level agreement on policy and goals with joint search for solutions, at many levels, that seems increasingly necessary in the current crisis⁹.

4.7 Short-term Measures with a Long-Term Logic

A vital characteristic of an effective Irish response is that we take short-term measures that, as far as possible, move us in the correct long term direction. It is definitely important to avoid measures that entrench the features that contributed to the current crisis or to repeat responses to past crises. While this is improbable in certain areas (such as unregulated credit creation), it is a real risk in other areas (such as the labour market, infrastructure and education).

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

9. This is consistent with the arguments advanced by Perez. She argues that the financial crisis and the ability to capture the opportunity associated with the full deployment of ICT and new technology requires significant and wide ranging institutional creativity in business, public sector and in other parts of society (Perez 2008).

4.8 Timing and Sequence

An integrated national response should be sequenced and timed in a way that supports the characteristics discussed above. 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 (see Chapter 5). In other cases, it will warrant gradual introduction of new measures. A central argument here is 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.

4.9 Retrenchment and Reform

We have summarised existing reactions to the five crises and discussed some characteristics of an effective overall response. Nobody is in any doubt that we are experiencing a severe reversal and that considerable pain will have to be borne. This 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 believes that Ireland needs to combine severe retrenchment with radical reform. This derives from the best available analyses of the five-part crisis. This 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.

5

Towards an Integrated National Response

5.1 The Limitation of Partial and Sequential Reactions

In Chapter 1, we catalogued Ireland's reactions to the crisis to date, distinguishing the five different crises or dimensions of the one crisis. The difficulty and perplexity of the crisis pose a profound challenge to both thinking and collective action. It is possible to devise a range of further reactions to the banking and credit crisis, the fiscal crisis, the economic crisis, the social crisis and the reputational crisis. Here we discuss the attraction and possible limits of each of these approaches.

Section 5.2 briefly discusses the challenge of stabilising the banking system and identifies the reasons why it will not be sufficient to focus solely on this part of the crisis. In Section 5.3 we identify some of the possibilities that would arise if the focus was primarily on the challenge of the public finances. Turning, in Section 5.4, to a focus on the challenges of the economic crisis—competitiveness, the fall in sterling, company closures and lay offs—we find it necessary to discuss in some detail ideas on how Ireland might respond. Considering a single-minded focus on the challenges of the social crisis, Section 5.5 identifies the broad lines of possible further responses. In Section 5.6, we briefly consider the challenge posed by Ireland's loss of international reputation.

Our analysis strongly suggests that a further series of partial and sequential measures, some of which are undoubtedly necessary, will not be sufficient and effective¹⁰. 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, Section 5.7 closes by arguing that Ireland needs to formulate an integrated response.

10. Indeed, a brief review, in Appendix D, of experiences across a number of European countries helps to illustrate the limits of partial and sequential measures and the difficulty in agreeing a national response to this crisis.

5.2 A Focus on Stabilising the Banking System

It is clear that, across the world, the management of problems in the banking system is an on-going task. Most governments have had to take initial measures to prevent the collapse of systemically important banks and subsequent action to recapitalise the major institutions. Despite the major capital injections in banks in many countries, there are concerns that they are not yet providing adequate credit to business. Efforts are continuing in the UK and US to devise ways of encouraging more credit provision by banks that now have adequate capital.

In Ireland the Government has taken major initiatives (see Table 1.1 in Chapter 1 above) to restore the banking system, including recapitalisation of the two major banks. Ongoing interventions are likely to be required to achieve a healthy banking system that is able and willing to lend to viable businesses and households. Ireland has the opportunity to benefit from the experience of the current and past interventions in the UK, the US and elsewhere. There is research under way to examine the possibility of creating a bad bank or risk insurance scheme to take bad debts off banks' balance sheets. It is important that these approaches not be used as a means of transferring capital to banks (by overpaying for assets or undercharging for insurance) in a way that does not give the State an appropriate share of the potential future returns from the profitable parts of banks, a risk highlighted by domestic and international commentators. A significant source of current banking problems was the rise in the ratio of loans to bank deposits to excessive levels, but an over hasty reduction in loan to deposit ratios should be avoided as it would add to deflationary pressure in the economy.

Problems in financial institutions confront Government with an urgent problem to which it must react and have a high media profile. Yet 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 recent policy measures provide protection to the increasing number of households with mortgage arrears;
- ◆ The need to ensure that recent 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; and
- ◆ 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. Government has consistently emphasised that its action on bank guarantees, recapitalisation and mortgage protection must be informed by the potentially-enormous impact on the public finances. 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.

5.3 A Concentration on the Public Finances

In Chapter 1 we catalogued existing Irish reactions to the crisis. As shown in Table 1.1, this included a range of public finance measures taken since July 2008. These entail expenditure reductions (such as the 3 per cent reduction in the public sector pay bill), expenditure increases (such as the recapitalisation of two banks), tax increases (such as the income levy, ranging from 0 to 3 per cent) and, of course, increased borrowing. Following poor exchequer returns in February 2009, the government announced that it will bring in further measures to ensure that the government deficit is kept to 9.5 per cent of GDP in 2009. In describing and explaining the crisis in Chapter 2, we noted the dramatic drop in revenue and the fact that the forecast increase in government deficit in Ireland is the highest in the EU. A compensating factor is that Ireland's debt/GDP ratio was 41 per cent at the end of 2008, with a net debt level of around 20 per cent of GDP.

In Chapter 3, and in particular in the accompanying Appendix A, we have summarised existing Council understandings, many of which refer to the public finances. Among these are the counter cyclical role of fiscal policy, the principles of good taxation and the need for improvements in the management of public finance.

It is clear that many further public finance measures will be required to bring Ireland through this severe crisis. The Government has set out the objective of a deficit of GGB of below 3.0 per cent in 2013, and this has been endorsed by the social partners in the recent Framework. This is a central goal around which a range of policy approaches can be oriented. There is agreement that this should be achieved by a combination of expenditure reductions and tax increases. In view of the uncertainties in the economy, the scale of the adjustments needed cannot be determined with any certainty at this stage.

The Government has set out its plans in broad terms to correct the public finances over the period to 2013 in a revised Stability and Growth Programme that has been submitted to the European Commission. The Commission has welcomed the measures set out by the Government but it has expressed its concern that the growth scenario is somewhat optimistic and the consolidation measures lack detail. It notes that there are further risks from the measures put in place and possible future measures to support the financial sector.

Any combination of expenditure reductions, tax increases and increased borrowing needs to be assessed not only on how it narrows the gap 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 and labour market policy and activation.

Since 2007 the tax share of GNP in Ireland has fallen by approximately 2.5 percentage points to an estimated 36 per cent of GNP in 2009 and is below the EU (15) average¹¹. 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 2009 level— if a satisfactory level of provision of services and benefits is to be achieved. In this regard it is important to recognise 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.

Key elements that a strategy to restore sustainability to the public finances needs to take into account include:

- ◆ The desirability of prioritising services and employment over remuneration in the adjustment period;
- ◆ The key role of the new public expenditure review group 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.

In a relatively optimistic scenario, FitzGerald argues that economic recovery could potentially contribute substantially to fiscal correction (FitzGerald, 2009b). He estimates that, if there were a global recovery in late 2009 or early 2010 and the Irish labour market were to prove sufficiently flexible to restore full employment over a five year period, then the rise in output and employment could eventually cut the deficit substantially. This would be a major contribution to the problems in the public finances and points to the rewards of appropriate economic policies. At the same time there would still be major public finance adjustments needed and it now appears likely that global recovery will be later than 2009. A less optimistic scenario would see global economic recovery having less beneficial economic effects if Ireland's cost structure and tax system are not adjusted sufficiently.

In Appendix B, the Council discusses some of the options that might be considered to support and improve fiscal stability and the broader process of recovery. The options discussed include:

- ◆ Current and capital expenditure programmes: efficiency and value for money;
- ◆ Increasing taxation;
- ◆ Discretionary tax reliefs;
- ◆ Non-tax revenue; and
- ◆ Alternative funding options

11. The 2009 tax share of GNP is based on the Addendum to the Stability Programme Update of January 2009. The outlook for tax revenue has shown a further deterioration since then. The EU (15) tax share of GDP in 2009 is estimated by the European Commission at 40 per cent of GDP. Ireland's relatively young population compared to the average EU country implies that, other things being equal, a lower level of taxation in Ireland is needed to provide a given level of services.

Increased expenditure during the current decade was necessary to address long-standing deficits in services, but often took place without adequate arrangements in place to ensure that the increased resources were effectively used. The Council again emphasises the need for much greater accountability by government departments and agencies in what is achieved with public money. There is a need for a much stronger culture of evaluation whereby government departments consider evaluation of their expenditure programmes as a core responsibility. There is scope for better use of the knowledge and skills of those directly engaged in the provision of services to achieve genuine improvements in effective use of resources. Public sector reform is discussed in Appendix A below.

The Council fully acknowledges the seriousness of the crisis in Ireland's public finances and supports the medium-term goal described above. 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 overall crisis. The cascade of expenditure reductions and tax increases, while understandable given the rapidly changing revenue and unemployment situation, has 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 Chapter 1, these observations are not made in a critical spirit. It was argued there that we should not berate ourselves—or indeed, each other—over the fact that existing reactions to fast moving events have, probably unavoidably, been partial and sequential. The purpose of the observation is to underline the importance of finding and articulating a clear account of the crisis and elements of a integrated national response.

In the light of these arguments, it can be argued that an excessive focus on particular public finance magnitudes could weaken, rather than support, achievement of an integrated medium-term national response to the five crises. It could do this, for example, by pressing particular measures to a degree that fails to achieve societal understanding and sacrifices social support for the range of policy responses that are necessary.

5.4 A Focus on Restoring Ireland's Economic Competitiveness

5.4.1 Introduction

The number of people on the Live Register in early March 2009 has reached over 350,000, representing a rate of unemployment of 10.4 per cent of the workforce. Nothing more graphically underlines the depth of the economic crisis facing Ireland. A central argument of this report is that we recognise and analyse not only the banking and fiscal crises, which are much discussed in recent months, but also the *economic* crisis—as evidenced in company closures, job losses and short-time working.

Various aspects of the necessary policy response to this crisis have been identified in earlier chapters. We have seen, in Section 5.2, that stabilisation of the banking system is critical in relieving the pressure on business and laying the foundation for future business activity. In addition, a focus on innovation and competitiveness is a key element of *Building Ireland's Smart Economy*. The plan includes tax incentives for innovation, better availability of venture capital and a new focus on commercialisation of ideas. Another key dimension of the plan will be energy and environmental issues. This will include investing in sustainable energy and other restructuring of the economy to address climate change. In Section 5.3 we saw that our ability to adhere to a medium-term stabilisation of the public finances will be significantly shaped by the level of economic activity and, very directly, by the extent of the increase in unemployment. Here our focus is on the challenges faced by employers and employees in the private sector, especially the pressures of international competition, solvency and redundancy.

As emphasised throughout this report, the current five-part crisis confronts government and the social partners with an extremely difficult and complex environment in which to achieve these economic and social adjustments. The central argument of the report is that Ireland requires an integrated response; this is starkly evident in the challenge of limiting employment loss and readjusting Ireland's economy.

5.4.2 The Crisis of Job Loss and Competitiveness

The description and analysis of the crisis in Chapter 2 shows that Ireland's economic structure and costs went significantly out of line over the years 2002 to 2007. The gradual loss of competitiveness was dramatically reinforced by the sharp fall in sterling in 2008-9. The underlying causes are complex, but prime among them is that the Irish economy was probably growing above its 'natural' rate in those years; this, in turn, was driven by the great increase in private international borrowing and facilitated by the availability of an increased labour force via immigration. This created market conditions in which the market could bear remarkably high prices and charges for a range of goods and services—operating in conditions in which limited competition in certain sectors meant that there was a number of, relatively protected, providers ready to charge whatever the market could bear. Examples of services where Irish enterprise and consumers face high costs include energy, transport, commercial rents, financial and legal services, pharmacy, dental, medical and legal services. This understanding is supported by the fact that Irish prices have exceeded EU *prices* by a greater margin than average Irish *wages* have exceeded average EU wages (see NES, 2008). It is also worth noting that the increase in costs and returns was less evident in the lower end of the private sector labour market, where there has been high mobility of workers from the accession states.

5.4.3 A Coordinated National Approach to Competitiveness and Incomes

A Coordinated National Approach Is Critical at this Time of Crisis

Over the past two decades the Council developed an analysis of the role of a coordinated national approach to income determination in the Irish economic and social context. As outlined in Appendix A, Section 3, this analysis highlighted the role of a coordinated approach in the context of agreement on a consistent combination of macroeconomic, distributional and structural policies. Agreement on such a consistent policy approach was, the Council argued since 1990, in turn dependent on a shared understanding of key economic and social mechanisms.

