

**SYMPOSIUM: RESOLVING IRELAND'S FISCAL CRISIS**

**Economic and Fiscal Policy since 1997:  
What Caused the Crisis and How Should It Be Rectified?<sup>1</sup>**

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*(read before the Society, 26<sup>th</sup> November 2009)*

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**1. INTRODUCTION**

In this paper I propose to examine the background to the current crisis which involves both a contraction in the economy due in part to the global crisis, and a collapse in the tax base due to the disappearance of property related taxes. I will argue that key tenets of neo-liberal economic policy that failed are a feature of both the international and domestic aspects of the crisis. The policy approaches to rising house prices and euro membership in the late 1990s were inadequate and contributed to the crisis. Also the success of the moderate pay combined with tax reductions strategy in the 1990's was incorrectly perceived as the "low tax model" being a driver of sustainable growth for the economy. The focus of fiscal policy for 2010 and the future will also be addressed.

**2. INTERNATIONAL FACTORS**

There are two separate but interrelated components to the crisis, with the global financial crisis leading to a contraction in the economy while the bursting of the property bubble has both lowered GDP, and permanently removed a significant proportion of the tax base. The ESRI has estimated this latter structural deficit at between 6 to 8% of GDP. (Bergin et al, 2009) If the international recovery currently taking place continues, it is likely that the cyclical component of the deficit in the tax base can be funded through economic growth. While the global economy has taken a very severe shock, the fiscal stimulus particularly in the US and Asia has been unprecedented, and free trade has continued without too much protectionist sentiment taking hold. In contrast, it was the protectionism instigated by the Smoot-Hawley Act 1930 of the US Congress that was a key factor that led to the Great Depression.

One of the factors that contributed to the global financial meltdown was blind adherence to the neo-liberal theory on efficient self regulating markets. The potential negative impact of an unregulated international financial industry has been a source of concern since the early days of the Eurodollar market in the 1970s. (Strange, 1971). The breakdown of the Bretton Woods exchange rate mechanism over the period 1971 to 1973 along with OPEC petro dollars exponentially expanded the global financial industry. However, the sustained period of growth in the international economy since 1980, led to the industry being viewed as a key driver of growth. The current Governor of the Central Bank remarked in 2006 that whereas economists previously regarded finance as the handmaid of the real sector, 'This old thinking has been superseded by evidence that an efficient financial system is a positive driver of growth.' (Honohan, 2006) The failure of the casino model of international finance should ensure a greater focus on the real economy in future.

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<sup>1</sup> Abbreviations used – (PESP: Programme for Economic and Social Progress); (PCW: Programme for Competitiveness and Work); (P.2000: Partnership 2000); (PPF: Programme for Prosperity and Fairness); (SP:Sustaining Progress); (T.16: Towards 2016)

However it would be incorrect to think that the crisis internationally is simply a failure of finance and banking. The expansion of a financial industry completely divorced from the real economy, with currency trading at up to 100 times that required for trade, and the development of complex off balance sheet products was ultimately the trigger for the crisis. The emergence of the global crisis with the collapse of Lehman Brothers in September 2008 is conventionally attributed to the US sub prime market. But the availability of finance at low interest rates seeking higher returns stemmed directly from the large current account surpluses built up in Asia as self insurance following the 1997 crisis. Higher commodity prices also increased the flow of global capital which was absorbed by the US running a large current account deficit. Many predicted a dollar crash, but some were not surprised that the imbalances affected the 'import side of the ledger'. (Madsen, 2009).

Indeed it is somewhat ironic that this crisis has affected the developed world to a greater extent than countries such as Brazil and the Asian economies who have weathered the storm better than in the past. In many previous crisis in the 80's and 90's emerging markets bore the brunt for crises triggered by an appreciating dollar. Since the demise of Keynesian economics due to the stagflation of the 1970s, neoclassical supply side economics has become the dominant ideology in the discipline. Krugman makes the observation that the modelling of the efficient market hypothesis rarely, 'asked the question as to whether asset prices made sense in terms of real world fundamentals such as earnings but instead asked only whether it made sense in terms of other asset prices' (Krugman, 2008). It has many similarities to the questions that were never asked in terms of Irish house prices. It is likely that this crisis will lead to a fundamental rethink in macroeconomics.

### 3. HOUSE PRICES 1997 TO 2007

In the 1990s Ireland continued with the export led development strategy, and successfully used the model of Social Partnership to stabilise and grow the economy through moderate pay increases linked to tax cuts which improved take home pay. House prices began to increase rapidly from around 1996 as the economy entered its Celtic Tiger phase in earnest from 1994 onwards. At that point while unemployment was still high the economy was on an upward trajectory with low stable inflation and exports growing at 17% a year. The tables below show the dramatic increase in house prices that took place between 1997 and 2007.

**Table 1: House Prices \* 1987 – 2007**

1987 → 1997	140%
1997 → 2007	241%

New Houses Dublin - Department of the Environment & Local Government

**Table 2: House Prices \* 1997 – 1999**

1997	26%
1998	32%
1999	20%
<b>Total 1997 – 1999</b>	<b>99.6%</b>

\* New Houses Dublin - Department of the Environment & Local Government

These Tables show that house prices doubled in the 1997 to 1999 three year period and that in fact the total difference in the price rises over the two decades is accounted for by that period. There were various factors behind this explosion in house prices. These included lower interest rates as membership of the single currency grew closer, demographic factors along with the wealth effect of a rapidly growing economy. A comparison of GDP along with pay rates for average and higher earners shows some evidence of linkage here. The potential for speculative gains was also facilitated by tax changes.

**Table 3: Increases 1987 – 1997**

House Price	GDP	Pay Secretary General	Average Earnings
128%	120%	113%	45%

The early indications of rapidly rising house prices was enough of a concern for CPSU to carry out a survey of members who reported that in their experience the