In mid 2008, the Council noted that there was a more complex set of relationships between macroeconomic, distributional and supply-side factors than has existed since the late 1980s. It concluded that a coordinated national approach to collective bargaining remains appropriate, given the dynamics of wage setting and the open nature of the Irish economy. This reflected the long-established advantages of coordinated bargaining in which there is a focus on both immediate and the long term interests and on the common good (see Appendix A, Section 3).

Since mid 2008, the relationships between macroeconomic, distributional and structural factors has become profoundly more complex and difficult. This is evident in the description and understanding of the crisis provided in Chapter 2. In recent months, the Council has discussed the evolving crisis on a number of occasions and it is from these discussions that this report emerges.

In discussing the *economic* crisis specifically, the focus has been on job losses, firm closures, the decline in output and exports and Ireland's loss of competitiveness. Critical areas of policy response, such as stabilisation of the banking system, are considered in other chapters. In considering the role of income determination in an integrated response, the Council needed to take account of unusual depth of the economic crisis and important new developments, such as falling prices and the incidence of debt problems among both firms and households.

Premised on a Shared Understanding of the Five-Part Crisis

In emphasising that a coordinated approach to income determination remains appropriate, indeed critical, the Council underlines the fact that this is premised on a shared analysis and understanding of Ireland's five-part crisis. Elements of that analysis have been outlined and discussed throughout the report. They include the banking crisis, the international and EU context, activation and labour market policy, social policy and the need for all groups to take ownership of Ireland's reputational crisis. As regards the economic element of the crisis—and the specifically the challenge of competitiveness and income determination—the shared analysis 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.

While the primary focus on employment and unemployment is self-evident, it is useful to elaborate on the second and third points. The shared view described here is based on an agreed understanding of the determinants of Irish price inflation and why it has exceeded the eurozone average at various times since 1999. The rate of Irish inflation is seen as determined by a combination of external factors and a number of structural features of the Irish economy. In the early years of the euro, one driver of Ireland’s inflation premium was movements in the euro/dollar and euro/sterling exchange rates. But even in the years 2000-2003, the price of services in Ireland rose at almost three times the euro area average. During much of the current decade, the inflow of finance, described above and in Chapter 2, played a major role in generating above-trend growth in Ireland and this put upward pressure on a range of costs and prices. Throughout the period since 1999, the rate of price increase of Irish services has exceeded that in the euro area, frequently by a very significant amount.

A Coordinated Approach Must Address a Range of Objectives

In earlier reports the Council identified the range of objectives that must be addressed in a coordinated approach to income determination. As reported in more detail in Appendix B, Section 3, these included full employment, competitiveness, low inflation, an acceptable sharing of economic output, balanced public finances, high-performance work practices and labour standards.

It is worth emphasising that in considering the objectives that must be met by the income determination system, the Council took account of the complex problems created when Irish prices and costs rose faster than—and eventually to a higher level than—those in other eurozone countries. This tends to erode the competitiveness of firms in Ireland, but also the real living standards of Irish workers—creating a context in which overall prosperity and living standards are vulnerable. Indeed, in its 2002 Strategy report the Council made reference to the difficult task that faced government and the social partners: to both achieve agreement on wage increases that met the range of goals listed above and to address the factors that gave rise to high costs and prices in Ireland.

While prices are no longer rising, an even more difficult set of competing objectives now confronts all those involved in finding a coordinated and integrated response to the crisis. In the current context, a coordinated approach to income determination must take account of the following factors:

- ◆ Employment—particularly the threat of further unemployment;
- ◆ Ireland’s loss of competitiveness over the past seven years;
- ◆ The pressures on certain enterprises created by the recent fall in sterling;
- ◆ The evolution of prices, including policy instruments that influence input costs to business, professional fees and rents;
- ◆ Domestic demand;

- ◆ The state of the public finances, which are directly affected by public sector pay developments and indirectly influenced by wider unemployment, economic and income developments;
- ◆ The burden of mortgage debt, particularly on those who become unemployed; and
- ◆ Social solidarity, encompassing the whole of Irish society, not just those whose incomes are determined in collective bargaining.

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 is 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. 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. To achieve the latter, it may be necessary to create new policy instruments and institutions.

5.4.4 Address Costs, Prices and Competitiveness in an Integrated National Response

In Section 5.2 we considered policy approaches that focus on stabilisation of the banking system and the public finances. We have concluded that, while these policies are necessary, they are unlikely to be sufficient. While recapitalisation of the main banks is a condition for recovery, it is unlikely to generate a flow of credit if enterprises do not see business opportunities. While a range of tax and expenditure measures, discussed in Section 5.3, are necessary to restore order to the public finances, and are critical in achieving a fair sharing of the burden of adjustment, they will have little impact on the economic crisis of company closures and job losses. The discussion in this section strongly suggest 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:

- ◆ 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;
- ◆ A re-targeting of NDP spending to support employment and enterprises; and
- ◆ Vigorous policies to demonstrate to the whole of Irish society that the full range costs, charges, fees and rents are contributing to the adjustment of Ireland's cost base and price level;
- ◆ Measures to assist people who, because of redundancy, face difficulties servicing their mortgages;

- ◆ Enhanced activation measures to support those who are losing their jobs;
- ◆ Measures to repair Ireland's international reputation .

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

5.5 A Focus on the Social Crisis

While the most prominent aspects of the current crisis are financial, fiscal and economic, the Council is in no doubt that the depth of these difficulties is giving rise to a significant social crisis. Indeed, it is not sufficiently recognised that the international origins of the crisis include major social policy deficits, particularly in the US and China. It was, to a significant degree, the absence of a proper housing policy in the US that pushed many low-income households to purchase sub-prime mortgages. In most Western European countries such people would be housed in the public system or with significant public support. Equally, the underdeveloped nature of social policy and social protection in China is a significant factor in sustaining the high rate of savings in that country. The imbalances created by these social policy deficits are important factors behind the economic crisis and resolution of the crisis is likely to require major social policy developments.

Within Ireland, 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 and taking measures to protect those newly experiencing loss of employment, income, savings and pensions. 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. It will also require significant reform to address the new and deeper problems created by the crisis. This is particularly so in the area of pensions, where Ireland's overall policy approach has been entirely undermined by development in the financial system and corporate sector. Some ideas on challenges facing Irish pensions policy are presented in Appendix B.

A second area in which the crisis calls for major reform is activation policy. Chapter 2 sketched the frightening rapidity with which employment is falling and unemployment rising, and the prospect of worse to come. 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 unfortunate to be 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, how jobless people access opportunities for retraining and further education should be immediately reviewed. The ambitions and analysis of the National Skills Strategy should be the fundamental framework for this review. 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. Earnest and 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. In this context, the qualifying six-month period of social welfare receipt required for access to courses under the Vocational Training Opportunities Scheme (VTOS) should be immediately reviewed given the significant strengths of the VTOS — i.e., the diversity of course offerings available, the duration of these courses (up to 2 years), the locations where they are offered (in 99 centres across the state) and the potential to increase VTOS capacity on the part of the 33 Vocational Educational Committees who run the Scheme.

In Appendix B, further ideas are put forward on the challenges facing Irish activation policy to stimulate the kind of policy invention and problem solving that is urgently required.

Overall, the Council urges 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.

Thirdly, the Council is strongly of the view that addressing the activation challenge requires, among other things, a vigorous implementation of the programme of public sector reform set out in the recent Government statement *Transforming Public Services: Citizen Centred*. Some Council ideas on public sector reform are outlined in Appendix B.

Paradoxically, the economic recession and collapse of private construction provides an opportunity to address some outstanding housing issues. In particular, attention might focus on:

- ◆ Construction and regeneration of social housing—which is relatively labour intensive;
- ◆ Renewing the Rental Accommodation Scheme—given the availability of vacant new accommodation.
- ◆ Building sustainable communities, through provision of social and cultural facilities—which is also labour intensive.
- ◆ Using opportunities that arise from intervention in the banking sector or otherwise to acquire public land banks on attractive terms—in its housing study, the Council advocated an element of active land management to meet the goals of housing policy (NESC, 2004).

The advantages and challenges of in-migration and increased cultural diversity have been documented in other NESC Reports (NESC 2006 and 2008). In a period of retrenchment and reform, integration policies assume greater importance. This is because of the earlier experience of other European countries at times of recession. In many countries, a recession after a period of strong immigration was a factor in tipping them towards problems between the native and migrant populations and the long run failure of integration (see NESC, 2006; IOM, 2006).

While the themes identified above would seem to be necessary social policy elements, this focus would be unsustainable and ineffective if it was not accompanied by a range of measures to address the other dimensions of the crisis. Prime among these are, of course, the crisis of the public finances and the economic crisis of exports, company failure and job loss.

5.6 A Focus on Restoring Ireland's Reputation

As noted in Chapter 3 and Appendix A the Council has long been of the view that Ireland's small size, location and model of economic development make it highly vulnerable if there were any loss of influence or status in the EU or, worse still, if there was a return to a less rule-based international system. There can be no doubt that, as well as the banking, fiscal, economic and social crises, Ireland now faces a reputational crisis. A number of dimensions of, and reasons for, this reputational crisis can be identified. Among these are:

- ◆ The uncertainty about Ireland's willingness to participate in major developments in the EU and its commitment to EU membership;
- ◆ The perception that Ireland's public finances are vulnerable to default because of a combination of low growth, difficulties in curbing public expenditure growth, contingent liabilities to the banking system and the increasing ratio of debt to GDP;
- ◆ The perception that Ireland has, along with a number of other countries, had a lax and ineffective system of regulation of the financial sector;
- ◆ The perception that Ireland's response to the banking crisis may not include sufficient change in governance, personnel and governance arrangements;

These perceptions make themselves 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. A second is the market valuation of Irish banks.

In thinking about these and other reputational issues, we probably need to take greater account of the changes in communications systems and patterns that have occurred in the past decade. The new technologies have facilitated radically faster and less structured communications networks. It is not surprising that many of the actors with the ability to protect and rebuild Ireland's reputation—government entities and, as we argue below, social partners—have not adequately adapted their methods to the new communications realities and, understandably, give higher priority to other aspects of their work. The recent damage to Ireland's reputation adds urgency to this challenge.

A further notable feature of the current context is the dominant role of the English language, combined with the fact that the UK is not a member of the eurozone. This combination 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. A significant degree of solidarity between EU countries has been a fact for several decades, and has taken various forms. But the current

crisis has revealed the need for EU solidarity to take the form of solidarity between eurozone members, and the role of the EU institutions in supporting this. There is evidence that this is now emerging and it can play a real role in countering damage to Ireland's reputation. In Section 2.4 we noted that the crisis poses a larger issue for the EU, one that was discussed in analysis of the European integration over the decades: the tension inherent in having a deeply integrated internal market—with free movement not only of goods and services, but also labour and capital—while maintaining separate currencies (Tsoukalis, 1977; NESO, 1989; Gross and Thygesen, 1998). The fear is that movement of a separate currency, such as sterling—either as a competitive devaluation or in response to market sentiment—could undermine the internal market.

As noted in Table 1.1, it is possible to identify a number of ways in which Irish policy has responded to the reputational crisis. One was the negotiation of an agreement with our European partners on the concerns of the Irish people on the Treaty of Lisbon (as reflected in the EU Presidency Conclusions of December 2008). Another was the recent agreement between Government and the social partners on the necessity to progressively reduce the level of Exchequer borrowing over the next five years in order to reduce the GGB to below 3 per cent by 2013 through an appropriate combination of expenditure and taxation measures, plus their agreement that 'a credible response to the fiscal situation requires a further adjustment at this stage of the order of €2 billion in 2009' (*Framework for a Pact for Stabilisation, Social Solidarity and Economic Renewal*).

The centrality of Ireland's reputational crisis in the grave overall situation we face is entirely consistent with some long-standing principles of Irish policy and with a modern understanding of sovereignty. That the contemporary international system is interdependent and increasingly so is not news. In *The New Sovereignty*, Chayes and Chayes go further. They 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):

Sovereignty, in the end, is status—the vindication of the state's existence as a member of the international system. In today's setting, the only way most states can realize and express their sovereignty is through participation in the various regimes that regulate and order the international system. Isolation from the pervasive and rich international context means that the state's potential for economic growth and political influence will not be realized (Chayes and Chayes, 1995: 27).

If sovereignty is status or good standing, then Ireland undoubtedly faces a threat to its sovereignty. Perhaps the only consolation 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, it seems 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, noted above, 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 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. As noted in our discussion of the banking, fiscal and economic crises, an effective response includes:

- ◆ 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. In addition to technical factors, ratings agencies are inclined to downgrade sovereign debt where they perceive that a country displays a 'lack of ability to rebound' or an 'inability to fix the problem' (*Wall Street Journal*, 16 February 2009). Writing in the *Wall Street Journal* Barley says 'The capacity of a national economy to recover and reinvent itself is driving ratings'. On the much more important issue of Ireland's desire to remain at the heart of Europe, it is clear that attitudes and behaviours across Irish society are critical.

These observations on the wide requirements for an effective response to Ireland's reputational crisis have an important implication: if Irish citizens and civil society organisations are damaged (materially and otherwise) by Ireland's loss of reputation—and they are—they have a reason to take ownership of the issue. It is not in their interest to assume that others—government or other organisations—will take care of the country's international reputation while they maximise their leverage on domestic issues. It seems that such a partial and short-sighted approach can damage the longer-term interests of those who adopt it.

Indeed, in time it may be advisable to explore the possibility of a 'participative diplomacy', in which a deep involvement of social partners in domestic governance is reflected in some involvement in communicating aspects of the Irish approach in ways that build and protect Ireland's reputation. To some degree, this exists already through participation in various EU and international institutions and networks. But, given the critical significance of reputational issues, it may require more deliberate articulation.

There is a final aspect of the link between international reputation and domestic credibility and effectiveness that deserves mention. It is true, as noted above, that the more credible and effective are domestic governance, the higher is a country's international reputation. But it also true that the more credible and effective are domestic governance, the less some aspects of international commentary matter. After its initial deposit guarantee, the Irish government could confidently ignore negative international press or policy comment. In time, something similar may apply to the ratings agencies. In a major *New York Times* article, 'The End of the Financial World as We Know It', Lewis and Einhorn identify the ratings agencies

as an important element in the dysfunctional financial system of recent decades. ‘Everyone knows that Moody’ and Standard & Poor’s botched their analysis of bonds backed by home mortgages’. They point out that their most costly mistake—one that deserves a lot more attention than it has received—lies in their area of putative expertise: measuring corporate risk. ‘Over the past 20 years American financial institutions have taken on more and more risk, with the blessing of the regulators and hardly a word from the ratings agencies’, which, they point out ‘are paid by the issuers of the bonds they rate’. They suggest that among the obvious changes in the financial system to be made is to ‘end the official status of the rating agencies’:

Given their performance it is hard to believe that the rating agencies are still around. There is no question that the world is worse off for the existence of companies like Moody’s and Standard and Poor’s...if public ratings are deemed essential, they should be publicly provided (Lewis and Einhorn, *New York Times*, 4 January 2009).

Clearly rating agencies exist and remain influential. Indeed, economists have pointed out that they have swung from dramatically underestimating risk to overestimating it. The more Ireland has an integrated, and widely-supported, national response to the range of crises it faces, the less likely it is to attract adverse opinions from rating agencies. Countries with credible and effective domestic governance arrangements can have confidence that they will fix their problems.

5.7 Towards an Integrated National Response

Table 5.1 provides a summary of the policy proposals discussed throughout Section 5 and the accompanying Appendix B. As we survey the policy possibilities for each of the five crises—banking, fiscal, economic, social and reputational—it is clear that an integrated policy approach is necessary. For example, recapitalisation of the key banks and holding bank executive and boards to account are necessary for success in addressing the crisis of company closures and job losses; among the reasons is the fact that it is hard to envisage cost, price and wage adjustment across the economy in the absence of clear evidence of restraint in bank salaries and an end to the bonus culture. Likewise, a period of public borrowing is necessary to offset the adjustment of incomes and demand.

While the paper argues that action on each part of the crisis depends on action on the other four, it is not suggested that only measures that deliver on more than one front be considered. Each part of the crisis requires appropriate analysis and policy instruments. Despite the inter-dependence between policies, some policies are effective in addressing some problems and other policies at addressing others. This is why we identify five distinct, but related, parts to the crisis. For example, while a fair sharing of burdens is critical to overall success, the policies that can ensure a sense of fairness (such as taxation and holding financiers to account) will not, in general, be very effective in addressing the economic crisis of firm closures and unemployment. In this sense, the paper seeks to draw on the Council’s particular contribution to Irish policy—the willingness and ability of diverse actors to engage in honest, joint, deliberation and analysis of evidence and explanations.

Consequently, the specific argument of this paper is not that there are advantages in engaging economic and social organisations in framing and implementing an integrated, national response to the crisis. This may be true. But the essential argument of this paper is that there is an analysis and understanding of the five distinct, but related, crises that suggest that Ireland needs an integrated, and clearly articulated, national response over the coming years. It is not the existence of diverse economic and organizations—or some general advantages of policy consultation or joint policy framing—that is invoked in support of an integrated approach. If anything, it is the reverse. The analysis of the crises and the necessary elements of an integrated response are a reason to frame an integrated response, as far as possible, in engagement with a range of Irish organizations. It is the shared analysis and understanding that warrants the integrated response, not the joint engagement that warrants an agreed response.

An effective integrated response would, of course, 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. Framing a shared analysis and understanding of the crisis is only a first step in creating such wider ownership.

Table 5.1 Responding to the Challenge Across the Five Parts of the Crisis

Stabilising the Banking System	Links Across Crisis
Ongoing Support: Actions should continue to be taken which secure the long term future of Irish financial institutions and adequate credit provision to viable businesses. While significant steps have been taken it is clear that further action may be required as international developments unfold.	Reputation Fiscal
Accountability: Convince Irish society as a whole, that those who led Irish financial institutions into their current reliance on the state are being held accountable and bearing their share of the adjustment burden.	Social Reputation
Credit to Business: Ensure that recent government action prompts a renewed flow of credit to businesses in Ireland.	Economic
Mortgages: Ensure that recent policy measures provide protection to the increasing number of households with mortgage arrears	Social Fiscal
Managing the Public Finances	Links Across Crisis
Target for Borrowing: Reach a deficit of GGB of below 3.0 per cent in 2013 by a combination of expenditure reductions and tax increases.	Reputation Economic
Tax: Increase the tax share of GNP—from its reduced 2009 level	Economic Social
Tax Reliefs: Assess critically the wide range of tax reliefs to both increase revenue and improve the rationality of public policy	Social
Investment: Continue with a high level of capital spending and enhance assessment of capital spending projects	Economic Social
Public Sector Reform: Ensure retrenchment measures are consistent with desirable structural reform and the transformational goals set out in the Task Force Report.	Social
Restoring Ireland's Economic Competitiveness	Links Across Crisis
Price Level: Reduce the full range of costs, charges, fees, rents and earnings that make up the Irish price level. This requires new policy instruments and institutions. This adjustment needs to be made part of an integrated, solidaristic, national response. Policies must demonstrate to the whole of Irish society that the full range costs including those beyond the scope of collective bargaining are sharing in the adjustment of Ireland's cost base and price level.	Fiscal Social
Smart Economy: Build innovative and entrepreneurial capacity in the enterprise sector as outlined in the Government Framework for Sustainable Economic Renewal Building Ireland's Smart Economy.	Banking Reputation
NDP: Re-target NDP spending to support employment and enterprises	Fiscal

<p>Supports for Employment: Government departments and agencies, employers, unions, third level colleges, and others—to explore new ways of responding to the employment and learning challenge, including:</p> <p>(a) Practical supports for people and innovations that sustain people in employment</p> <p>(b) Re-training and fundamental levels of upskilling, the need for courses of long duration and the impact on current programmes; and the provision of part time courses and the impact on funding of third level education.</p> <p>(c) Ways of matching investments made by employees</p>	Social Fiscal
<p>Jobs and Skills Summit: Convene 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 to meet these goals.</p>	Social
<p>Public Sector Reform: Improve the quality and flexibility of public services, secure greater efficiencies deliver more complex services with reducing resources and ensure that staff are engaged in productive employment. This requires changes in the nature of central reporting.</p>	Social Reputation
<p>Fiscal Offset: Acknowledge the importance of the significant fiscal offset, in which temporary public borrowing supports key services and limits the contraction of domestic demand.</p>	Fiscal Social
<p>Responding to the Social Crisis</p>	Links Across Crisis
<p>Debt: The incidence of debt problems must be minimised and addressed. This requires measures to assist people who, because of unemployment, face difficulties servicing their mortgages.</p>	Fiscal Social
<p>Pension Reform: Reform Irish pension policy to deliver a more sustainable and equitable system with less reliance on market-based models and a greater emphasis on universal provision.</p>	Economic
<p>Social Policy Reform: Continue policy reform and integration by promoting the life cycle approach</p>	Economic Social
<p>Practical Supports: Stimulate the search for practical measures that will re-order and re-fashion existing training, education and social welfare budgets. This includes:</p> <p>(a) Accelerating the review and reform of how newly unemployed people access opportunities for retraining and further education. Bring forward targeted responses for those in high risk sectors, white collar workers, new graduates, socially disadvantaged workers and foreign workers. The ambitions and analysis of the National Skills Strategy should be the fundamental framework for this review.</p> <p>(b) Reviewing qualifying terms and conditions, and payment mechanisms, to ensure people can access social welfare payments and that pathways into education and training opportunities and are not debarred by overly bureaucratic rules.</p>	Economic
<p>Housing: Address outstanding housing issues and use opportunities that arise from intervention in the banking sector or otherwise to improve housing and land management policy.</p>	Fiscal

Social Entrepreneurship: Support social and economic enterprises and community development initiatives that potentially lead to new business and social opportunities in the future.

Economic

Public Sector Reform: Public sector bodies must respond to changing and diverse needs and to perceived failures across the spectrum of economic and social policy. This is reinforced by the deterioration of the public finances.

Social
Reputation

Restoring Ireland's Reputation

Links Across Crisis

Energise People: Ensure that this agreed integrated national response is widely understood, that it commands support and that it engages the ability and energy of Irish people.

Social
Reputation

New Regulatory Regime: 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.

Banking

Citizen Engagement: Allow Irish citizens and civil society organisations to take ownership of the damage caused to Ireland's reputation through a combination of information sharing, dialogue and opportunities for action.

Social

Local Level Partnership: Engage people at all levels in finding solutions—including the social partners, public service staff and managers, citizens, academics and politicians.

Economic

A

Appendix A Existing Council Understandings

This appendix summarises the Council’s discussion, at various times since 1986, of the mechanisms of adjustment that are necessary and appropriate in a small country within the euro zone. In their analysis of Ireland’s fiscal crisis in the 1980s, industrial development, the unemployment challenge, wage bargaining, the EU internal market, the ERM and European monetary integration, housing policy, and Irish social policy, Council reports identified risks, vulnerabilities and policy requirements in the following areas:

- ◆ Interdependence;
- ◆ Consistent policy, the scope of negotiated agreements and the nature of partnership;
- ◆ Incomes policy;
- ◆ Fiscal policy and public finance management;
- ◆ Vulnerabilities inherent in Ireland’s growth as a regional economy;
- ◆ Social policy;
- ◆ Housing, land management and sustainable neighbourhoods; and
- ◆ Principles of taxation and tax reform.

1. Interdependence

A central element of the Council’s understanding of Ireland’s economy and society is interdependence. Initially the focus was on economic interdependence of various kinds, and in recent years this has been extended to include the close connection between the economy and society. In its 1996 Strategy report, NESC reviewed Ireland’s economic development in the three decades after 1960. It pointed out that, although the Irish economy achieved significant economic growth, adjustment, modernisation and inward investment in those decades, these successes were qualified in important ways.

Inevitable adversities were allowed to become divisive and produced delayed and insufficient responses. Overall, there was an insufficient appreciation of the interdependence in the economy—between the public and the private sectors, between the indigenous economy and the international economy, and between the economic and the political (NESC, 1996a: 4).

A central argument of that analysis was that this problem arose as much in periods of strong economic growth, as in periods of international recession. In explaining this, the Council emphasised that in every economy output is subject to competing claims which must be resolved, one way or another. 'Even in periods of strong economic growth—1960-73 and 1973-79—inconsistent claims on Irish output were allowed to develop and were resolved in ways which created major economic problems' (NESC, 1996: 21). Documenting those problems, it was argued that 'the common factor in each of these failures would seem to be insufficient appreciation and acceptance of the inter-dependence in the economy and society':

Failures seem to have arisen—in periods of both growth or recession—when there was insufficient recognition that the cost and efficiency of the public sector impacted strongly on the competitiveness of, and burdens on, the private sector. The dramatic structural adjustments have been borne primarily by private sector employers, workers, and, most of all, the unemployed... Any loss of focus on the inter-dependence between the public and private sectors—whether in growth or recession—seems sure to damage economic and social performance (NESC, 1996: 25).

It pointed out that failures also seem associated with insufficient recognition of the inter-dependence between the traded and non-traded economies.

Like many other countries, Ireland has painfully discovered the extent to which domestic economic and social arrangements are exposed to international competition... A paradoxical effect of globalisation is an increase, rather than decrease, in the significance of local and domestic factors. In a global economy, it is vital to have effective internal economic, political and social arrangements. Weaknesses in these arrangements will be cruelly exposed and punished by international competition... Irish policy-makers and economic actors can surely now be in little doubt of the way in which inefficient, ineffective or costly non-traded activities will damage overall economic performance (NESC, 1996: 25-26).

Failures since 1960 seem also to have arisen, the Council argued, when sight was lost of the third inter-dependence: that between the economic and the political:

By this is meant the idea that inconsistent claims on national output, and damaging actions, can arise from either economic actors or policy-makers, or from the interaction between them. The areas of taxation policy and exchange rate policy illustrate this graphically. Success requires that both economic actors and policy-makers adopt a strategic, long-term, and mutually consistent approach. Opportunist behaviour in either sphere can damage economic performance directly. In addition, short-term or narrow action in one sphere tends to prompt similar responses in the other. A key requirement of national strategy is to adopt an approach which ensures a long-term orientation of both public policy and private economic actors, and which achieves consistency between the two (NESC, 1996: 25-26)

Much of the Council's discussion and analysis, summarised below, has been focused on how such an orientation and consistency can be achieved in the changing economic, social and policy context that Ireland has experienced since the mid-1990s.

During this decade, and especially since its 2005 report, *The Developmental Welfare State*, the interdependence between the economy and society—and the complementary relation between social and economic policy—has been a central thrust of the Council’s work. This perspective—which was endorsed by Government and the social partners in *Towards 2016*—is discussed further in Section 6 of this appendix and 5.5 of the main report.

2. Consistent Policy, the Scope of Negotiated Agreements and the Nature of Partnership

2.1 Consistent Policy and the Scope of Negotiated Agreements

In 1990, NESc argued that there are three requirements for a consistent policy framework in a small, open, European democracy:

- (i) **Macroeconomic:** the economy must have a macroeconomic policy approach that underpins low inflation and steady growth of aggregate output;
- (ii) **Distributional:** there must be an evolution of incomes which ensures continued improvement in competitiveness, handles distributional conflict in a way that does not disrupt the functioning of the economy, and is fair; and
- (iii) **Structural:** there must be a set of complementary policies which facilitate and promote structural change in order to maintain competitiveness, eliminate barriers to participation and achieve social cohesion in an ever-changing environment.

The Council noted that the manner in which a consistent and effective overall approach is developed varies considerably across countries. It compared the approach in a range of countries and argued that, over the long run, Ireland had not had a fully consistent and effective combination of policies. It suggested that in the late 1980s ‘progress has been made towards achieving two of the three elements which are necessary’. In particular, ‘macroeconomic policy centred on the EMS and negotiated consensus is a desirable combination for achievement of the Council’s objectives’ (NESc, 1990: 419).

It then asked: if a negotiated national approach is desirable in the Irish context, what range of policies needs to be included in the consensus?:

The answer is that to be really effective in promoting employment and resolving conflicts, a social contract must include, at least, the evolution of pay, taxation, the public finances, exchange rate and monetary policy, the various publicly provided services and social welfare. Together with the correct macroeconomic approach, such a social contract can create the conditions in which it is possible to make a serious attack on the problem of unemployment (NESc, 1990: 420).

Indeed, it noted that additional benefits flow from the fact that an agreed approach tends to suspend distributional conflict (see below). This has been a central element of the Council’s analysis of the Irish economy over several decades. There are both technical economic arguments as well as normative considerations which make

it of continuing relevance. Indeed, looking back, it is evident that this is—broadly speaking—the approach adopted in the small EU countries that have achieved high levels of prosperity, social inclusion and stability in recent decades.

2.2 The Nature of Partnership

As this approach to policy developed in Ireland, the Council reflected on the nature of, and conditions for, an effective system of social partnership. In its 1996 report, *Strategy into the 21st Century*, NESc offered the following characterisation of social partnership, as it has developed in the decade from 1987 to 1996.

- (i) The partnership process involves a combination of *consultation, negotiation and bargaining*.
- (ii) The partnership process is heavily dependent on a shared understanding of the key mechanisms and relationships in any given policy area;
- (iii) The government has a unique role in the partnership process. It provides the arena within which the process operates. It shares some of its authority with social partners. In some parts of the wider policy process, it actively supports formation of interest organisations;
- (iv) The process reflects inter-dependence between the partners.
- (v) Partnership is characterised by a problem-solving approach designed to produce consensus, in which various interest groups address joint problems;
- (vi) Partnership involves trade-offs both between and within interest groups;
- (vii) The partnership process involves different participants on various agenda items, ranging from national macroeconomic policy to local development.

A decade later, in *NESC Strategy 2006*, the Council examined the achievements and limitations of the partnership process. It believes that the characterization adopted in 1996 and the later analysis of the problems which confront both bargaining and implementation remain relevant in exploring the possibility of a partnership response Ireland's current five-part crisis.

3 Incomes Policy

This section looks at the various aspects of the Council's analysis of incomes policy. It discusses:

- 3.1 Relationship between the monetary regime, fiscal policy and distributive policy;
- 3.2 Advantages of Coordinated Wage Bargaining
- 3.3 Mechanisms of Economic Adjustment in the EMU
- 3.4 Wages, Growth and Competitiveness; and
- 3.5 Public Sector Pay Determination.

3.1 Relationship Between Monetary Regime, Fiscal Policy and Distributive Policy

Over the past two decades, the close relation between the monetary regime, fiscal policy and wage bargaining has been a central theme of the Council's work and its policy recommendations. In its 1989 study of Ireland's experience and prospects in the EC, it concluded that 'there is no doubt that the macroeconomic policies pursued after 1979 were inconsistent with the decision to join the European Monetary System and to keep the Irish pound stable within that system' (NESC, 1989: 216). The Council emphasised that:

Our analysis of this episode shows that the public policy and private spheres interact to an enormous extent, and this illustrates that satisfactory implementation of the decision to join the EMS required not only recognition and acceptance of the macroeconomic policy conditions, plus acceptance of the implications for wage increases in the private sector, but also consensus on the management of the public finances, especially taxation. This was not adequately appreciated by government or the social partners at the time' (NESC, 1989: 216).

Consequently, the Council argued that continuation and development of the consensus represented in the Programme for National Recovery must be an integral part of Ireland's overall European policy.

3.2 Advantages of Coordinated Wage Bargaining

Beginning with its 1990 Strategy report, the Council has analysed the evolution of Ireland's wage bargaining system and, drawing on its understanding of Irish economic development, outlined some of the advantages of coordinated wage settlement. One major advantage of an agreement — such as the PNR — which covers monetary policy, taxation and incomes, 'is to suspend distributional conflict' (NESC, 1990: 420). This encourages employment growth, both because it enhances cost competitiveness and frees industrial relations energies to address other issues—such as corporate strategy, technical change, training and working practices—which also influence international competitiveness.

The most extensive Council discussion of wage bargaining was in the 1996 Strategy report. It reviewed the international research on the advantages and disadvantages of various wage bargaining systems and analysed the evolution of Irish wage bargaining since the Second World War. The international evidence suggested three conclusions:

- (i) The case for coordinated wage bargaining is strong, on both empirical and analytical grounds;
- (ii) Co-ordinated wage bargaining must be led by the private, exposed, sector of the economy;
- (iii) The success of co-ordinated bargaining is dependent on the wider policy framework, including exchange rate policy, taxation, public provision and the extent to which unions adopt a long-term and national perspective (NESC, 1996: 102).

The Council's review of the evolution of the Irish system led it to observe that the same basic elements which produce highly destructive outcomes in one context, can be supportive of success in another context:

The key factor would seem to be the presence or absence of a consistent overall policy framework and a sufficiently shared understanding of key mechanisms... What distinguishes income developments since 1987 from previous national wage bargaining agreements is the explicit linking of agreement on wages to agreement on the evolution of taxation, social security, social equity, public finances, and exchange rate and monetary policy. This marks a major change from previous periods of centralised bargaining, in which the various actors frequently operated with inconsistent views of the underlying economic realities and had divergent agendas (NESC, 1996: 103).

Drawing on this analysis, the Council was anxious to emphasise that cooperative behaviour is more important than the precise degree of centralization or decentralisation of wage bargaining. Indeed, it is the cooperative 'mood of play'—in which long-term self interest and the common good figure—that underlies one of the important differences between wage bargaining systems: their vulnerability to external shocks. It is this, in large measure, which explains the finding that co-ordinated bargaining produces greater *overall flexibility* and responsiveness of aggregate wages to economic conditions, even if it produces less flexibility in *wage differentials*. This, the Council suggested, 'underlines the importance, in Irish discussion, of distinguishing between different dimensions of flexibility' (1996: 101).

In its 2002-3 Strategy report, NESC undertook a further review of developments in wage bargaining across the EU in the context of the euro, assisted by a leading international expert. It concluded that both analytical developments and experience in other European countries suggest a number of lessons.

One was the continuing importance of a shared understanding of the economic and social context. A second was that the chance of creating and maintaining a co-operative mood of play depends as much on institutions as on the disposition of wage bargainers. A third is that purely centralized bargaining is likely to come under pressure, both because of short-term economic conjunctures and underlying trends in markets, organisation and technology. A fourth lesson was that when tensions appear in centralised bargaining, there are significant advantages to moving to a form of 'organised decentralisation' or 'coordinated decentralisation, rather than 'unorganised' decentralization. The final lesson concerned some of the ingredients of a successful system of 'coordinated decentralisation'. These include 'stable partners in whom one places confidence' and institution building for conflict resolution. 'The upgrading of public services—care provision, health services, housing and transport—helps the functioning of labour markets and gives people a better background for making real choices' (NESC, 2003: 284).

3.3 Mechanisms of Economic Adjustment in EMU

In the current context, a most important element of existing Council understanding is that concerning the mechanisms of economic adjustment in EMU. This was discussed in some detail in NESC's 1996 and 1999 Strategy reports. The 1996 analysis brings to the surface a number of aspects of the Council's view of labour markets and incomes policies that should be noted in current circumstances. The 1999 report considered how Ireland might adjust to four different economic scenarios within EMU. We summarise these analyses here.

3.3.1 Is Coordinated Incomes Setting Still Appropriate in a Fixed Exchange Rate Regime?

In 1996 the Council explicitly addressed the proposition, advanced by a number of analysts in Ireland, that centralised bargaining was inconsistent with Ireland's adherence to a fixed exchange rate regime such as the ERM, and particularly inappropriate in the event that Ireland joined a European single currency. It concluded that, provided both public policy and the social partners internalised the constraints of the currency regime and adopted a 'cooperative mood of play', a coordinated approach could remain advantageous (NESC, 1996: 119-124).

The Council discussed three criticisms of the partnership approach: first, that partnership probably had the effect of raising the level of unemployment and emigration; second, that centralised wage bargaining was inconsistent with a fixed exchange rate regime, and; third, that, if partnership was to continue, Irish wage contracts should be explicitly related to the sterling exchange rate (see NESC, 1996: 110-112 and 119-125). Explicit or implicit in each of these criticisms is the argument the partnership approach prevents downward flexibility of nominal wages. The Council argued that these arguments and proposals confronted problems of a factual, conceptual and practical nature.

Factually, these arguments seemed to be based on the misapprehension that the PNR, the PESP and the PCW were entirely inflexible arrangements, which prevent managers and workers addressing problems arising from the weakness of sterling. The Council argued:

All evidence suggests that this assumption is unwarranted. Under each of the national programmes, there are numerous ways in which particular difficulties were addressed by both management and workers. There is clear evidence of this, even if we confine ourselves to wage flexibility. Deferrals of pay increases, invocation of inability to pay clauses and even settlements below the norm, have been common responses to commercial difficulties (1996: 120).

The idea that partnership prevented wage undercutting—or, if continued, should include wages explicitly linked to the sterling exchange rate—overlooked some fundamental features of labour markets. The Council cited the argument of Nobel Prize winning economist, Robert Solow who, in *The Labour Market as a Social Institution*, suggested that one of the fundamental features of labour markets, observed almost everywhere, is the absence of wage undercutting by unemployed workers. Solow developed a conceptual framework—containing notions of fairness and institutional norms—which explain why wage undercutting is no more in

the interests of firms, than it is of workers and unions. Drawing on observation of labour markets and the work of economists who have studied them in detail, Solow (1990) identifies four important characteristics. First, wherever buyers and sellers have a durable relationship, notions of fair treatment are likely to make an appearance. Second, wage rates and employment are profoundly entwined with social status and self esteem. Third, fair wages will tend to be sticky wages, and analysis of labour markets must try to understand, rather than criticise, the relative inflexibility of wages. Fourth, since management and labour are in an ongoing relationship, complex patterns of co-operation tend to emerge. NESC suggested that this raises some doubts about the 'importance of getting the principle of pay flexibility accepted', and the feasibility of a national pay agreement incorporating a bonus linked to exchange rate movements (NESC, 1996: 122).

In addition, the Council said that arguments against the partnership approach tend to 'ignore the fact that without national programmes, income determination will remain a non-competitive, highly collectivised, process, with tendencies to monopoly power on both sides of industry' (NESC, 1996: 112).

Given the structure of the Irish economy and the competitive positions of firms in both the traded and non-traded sectors, there are strong grounds for believing that decentralised bargaining would produce strong wage pressures, with higher settlements in high productivity or low competition sectors rapidly transmitted to the rest of the economy (1993: 138).

The Council concluded its 1996 discussion of the incomes policy by identifying a number of requirements for dealing with the possible occurrence of Sterling weakness in the context of Irish membership and UK non-membership of EMU. First among these:

It is necessary that, in the face of a rapid depreciation of sterling, the relevant Irish partners have sufficient trust to address the problem in a timely and effective way. In the Council's view, co-ordinated wage bargaining, in the context of a negotiated social partnership programme, which is operational at the level of the individual enterprise, is the environment most likely to guarantee the necessary degree of trust, information-flow and burden-sharing. The existing arrangements for monitoring national programmes could be utilised to provide a mechanism for review should this be necessary (NESC, 1996: 123-4).

The Council saw this as one of the characteristics of an effective system of pay determination, other elements of which are summarised below.

3.3.2 Council Analysis of Possible Scenarios in a Monetary Union

In the EMU there is no independent currency whose changing value can act as a mechanism of economic adjustment and no independent interest rate to play the role of a buffer. 'Therefore, in a monetary union, the maintenance of competitiveness is crucial in the face of an economic disturbance' (154). In its 1999 Strategy report the Council argued that it is helpful for policy-makers, the social partners and the wider public to discuss the steps that would be called for by serious shocks to the Irish economy. 'The purpose of discussing certain scenarios is not to forecast

the future but to highlight the relationship between the state of the economy, the tools of stabilisation (fiscal and labour market policies including competitiveness) and the goals of maintaining employment and living standards in ways that promote social cohesion' (1999:158) The Council asked: 'How might a small economy be affected by a major economic disturbance and what should be the response of policy makers?'. Three kinds of possible disturbance were discussed:

- ◆ a currency shock such as a large sudden fall in the value of sterling;
- ◆ reduction in demand for European (including Irish) goods, perhaps caused by a financial crisis or sharp fall in the US stock market; and
- ◆ a purely domestic shock to the Irish economy, in this case the Council considered the effects of a positive shock, which boosts output employment in the Irish market.

Special mention was made of the housing market 'because of the risk that an economic shock could be considerably aggravated by the susceptibility of the present [1999] levels of house prices to an economic downturn' (1999: 158-9).

From its discussion of these scenarios, the Council derived four main general policy conclusions:

- ◆ First, the impact of a currency shock on the Irish economy would be lessened to the extent that pricing and wage-setting behaviour adapted relatively rapidly to the need to moderate price and wage increases in order to restore competitiveness;
- ◆ Second, in order to be able to partly offset the impact of a negative shock to the Irish economy, fiscal policy should aim to maintain substantial overall budget surpluses at close to present [1999] levels;
- ◆ Third, under conditions of very strong economic growth that place upward pressure on wages, economic policy should seek to ensure that income expectations do not outstrip the capacity of the economy to meet pay demands, thereby jeopardising future employment and prosperity; and
- ◆ Finally, a bubble in house prices would greatly increase the vulnerability of the economy to outside shocks. Economic stability would be improved by bringing housing supply further into line with housing demand (1999: 167).

The current situation contains elements of exactly the scenarios analysed by the Council in 1999: there is a currency shock due to the weakness of sterling, a dramatic world-wide reduction in demand, the aftermath of an Ireland-specific boom and the aftermath of a construction boom and a bubble in Irish house prices. Consequently, the Council's analysis of necessary policy responses has a definite relevance now.

3.4 Wages, Growth and Competitiveness

In recent years, the Council identified a number of objectives for the pay determination system:

It must achieve outcomes that maintain cost competitiveness and full employment, including the ability to respond to shocks. It should avoid embedding inflationary expectations into the system and achieve outcomes that are consistent with a reduction in inflation. It must provide for an acceptable sharing of the benefits of growth. It must be consistent with high performance work practices and associated reward systems. It must be consistent with a sustainable public finance position (NESC, 2002: 88-89).

In its analysis of the situation in 2002, the Council noted the possibility of loss of competitiveness, the structural and cyclical factors that can create pressure for wage increases in the Irish context and the way in which many other euro zone countries manage these challenges:

In the short-term, an effective system of wage bargaining must achieve a consistent and viable outcome, given the pressures of prices, housing costs, public service levels, rents, taxation, reward systems, international competition and profit levels. This would include taking into account wage developments in other Euro zone countries and Ireland's principal trading partners.

During the 1990s, that approach, used in many EU member states, did not seem appropriate in Ireland, given the rapid pace of economic growth and the dynamic structural change in the Irish economy. Now that growth has slowed—and Ireland's competitiveness is not automatically maintained by the virtuous circle described in Section 1—comparison with wage growth in other countries may be a useful component of an effective wage determination system.

In the medium term, the partners should work with government to weaken the pressures listed above by altering some of the key parameters. This can be done by reducing inflation, improving those services that are now scarce and expensive, reducing the cost of housing, improving infrastructure and settlement patterns, extending gain-sharing and widening the tax base.

An effective partnership agreement would, first, deal with the current conjuncture, in which the claims on economic output must be made consistent with one another and, second, alter the parameters of pay and profits by creating a shared understanding on key services, taxation and productivity. (NESC 2002: 89)

This underlines the Council's recognition of the fact that—although it is critical to make claims on Irish output consistent at any given time—this requires both an effective ongoing system of income determination and structural and reform policies that address the causes of inconsistency and, thereby, ease the pressures towards inconsistency and conflict.

3.5 Public Sector Pay Determination

The need for evolution in Ireland's system of public service pay determination has been a subject of Council analysis and broad agreement since the mid-1990s. In 2002 it was argued that public service pay increases are to be expected in a growing economy. 'What is important is that pay levels in the public service do not exceed those in the private sector or drive economy-wide pay developments—directly or through their implications for the tax burden—and that there is continuing adaptability and co-operation with on-going change in delivering public services' (NESC, 2003: 200). In *NESC Strategy 2006*, the Council set out the following four principles:

- ◆ First, the Council believes that the competitive sector of the economy should set pay levels and that public service pay should follow that set in the competitive sector.
- ◆ Second, the Council considers that ongoing change in a modern public service must be the 'default' position.
- ◆ Third, the normal rate of pay advancement in the public service should be the general pay increases negotiated at national level.
- ◆ Fourth, the Council considers that it is appropriate that there are periodic reviews of pay in the public and private sectors which can be achieved through a benchmarking process (NESC, 2005b: 264)

Elaborating on the fourth principal, the Council noted that, in a context in which those in the private sector are increasingly conscious of the value of pensions, 'the value of pension entitlements is an important consideration' in assessing public and private pay (NESC, 2006: 265).

These principles are relevant in current circumstances and in designing the further evolution of the system of public pay determination.

4 Fiscal Policy and Public Finance Management

4.1 Fiscal Policy

Over the past decade, the Council has proposed that fiscal policy should be conducted in accordance with two core principles: sustainability and stabilisation. The latter implies that at a minimum, it is desirable that the public finances should not add to cyclical fluctuations in the economy and, in general, when the economy is performing well, flexibility should be maintained in order to provide scope for some relaxation of fiscal policy in economic downturns (NESC, 2008: 284). In addition, the Council supported the management of the public finances in accordance with the EU's Stability and Growth Pact (SGP).

Indeed, the Council's analysis sought to take account of two opposing factors: the small size and openness of the economy (which tends to limit the impact of fiscal policy) and the single currency (which implies that greater weight must be placed on fiscal policy as an instrument of adjustment):

With the pooling of exchange rates and monetary policy instruments in the EU, the primary macroeconomic instrument available to manage demand is fiscal policy. It is well known that the effectiveness of fiscal policy is very limited in a small open economy such as Ireland. But this does not mean that it has no effect. Research suggests that fiscal policy in Ireland in recent years has been strongly pro-cyclical; i.e., it has added to the already strong growth in the economy (Duffy et al., 2001). This is an undesirable policy approach. The Council recommends that fiscal policy should contribute to the stabilisation of the economy (NESC, 2002: 73).

The limited, but non-negligible, counter-cyclical effectiveness of fiscal policy allows identification of the range of pressures and risks that confront policy makers:

The emergence of a 'political business cycle' would not be desirable either in terms of long term planning or cyclical balance. Excessive spending or tax reductions during economic 'good times' leads to a loss of flexibility during a downturn, resulting in the need for expenditure cuts or slowdown in a downturn. The Council believes that it is important to avoid this situation. Excessive spending increases also make it more difficult to secure a planned improvement in public services and infrastructure on a sustainable basis (NESC, 2005b: 252)

Perhaps the most complex aspect of fiscal policy, as analysed in the Council's work, is the relationship between the core goals of stabilization and sustainability. In *NESC Strategy 2006*, it pointed out that the public finances were benefitting from the construction boom, observing that 'Not all of this revenue is sustainable and the public finances are vulnerable to a fall in construction output' (NESC, 2005b: 251). In Irish conditions, adherence to the SGP is not sufficient to guarantee either the stabilisation or sustainability goals.

The Council identified a number of risks to continued strong economic growth 'including a sharp correction of the property market, a sustained loss of competitiveness or a contraction of the global economy stemming from a correction of the US current account deficit' (NESC, 2005b; 251). In this context, it observed that 'There is a risk that the current flexibility in the public finances could result in excessive short-term variations in tax or expenditure, even within the SGP limits. There is some evidence that this has occurred in the past' (p. 252).

4.2 The Management of Public Expenditure

Another aspect of the Council's existing understanding is the need to significantly improve the management of public expenditure. Given the very strong growth of public expenditure over the past decade, the Council has consistently emphasised the importance of achieving better value for money in the public system. In *Achieving Quality Outcome: the Management of Public Expenditure* (2002), it argued that this required 'clear plans on what expenditure is to achieve' and 'publication of much clearer information on, and greater accountability for, what has been achieved'. Problems in policy implementation and partnership were discussed in considerable detail in *NESC Strategy 2006*. Indeed, the Council has for the past decade seen organisational change as central to Ireland's current challenge and given it prominence in its three-yearly Strategy reports and other studies (NESC, 2002a and b; 2003; 2004; 2005a and b; 2006, 2008).

5. Vulnerabilities Inherent in Ireland's Position as a Regional Economy

In 2002, the Council's analysis and interpretation of Ireland's long-run economic development as a regional economy led it to conclude that the small size, peripheral location and type of economic development achieved in recent years contains undoubted vulnerabilities. Here we draw attention to those that are particularly relevant in understanding Ireland's current crisis.

A first implication of extreme openness is that 'it is hard to measure and forecast the Irish economy and, therefore, hard to keep a clear view of facts, timing and trends' (NESC, 1990, Keating, 2000; Blanchard, 2002)' (NESC, 2002: 12). The Council observed that this 'makes it difficult to coordinate the actions of employers, unions and government'. Indeed, as examples of these difficulties, the Council cited inflation prediction during the *Programme for Prosperity and Fairness* (2000 to 2006), debates over Irish wage levels and predictions of revenue (NESC, 2003: 53). The events of the past year underline this point; both short-term forecasts (of independent analysts) and medium-term projections for the Irish economy (such as the ESRI Medium Term Review) have been confounded by events. The enduring difficulty in measuring and predicting the Irish economy, and the fact that this poses a challenge to coordination, should be kept in mind in the current period of quite-exceptional uncertainty.

A second vulnerability is that the possibility of extensive growth can give rise to a range of problems¹². In 2002, these included super-normal profits, rents and asset prices, inflation, the challenge of integrating people from abroad, patterns of spatial development that are unanticipated, and pressure on the environment. Third, it was noted also that 'financial openness can create problems, as well as advantages, for the corporate, personal and public sectors' (NESC, 2002: 13).

Among the most important vulnerabilities identified was that 'Policy errors, such as pro-cyclical fiscal policy, will be punished severely, because of the importance of competitiveness' (NESC, 2002: 13). Indeed, it was noted also that the possibility of extensive growth implies the possibility of extensive decline, such as that experienced through much of the 19th and 20th centuries. Awareness of this is critical, given the depth of Ireland's current crisis.

The Council argued that the openness of the Irish economy and society, and its small size in world terms, means that the existence of effective international political and regulatory institutions, such as the EU, is absolutely critical to economic development and social cohesion. 'Ireland's size, location and model of economic development make it highly vulnerable if there were any loss of influence or status in the EU or, worse still, if there was a return to a less rule-based international system that did not constrain the naked use of diplomatic and economic power' (NESC, 2003: 54). At the same time, the Council noted that 'The small size of the country, and its peripheral location, can make it difficult to devise the best strategic and regulatory regime in networked sectors, such as telecommunications, energy and parts of transport' (NESC, 2003: 54).

¹² Recognition that Ireland has characterises of a regional economy requires that we distinguish between 'intensive' and 'extensive' growth. Intensive growth is that traditionally considered in economic analysis. It refers to the increased output per year of given stock capital and labour. Extensive growth refers to increased output credited by an enhanced stock of capital and labour, that can occur as firms and people move into a region. Both intensive and extensive growth can occur together. As can extensive decline.

The final vulnerability identified in 2002 echoes the 1999 analysis of currency union, cited above, and is of considerable current relevance: ‘While long run prosperity is determined by the quantity and quality of resources and capabilities, wage trends can have very significant positive or negative effects’ (NESC, 2002: 13). Explaining this point, the Council quoted Blanchard’s observation that ‘in an economy such as Ireland, open in trade, capital, and most importantly labour markets, wage explosions can kill; on the other hand, wage moderation can do miracles’ (NESC, 2003: 54; Blanchard, 2002: 2). His analysis suggests that ‘In a small open economy like Ireland, the world interest rate is given, and so the response of capital and output to wage moderation is larger’ (Blanchard, 2002: 6). Indeed, there is both analytical and empirical reason to believe that the long run size of a regional economy (its level of employment and output) is, in many respects, indeterminate: ‘Only adjustment costs explain where the economy is today, and small shocks can lead to very large changes in output’ (Blanchard, 2002: 8). A key determinant of not only the short-run, but also the long run, scale of the economy is whether wage adjustment is effective, so limiting the increase in unemployment, and maximising the resumption of production by both local firms and inward investors. If this raises the fearful prospect of long-run stagnation and decline, it equally suggests that speedy adjustment will have a big, and long-run, impact. In like manner, earlier the Council had observed that, because of Ireland’s structural position, ‘the reward for getting policies right as well as the penalty for getting them wrong are both greater in a small economy. A successful smaller economy can expand very rapidly as both workers and corporate investment relocate there’ (1999: 149).

The Council’s view was that acceptance of the core elements of Ireland’s economic strategy demands a recognition of these vulnerabilities. In particular, the Council argued that in accepting our adoption of an internationalised economy and a social model based on high levels of employment, we must:

- ◆ recognise that this combination can, in certain circumstances, tend to inequality and poverty, and there must be a major policy focus on addressing these problems;
- ◆ recognise that this approach is only socially acceptable and economically sustainable if a few key aspects of personal and social well-being—housing, education, health services, transport, enough income to live with dignity and, nowadays, training and life-long learning—are secured for everybody (NESC, 2002: 40).

In 2002, the Council suggested that several of the economic and social vulnerabilities had materialised simultaneously, as a result of both a long period of extensive growth and a sharp economic downturn in 2000 and 2001. The much deeper crisis experienced now can be seen as an even more profound and comprehensive materialisation of Ireland’s vulnerabilities, as discussed further below.

6. Social Policy

Social policy has been a central element of the Council's work and, as specified in *NESC Strategy 2006* 'social and economic goals must be jointly addressed: social progress depends on economic prosperity and social policy has a critical role in facilitating a high-participation, dynamic economy' (NESC, 2005b: xv). This analysis is accepted in the current national social partnership agreement *Towards 2016*, where a shared overall goal is 'nurturing the complementary relationship between social policy and economic prosperity' (Department of the Taoiseach, 2006:5). This 'intertwined' relationship needs to be understood and analysed for its contribution to stabilising and reforming Irish society at a time of economic crisis.

The Council has reflected at length on weaknesses in Ireland's welfare state in providing people with the social supports they need in contemporary society (NESC, 2005a). In particular, it identified deficits in services that, alternatively, are too tightly targeted, too expensive or of poor quality to people on low incomes (including those on modest earnings). Current aspects of Irish life—such as the high cost of childcare, difficult access to public wards in hospitals, poor value for money in health spending, tightly rationed supply of social housing and limited reach of public transport networks—contribute to making life difficult and expensive for many in employment as well as for those in receipt of social welfare. In addition, features of Ireland's income support arrangements have been identified as needing reform. Long durations on social welfare for a significant number of people continued right through a period of full employment and rapidly rising social spending. The expectations of, and aspirations for, recipients embedded in social welfare programmes have been low, high benefit withdrawal rates have survived, which contribute to making it difficult to move from welfare to work, and new poverty and employment traps have been created. A particularly telling window onto the scope for improvement in Ireland's welfare state is provided in the 2006 *Government Discussion Paper: Proposals for Supporting Lone Parents*. Despite total expenditure on income supports and services for lone parents of €1.35 billion, lone parents are still characterised by their high risk of poverty, low earnings levels and weak labour market skills. Lack of affordable quality childcare and difficult access to education and training continue to dog them.

The Council has proposed a developmental welfare state model as a way of addressing social deficits, with three overlapping areas of welfare activity: services, income support and innovative and activation measures¹³. These three areas can provide essential services and stability at a time of economic crisis, maintain employment and make available creative and innovative spaces for new approaches to building social, community and economic capital (for further suggestions see Appendix B).

The application of the developmental welfare state includes the 'more effective pursuit of equality, the better integration of services, income supports and innovative measures, the development of new structures of governance to improve the implementation of agreed strategies, and the fairer allocation of scarce resources' (NESC,

¹³ The Developmental Welfare State model can be described as a set of core services (health, education, housing, childcare, eldercare, transport, training, employment services) which the state should ensure are available to all members of society, at accepted standards and in ways tailored to people's circumstances (including ability to pay). The second area comprises income support arrangements that address weaknesses in current welfare payment structures in relation to child income supports, pensions and payments for people of working age. The third area is made up of measures to foster social innovation and activation at the local level, especially recognising the role of the community and voluntary sector (NESC, 2005 [NESC Strategy 2006]: 145).

2005a: 146). A life cycle approach has been proposed in building the developmental welfare state, focusing on the provision of services, income supports and innovative actions for six cohorts of people. Adopting a life cycle approach in building the developmental welfare state requires an on-going reordering and restructuring in how government departments, service providers and NGOs work together.

This approach, including common understandings, have been articulated and commitments made in *Towards 2016*, the National Development Plan 2007-2013, the National Skills Strategy, the National Action Plan for Social Inclusion 2007-2016, the National Disability Strategy and elsewhere.

7. Sustainable Urban Development and Land Management

The Council's vision for sustainable development, land management and housing has renewed relevance in the light of the current crisis. It is also relevant to note that the Council's understanding of the housing market did not anticipate the likelihood or full consequences of the down turn in construction. This section elaborates briefly on both these points.

Firstly, in its 2004 report *Housing in Ireland: Policy and Performance* the Council set out a vision of the kind of high-quality, integrated and sustainable neighborhoods that are worth building. It argued for five principles of sustainable housing and integrated development: sustainable urban densities; consolidated urban areas; compact urban satellites; rapid communication networks; and sustainable rural settlement. It suggested that developments in spatial planning and residential settlement were potentially of great significance in assuring both high quality sustainable development and adequate supply. This perspective not only helps us understand the reasons for the current crisis but may also be one of the ways in which Ireland can now respond to the crisis. The publication by Government in 2007 of a policy report, *Delivering Homes, Sustaining Communities*, is a comprehensive response to the NESC analysis.

It is of interest that this perspective figures prominently in recent analysis of the US housing bubble. Shiller, of Yale University, is the author of *Irrational Exuberance*, one of the first studies to draw attention to the dangers of the US housing boom. In consequence, he has emerged as a leading thinker on the sub-prime crisis and possible solutions to it. While a significant part of this work is on the way financial markets failed to protect against risk, and how they might be reformed, his analysis identifies urban planning as absolutely central in preventing undesirable and unstable housing booms. Shiller argues that the scarcity value that homes convey is due to a perceived scarcity of urban centres (Shiller, 2008). What is needed is 'massive urban planning', creating large urban centres more¹⁴, since building more of these would increase supply and thereby bring urban home prices down. The Council noted the magnitude of the challenge involved in moving perceptions in Ireland beyond extensive development to urban and sustainable development.

14 Other aspects of Shiller's work focus on the ability to democratise finance meaning that citizens would be able to use greater array of financial tools to allow them reduce the risk of owning property in any given location.

In the working out of the current crisis it is this vision of sustainable urban development that should inform efforts to re-energise the housing and commercial property sectors. In this context, the Council welcomes the recent publication by the Department of Environment, Heritage and Local Government, at the end of 2008, of statutory planning guidelines on Sustainable Residential Development in Urban Areas. The guidelines emphasise the importance of quality housing, the integration of schools, community facilities, employment and transport and amenities and adequate density.

Secondly, it is important to acknowledge that the Council did not anticipate or fully understand the impact of the downturn in construction on the Irish economy. The Council's recent report on the Irish economy (NESC, 2008) noted the dependency on construction and a likely decline in market completions, but did not predict the consequences now being experienced across the economy. The Housing Report (November 2004) identified the cyclical nature of housing and recurrence of asset bubbles and burst phenomenon. In this, it relied on existing studies of affordability and stress tests in reaching the conclusion that, despite some overvaluation, the Irish housing market could slow down as supply met the underlying need for additional housing. However, it also highlighted the need for new housing and argued that while output did exceed supply there was evidence of 'pent up' demand, based in large measure on the low number of households per 1000 in the population in Ireland and need for more social and affordable housing. The key uncertainty identified was the timing of any decline in housing output. A soft landing was envisaged.

8. Principles of Taxation and Tax Reform

In relating the current crisis to existing Council understandings it is important to note that principles of taxation played a central role in the Council's thinking from 1986 onwards. Tax reform was one of the four central elements of the strategy for economic and social development adopted by the Council in 1986. Tax reform acquired this prominent position in the Council's strategy as a result of a detailed study of the structure of the evolution of the tax system and an analysis of the tax reforms proposed by the Commission on Taxation. This revealed a system which contained many anomalies and inequities and which had deteriorated very seriously from the late seventies to the mid-eighties. This strongly suggested that tax reform should be among the central elements of an overall strategy for economic and social recovery in the late 1980s and early 1990s.

In considering how the tax system should be reformed the Council endorsed the main principles adopted by the Commission:

- (i) a comprehensive definition of income;
- (ii) equivalent tax treatment of income from different sources;
- (iii) neutrality with respect to inflation;
- (iv) minimum tax impact on individual or business choices;

- (v) general reliance on direct payments to those in need rather than assistance through the tax system,
- (vi) no earmarking of taxes;
- (vii) evaluation of compulsory social insurance contributions as taxes (NESC 1990: 149).

Indeed, the principles set out above were widely discussed and understood not only in policy circles, but also in Irish society. They have a renewed relevance in a period when the redesign of the tax base and rebuilding of revenue—and associated reform of the tax system—is, once again, a central task of policy.

In subsequent years, the Council drew on these principles in order to derive recommendations on taxation in each of its three-yearly Strategy report. In its 1996 Strategy report *Strategy for the 21st Century*, the Council said that its priority in income tax change was ‘the reduction of the tax burden for lower to middle income earners’. The Council noted that ‘in practice, this implies that priority should be given to increasing the basic allowances, rather than a reduction in income tax rates, as the latter would provide only limited relief to the lowest income earners’. In contrast to a reduction in rates, the Council advocated the use of increased personal allowances which would have the effect of not only reducing the tax burden for low earners but also providing tax reductions for the generality of taxpayer. It also favoured a move toward a system of tax credits as a highly transparent, easily understood, and equitable mechanism for making tax changes (NESC, 1996).

In its 1999 report *Opportunities Challenges and Capacities for Choice*, the Council restated these views and cautioned against the ‘proliferation of discretionary tax reliefs’ which erode ‘the tax base and the effective progressivity of the tax system’ (NESC, 1999: 196). It suggested that while ‘the overall effect of tax reductions since 1996 has been consistent with the approach outlined by the Council in its strategy’ and ‘have contributed to the strong economic growth that has been achieved’, it also cautioned that ‘at the current stage of the economic cycle, the *level and design of tax cuts* need to take account of possible overheating of the economy’ (NESC, 1999: 201). In its 2002-3 Strategy report, in reviewing Ireland’s long-run economic and social development, the Council noted that ‘while Ireland continues to have a tax and welfare system that significantly reduces the degree of inequality in market incomes at any given time...the overall balance of tax and welfare changes have been more favourable to those on higher incomes’ (NESC, 2002: 43).

B

Appendix B Further Ideas for Action

This appendix outlines ideas for concrete action in four areas:

- ◆ Fiscal stabilisation
- ◆ Labour market and activation
- ◆ Pension Reform
- ◆ Public Sector Reform

1 Fiscal Stabilisation

The Council supports the Government's objective of restoring order to the public finances over a five-year period. It sees a deficit of GGB of below 3 per cent in 2013 as a central goal around which a range of policy approaches can be oriented. In view of the uncertainties in the economy, the scale of the adjustments needed cannot be determined with any certainty at this stage. This is not, however, a reason for deferring action. Credible actions that restore confidence can boost competitiveness and maximize the ability of the economy to benefit from a global upturn.

1.1 Current and Capital Expenditure

There is considerable scope for both retrenchment and reform in current public expenditure. In the context of economy-wide downward adjustment of incomes and prices, it is appropriate that the public service make a proportionate contribution to national recovery.

The new public expenditure review board has a key role to play in identifying scope for enhancing efficiency of expenditure. It is desirable to engage people at all levels in finding solutions—including the social partners, public service staff and managers, citizens, academics and politicians. On an ongoing basis the management of public expenditure is critical.

There is also a need to consider how government departments make use of increased expertise in reviewing and allocating expenditure. Consideration could be given to procedural reforms to enhance the level of expertise in economic policy. Relevant models for consideration are the US Council for Economic Advisors and the Swedish Fiscal Policy Council.

Public capital expenditure is in the region of 5 per cent of GNP. In the past, adjustments to the public finances relied on substantial cuts in capital expenditure. There are arguments for avoiding this approach. Ireland still has significant deficits

in its public capital stock. The Council has confidence in the long term future of the Irish economy and believes that enhanced infrastructure is crucial to long term economic and social prosperity. In the current environment it is possible to achieve considerably greater value for money than was the case in previous years. In addition, capital spending provides a helpful stimulus to a depressed economy. These factors point to continuing with a high level of capital spending. However, in the situation of very high government deficits, it can be argued that capital expenditure should not be exempt in principle from cuts in expenditure. There is a need for enhanced assessment of capital spending projects to ensure that only worthwhile investments are undertaken. The opportunity should be taken to greatly reduce the land acquisition costs of public infrastructure projects.

1.2 Taxation and Revenue

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 2009 level—if a satisfactory level of provision of services and benefits is to be achieved.

One route to doing so is to take opportunities to widen the tax base. This is consistent with good principles of tax reform as discussed in successive NESC strategy reports. A long standing feature of the Irish tax system is a complex range of discretionary tax reliefs. There continues to be a wide range of tax reliefs. Table B.2 shows the principle tax relief and tax exemptions as reported by the Revenue Commissioners. Reliefs should be further critically assessed and there is likely to be scope to both increase revenue and improve the rationality of public policy. There should be additional progressive tax measures consistent with the social solidarity approach so that those who benefitted most from the economic boom will contribute to the adjustments required.

The largest single area of tax expenditures is on pensions—estimated at €2.9 billion in 2006, net of tax paid by those in receipt of pension benefits. There is potential for increased revenue in the environmental tax area. The Programme for Government contains a commitment to introduce a carbon tax.

Ireland's complex range of tax reliefs and concessions can result in unintended consequences. One consequence of relevance in the current market concerns the stamp duty concession on new houses. In the current market this has the effect of discouraging builders from renting unsold houses as it results in loss of 'new house' status. Unintended tax effects that adversely affect the housing market should be examined without introducing further concessions that impede prices from reaching market clearing levels or adding further complexity to the system.

There is scope for additional non-tax revenue. From time to time, the state allocates various intangible assets such as mobile phone licenses, radio licenses, non-EU import quotas and so on. Typically these assets are allocated below their market value through what McCarthy and White (2008) has referred to as 'beauty contests'; i.e. contestants make the case that they are best placed to make use of the asset. It would be generally preferable to auction such assets to the highest bidder. In addition to revenue gains, this would also increase efficiency and transparency (McCarthy and White, 2008).

Table B.1
Principal Tax Reliefs and Exemptions (2004) and Property Reliefs (2006) in Millions Euro

Personal Tax Reliefs and Exemptions		Enterprise Tax Reliefs	
Mortgage interest relief	231.5	Capital Allowances ¹	1,683.6
Private rent relief	33	Double Taxation ²	433.3
Pensions (2006)	2,900	Group Relief ³	207.6
Health Insurance	218.2	Business Expansion Scheme	21.1
Health Expenses	109.6	Seed Capital	2.7
Work Expenses	122.1	Films	19.5
Third Level Fees	11.1	R & D	70.5
Artists & Writers	28.1	Stallions	10.7
Rent a Room	2.7	Woodlands	3.7
Charities	19.3	Patents	62.8
Approved Bodies in Arts and Education	25.9		
Redundancy Payments	88.6	Continuing Property Reliefs (2006)	
Service Charges	12.7	Convalescent Homes	1.7
Trade Union Subscriptions	11.7	Private Hospitals	10.6
Profit sharing	41.8	Mental Health Centres	0
Savings-Related Share Options	1.8	Palliative Care Units	0
Significant Buildings Heritage Donations	5.2	Child care facilities	6
Special savings (discontinued)	548	Nursing Homes & Residential Units	16.1
		Mid Shannon scheme	0
Exemptions From Tax of Certain Social Welfare Payments		Discontinued Property Reliefs (2006)⁴	
Child Benefit	404.9		429.9
Maternity Allowance	9.7		
Government Borrowing Related			
Interest on Savings Certs etc	150.1		
Non-resident government holders	199.7		

Source: Revenue Commissioners, Statistical Report 2006 and Reply to Parliamentary Question, 4th November 2008.

Explanatory Notes:

1. Normal capital allowances related to the depreciation and allowances in the form of incentives.
2. Relief to prevent double taxation of profits generated by enterprises operating across countries.
3. Relief to allow one member of a group to surrender its trading loss to another member of the same group with common ownership.
4. Includes Section 23 type reliefs for rented residential accommodation.

1.3 Alternative Funding Options

Alternative funding mechanisms that merits further consideration is a recent proposal to introduce a 'notional defined contribution' pension scheme (McHale, 2009). Section 3 below, which looks at pension reform provides further detail. However, the proposal also addresses the immediate fiscal crisis.

In short, under this proposal people in employment would pay a percentage of their earnings into this pension scheme. Mc Hale suggests a contribution rate of 6 per cent applied across the wage bill which would provide substantial revenue. The contributions would not actually be invested; rather the scheme would operate on a pay-as-you-go basis. When the scheme is introduced, there is revenue from contributions but no payments as entitlements would not yet have been established.

McHale envisages that these funds would go to the exchequer and thus reduce the deficit immediately. The proposal avoids the disincentive effects associated with an increase in tax. Indeed it is reasonable to not refer to the contribution as a tax. The approach can be viewed as an alternative form of borrowing. It also has the benefit of reducing borrowing on volatile bond markets.

There are other possible ways of raising funds. Honohan (2009c) has proposed a scheme of compulsory savings. Contributions would be credited to an account and repaid after a period of, say, 10 years. Repayment would be explicitly conditional on improved economic conditions. A national recovery bond has been proposed by ICTU. This could also reduce reliance on international bond markets and is worth exploring.

2 Labour Market and Activation

The Council believes that there is an urgent need to stimulate the search for practical measures that will re-order and re-fashion existing training, education and social welfare budgets in ways that more effectively help workers now losing jobs and those seeking a first job in the current recession.

2.1 General proposals

Maintaining people in employment must be the first priority. Practical supports to people forced by the crisis to work reduced hours are preferable to the same people becoming wholly unemployed.

The current strong inflow to unemployment makes it imperative to give priority to identifying supports in the early months of unemployment that may make its duration less likely. These should be designed paying close attention to the profile of the current inflow which is different in key respects from previous periods of high unemployment.

The priority should be to support job seekers with weak formal educational attainments in accessing training and further education programmes that are (i) closely related to the market (ideally, featuring the participation of companies and employers familiar with market needs and trends) and (ii) of sufficient duration to offer the prospect of a quite fundamental up-skilling. In this context, it is

important that the presence of existing unused capacity on the part of providers, or of capacity that is easily expandable, should not dictate what is offered but that market relevance and individual choice remain the primary determinants.

The procedures and culture governing the administration of labour market policies should be examined for consistency with the long-term vision in the NESC Developmental Welfare State. Changes should be sought that increase the efficiency and courtesy of the process of applying for unemployment benefit. For example, six weeks, or longer, before a person receives the first payment to which they are entitled is not acceptable. It is also important to note that recent changes — namely, curtailing the period for which JB is paid from 15 to 12 months and ceasing to pay JB into claimants' bank accounts but only on attendance at Post Offices— may bring forward the day when more claimants, in a downturn expected to be of long duration, must transfer to means-tested assistance. This can have major consequences for the individuals involved (e.g., the rapid erosion of their savings) and increases the administrative costs in providing income support to unemployed people overall.

Innovations in Sustaining Employment

Many enterprises are responding to current pressures by reducing employment. In the Netherlands companies facing an acute fall in turnover can avail of a new 'exceptional short-time working scheme' on a temporary basis. Employees remain on the company payroll while the employer receives unemployment benefit payment for a proportion of the workforce. Employers are encouraged and indeed required to make a best effort to secure training and secondment opportunities for their employees. Companies can seek assistance on training and secondment from a public agency.

Ireland has a long established mechanism for placing people on short-time working that allows employees to receive unemployment benefit for days when they are not working, subject to certain conditions. This is a useful scheme but lacks a developmental dimension, and needs the identification of what constitutes "short-time working" to be viewed in the light of contemporary labour market developments. A recent innovative private sector Irish response to the downturn was the offer by Irish Life and Permanent of a lump sum payment to employees who took an extended period of leave from the company.

Life Long Learning

One effect of the current situation is that the 'opportunity cost' of engaging in training or education is lower than before due to the fall in demand for labour. The opportunity should now be taken to make real progress in putting in place supports for lifelong learning. In particular, the financial costs of training should not be a barrier for people in the workforce with less than a completed second level education. In addition, the funding of third level of education should be restructured to recognise the value of the provision of part time courses. Beyond these suggestions the relevant actors in training and education—government departments and agencies, employers, unions, third level colleges, and others— should collectively engage in an urgent exploration of new ways of responding to the employment and learning challenge. History shows that elements of a better long-term national system of lifelong learning can be discovered in this kind of response to crisis.

2.2 Targeted Suggestions

White-collar/ High Skilled

A large number of white collar and skilled workers are now becoming unemployed. There may be particular opportunities to redesign and improve programmes that support new company start-ups and self-employment on their part.

Consideration should be given (by Enterprise Ireland and County Enterprise Boards) to contributing matching funds to the capitalisation of a new start-up where a former employee commits part or all of his/her redundancy payment to do so. A similar arrangement might also be considered for redundant workers who opt to invest part or all of their redundancy payments in further education or training. Again, the funds they devote to this could attract matching funds from the appropriate state sources.

New Graduates

The crisis requires an innovative and generous response to impact on those graduating from higher education. The global reach of the current economic downturn limits the option of emigration. Imaginative ways are needed to help graduates continue developing their skills even while the labour market is stalled.

Action could be taken to co-ordinate increasing significantly the supply of placements, scholarships and internships abroad, including in China and other Asian countries.

Socially Disadvantaged

The current surge in unemployment reinforces the challenge of ensuring that socially disadvantaged job-seekers are not, effectively, 'written off' as having no future in the labour force by the manner in which support is provided them. If this were to happen, the cyclical rise in Jobseeker's Allowance could, once again, lead to the erosion of skills and work habits and higher structural unemployment.

Consideration should be given to making the Back to Education Allowance more attractive for a larger proportion of those in receipt of Job Seeker's Allowance (JA); and bringing forward the time when the prolonged payment of JA to young people aged under 25 years is not an option within Ireland's welfare state and to encouraging the DSFA, DETE and DES and their respective agencies to come forward with alternatives that are more developmental for the young people concerned.

Foreign nationals

In the current unemployment crisis, for the first time, significant numbers of foreign nationals are among the unemployed. Their being unemployed for the first time in Ireland presents particular challenges and opportunities. They remain as long as they so choose, full members of Ireland's workforce and their status and entitlements should be vigorously monitored and protected.

At the same time, they may be particularly able to benefit from timely information on developments in the labour market of their home countries and elsewhere in the EU.

Local development

At a time of national crisis, it is important to harness and develop the interests, enthusiasm, skills and gifts of people. There are currently many initiatives operating at local level, but sometimes a lack of coherence at local or national level in co-ordinating these approaches and in learning and translating the lessons from what is working and what is not. The opportunity exists in this climate of retrenchment and reform to harness local skills and innovation by supporting local social and economic enterprises and community development initiatives which are locally led, that promote the common good, and potentially lead to new business and social opportunities in the future.

3 Pension Reform

The current financial and economic crisis reinforces the need for immediate reform of Irish pension policy. The crisis brings to the fore the adequacy and appropriateness of the pension coverage of the Irish population in particular in the private sector. In the longer term the financial sustainability of state pensions and public service pensions remains a critical concern. The crisis highlights the need for medium term reform to deliver a more sustainable and equitable pensions system in Ireland. The Government published a *Green Paper on Pension Reform* in October 2007. The challenge now is to bring forward proposals that can alleviate some of the immediate pressures but which are also sustainable given the longer term demographic changes.

In devising a more effective overall system, a key question is whether to continue with the voluntary, but tax-supported, approach to earnings replacement or to adopt an alternative approach. Earlier work and recent developments suggest that there is a need to move pensions from their current reliance on a market-based model with a focus on high risk investments, high administrative costs and low levels of transparency.

In this context, one of the options which merit attention is the introduction of a universal state pension. This would include a significant increase in the state pension available on a universal basis, the option of a contributory element and significant reform of the existing system of tax reliefs. Any proposal in this regard needs to take into consideration the funding challenges or sustainability question associated with long term public pension provision: Spending on public pensions (social welfare and public service occupational pensions) is projected to increase from roughly 5 per cent of GDP (6 per cent of GNP) in 2007 to 13 per cent (15 per cent) by 2050 (Green Paper: 27). It is also likely that the current crisis will bring the question of state support for private sector pension funds into question. In reforming the pension system, attention should be given to anomalies which can make some ineligible for state pensions.

An important proposal in this regard is the idea of a 'notional defined contribution' (NDC) pension scheme (Mc Hale, 2009). This would be a state pension in which pensions benefits would be closely linked to individual contributions. It would be additional, both as regards contribution and benefits, to the existing state pension.

People in employment would pay a percentage of their earnings into this pension scheme. Individual contributions would be recorded and receive a notional return. On retirement the accrued contributions would provide an entitlement to a pension. The contributions would not actually be invested; rather the scheme would operate on a pay-as-you-go basis. The contributions of each generation would pay for the pensions of earlier generations. The rules regarding contributions, rates of return and entitlements would be designed to ensure that the system is financially sustainable over time.

Section 1, above, noted the fiscal advantages associated with this approach, namely the immediate impact on revenue; lack of disincentive effect associated with alternative ways of raising revenue. The proposal also helps build confidence about future incomes in retirement as contributions are linked to higher future benefits. It provides a real alternative for workers, at least those starting or recently started in their careers, to build up more secure and appropriate pension wealth.

It would provide enhanced pension benefits for contributors but it would not in itself be a solution to all of the current pension challenges. In particular it would not resolve the problems of those nearing retirement with reduced or depleted pension funds.

If it were decided to adopt this approach there would be many key details to be resolved. Sweden has a scheme along these lines as one element of its pensions policy and this experience could be drawn upon.

4 Public Sector Reform

Government has a very high ambition for the Public Service. This is demonstrated in its request to the OECD to carry out a detailed examination of the Public Service. The subsequent Government report *Transforming Public Services: Citizen Centred – Performance Focused* is an important milestone in current phase of Irish public sector reform and the Council welcomes the government's commitment to implementing the transforming public services change agenda. Public sector is one of the most important challenges facing Ireland and essential in an integrated response to the current crisis. As noted throughout this paper the public sector bodies must respond to changing and diverse needs and to perceived failures across the spectrum of economic and social policy. This is reinforced by the deterioration of the public finances.

The current crisis means that that across the public service there is a need to:

- ◆ **Improve the quality and flexibility of services:** Citizens will judge the performance of the public sector and Government on the basis of the services provided, the ease of access and timeliness of those services. The public sector must respond flexibly to the changing needs of citizens facing the full consequence of the financial and economic turmoil (see box below).

Scope for Improvement in Quality and Flexibility: An Example

An unemployed worker first has to present their claim at the local social welfare office, those with a pressing and immediate income need will then have to re-present much of the same information to the CWO to obtain an interim SWA payment and/or apply for supplements (e.g. rent or mortgage interest), and must then have a further engagement with an Employment Services Officer in FÁS.

Public sector reform needs to address such issues if it is to be capable of delivering the system change required to deliver the kind of high quality and efficient public services to which we aspire.

- ◆ **Secure greater efficiencies:** Constraints on available resources¹⁵ for the coming period should be utilised to incentivise organisations and individuals to secure greater efficiency.
- ◆ **Deliver more complex services with reducing resources:** Given the increasing need for tailored services (such as those arising from recent disability, healthcare and education legislation), and more complex diagnostic, monitoring and inspection roles (in areas such as environmental protection, health and care settings and other standards-based systems).
- ◆ **Ensure that staff are engaged in productive employment:** In looking at opportunities to save costs, the aim should be to keep people in employment, and all options—in particular in relation to effective re-deployment and re-training—should be fully explored to ensure quality of service delivery.

In the context of these four immediate pressures for change, the Council attaches particular significance to a number of dimensions in the Transforming Public Services change agenda outlined by the Government.

- ◆ **Public Expenditure Review Board:** It is important that the work of the Public Expenditure Review Board, announced in the 2009 Budget, be closely aligned with transformational goals set out in the Task Force Report.
- ◆ **Address management challenges in the public sector:** Challenges identified in the work of the OECD and the Government's Task Force, of linked to management must be addressed. These include moving beyond reform processes to ensure that they are embedded in practice; moving beyond the reporting of performance to the active management of performance and underperformance; and strengthening public sector governance to enable it respond to changing circumstances.
- ◆ **Focus on outcomes and outputs:** There should be a move by central government and parent organisations away from an overemphasis on compliance and input controls and a refocusing on outputs and outcomes.
- ◆ **Liberate the talent:** There is a need to develop models of delegation and performance based accountability that will, in effect, 'liberate the talent' in the public service. This will require a change in the role of the centre.

¹⁵ Public sector resources have increased substantially since the mid-1990s. Between 1995 and 2007, total public sector employment increased by almost 30% while employment increased by 73% in health and 42% in education. The OECD (2009) study found that public service employment in Ireland relative to the size of the labour force was relatively low by OECD standards (based on 2005 data).

There should be no delay in moving towards output and outcome indicators. Many public sector organisations at the delivery end, and even more of the voluntary organizations that are contracted by statutory bodies, are already undertaking in-depth review and monitoring of their own practice, achievements and failures. Where this is happening, it is the central department or agency that needs to change to become capable of receiving the rich information generated in such diagnostic monitoring and capable of resisting the urge to demand compliance information. Where it is not happening, the centre should impose the obligation that it begins right away.

The role of Government and central departments, such as the Department of An Taoiseach and Finance, is not diluted by these proposals. The argument suggests that in specifying priority outcomes they can rely to an increasing degree on the knowledge of those working at the front line. How these priorities are managed within and across the system remain the responsibility of Government, though it does suggest changes to the nature of central reporting. Innovative responses should be encouraged at the level of the individual organisation and enterprise to tackle the current economic downturn.

A problem-solving partnership-based approach which enables organisations 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.

The proposed Central Programme Office will review and recommend changes to current central reporting requirements in the second half of 2009. However, there is no reason to delay action on this process of reform. There are significant benefits attached to asking individual units to commence the process of proposing initial indicators and metrics. This would help identify immediate opportunities for improvement in the public service, it would begin the 'performance dialogue' recommended by the OECD, and support the work of the Central Programme Office in implementing the transforming public services agenda.

C

Appendix C Technological Revolutions and Financial Capital

1. Technological Revolutions and Financial Capital

This section looks at one body of analysis, associated with the work of Carlota Perez, which suggests that the crisis of the kind currently underway internationally is the harbinger of the full deployment of the information and communication technologies, in ways that will create vast business, technical and social opportunities.

Professor Carlota Perez, an analyst of economic and technological change, argues that we are at a turning point in the information and communication technological revolution. Her work has identified that in each surge of economic development there is a turning point in which there is a major financial crisis.

From her analysis of technological cycles since the first industrial revolution, Perez has developed an important theory of how each technological revolution has given rise to a tech-economic paradigm that lasts for 50 or 60 years (Perez, 2002). She identifies five such technological revolutions and associated paradigms: the first industrial revolution, the age of steam and railways, the age of steel, electricity and heavy engineering, the age of oil, cars and mass production, and the Information and Communication Technology age. In her view, technological change not only gives rise to new industries, but provides the means for modernizing all the existing industries and activities. Each technological cycle has two main phases, each lasting 20 or 30 years. The phase of installation sees the creation of the main industries and infrastructures of the techno-economic paradigm. This creates the condition for the second phase—deployment. During this phase the transformation potential of the technological revolution spreads across the economy and society, yielding its full development benefits. Interestingly, Perez argues that the transition from the installation phase involves a “turning point” during which a financial crisis forces greater regulation of speculative activity and brings finance back into the service of the real economy.

This analysis suggests that the world economy is currently at the turning point in the Information and Communication Technology age. After several decades of installation, from the 1970s to the turn of this century, the full deployment of these technologies will occur in the coming two or three decades. This deployment phase can see the opening of many economic opportunities, not only in information and communication technologies, but also in a wide range of manufacturing and service activities enabled by these technologies.

In this phase, products and services will be highly differentiated and markets will be highly segmented. For a country to fully participate in this long phase of economic progress requires that its citizens and consumers are capable of using these products and services and its entrepreneurs are capable of creating them. But achievement of full deployment is dependent on the adjustment of public institutions, industrial organisation and social arrangements. Where this occurs, there can be synergy between technology, economy and society—reflected in a phase of progressive development in which inequalities are reduced, in contrast to the frenzy and disruption of the earlier installation phase.

The opportunities in the deployment phase will depend on the ability to use and think creatively about the use of information and communication technologies, in particular in relation to sustainable energy and clean technology. The key in this phase is finding new uses for technology more so than development of new software and applications, components, networks or systems. At the same time Perez argues for the need to increase basic discovery and scientific research in the emerging bio and nano technologies.

D

Appendix D Partnership and Policy Responses

A brief overview of current trends in other EU states suggests that the governments and the social partners —either individually or collectively— are struggling to frame an integrated strategy capable of addressing the complex problem load associated with the an ever deepening fiscal and economic crisis. Outside of the Netherlands there would appear to be as yet limited evidence of governments and the relevant social partners forging an agreed consensus based approach to the worsening crisis.

The prevalent trend across the EU at the macro-political level is a mixture of calls for ‘urgent action’ and/or unilateral action by governments neither of which have as yet provided the basis for the negotiation of new solidarity pacts designed to address the deepening economic recession. Table 1 provides an overview of activity in a small number of EU countries.

There is on one level a degree of commonality to the types of response that have been suggested by different stakeholders —tax cuts, labour market reforms, pay freezes, wage cuts, support for SMEs and increased public expenditure to support employment. Indeed it may be that as the crisis deepens the parties will be constrained towards consensus and certainly in Finland the momentum is growing towards a national solidarity pact equivalent to that which was negotiated in the early 1990s. In the Netherlands, some analysts have indicated that the initial innovative and rapid response of the social partners to rising unemployment may prove insufficient due to an expected raft of job closures in major companies. This suggests the importance of a longer term perspective alongside a capacity to implement ‘quick fixes’ which can provide the parties with the necessary breathing space that enables them to engage proactively with the growing range of policy problems.

The experience across Europe suggests that formulating an appropriate and effective response to the deepening malaise requires a strategic capacity to forge a renewed consensus that not only embraces the changed economic context but is also informed by new sets of ‘policy possibilities’ designed to protect employment, secure social cohesion and restore competitiveness. This strategic capacity is enabled and supports the emergence of innovative responses at the sectoral and local levels.

The last six months have witnessed a considerable degree of activity at company level with management and unions, in some of the major European employers negotiating relatively dramatic and, in some cases innovative, responses to the current crisis. Importantly, there has been a strong emphasis on trying to ‘retain employees’ through a combination of flexible working, reductions in wages and hours and other cost-cutting measures. These company level agreements have been characterised as effectively tearing up the ‘employee relations hand book’ as what has been agreed in the last few months would have been considered as unbelievable and undoable prior to the onset of the current crisis (BEERG, 2009).

**Table D.1 Partnership and Pay Agreements —
Sample of Activity across Europe**

Major Social Policy Reliefs and Exemptions

Netherlands	<ul style="list-style-type: none"> ◆ Concluded annual social dialogue process (October 2008) ◆ Agreed a new set of measures focused primarily on supporting employees under threat of dismissal by allowing companies to temporarily register employees under the Unemployment Insurance Act (November 2008) ◆ Supplementary measures focused on unemployment and supporting enterprise (November 2008).
Finland	<ul style="list-style-type: none"> ◆ Confederation of Finnish industries proposed a re-evaluation of the agreed pay increases arguing that pay increases be postponed or frozen in order to safeguard jobs (November 2008) ◆ Offer rejected by Government and trade unions primarily on the basis that it would depress domestic demand (November, 2008) ◆ Chemical Industry Federation initiated negotiations on adjusting the agreed sectoral pay increases (Jan 2009) ◆ Council of Finnish Trade Unions called for the negotiation of a new solidarity framework to maintain labour market stability and prevent a fall in purchasing power (February, 2009)
Germany	<ul style="list-style-type: none"> ◆ German Council of Economic Expert's propose series of short-term measures to stimulate domestic demand in conjunction with call for further labour market reforms. While the social partners welcome the former they remain divided over call for further labour market deregulation. (November 2008)
Italy	<ul style="list-style-type: none"> ◆ Italian government's new economic strategy for addressing the economic crisis was welcomed by business organisations but criticised by the unions who called a half day general strike in protest (November – December, 2008)
Sweden	<ul style="list-style-type: none"> ◆ Government's new stimulus package criticised by both employer and union bodies on the basis that it was insufficient (December, 2009)
Spain	<ul style="list-style-type: none"> ◆ Negotiations between the Spanish government and social partners on labour market reform due to begin ◆ Employers have proposed changes to make collective dismissals more flexible in an attempt to curb the rising unemployment. The unions have accused the Employers of seeking to undercut established social standards (February, 2009).

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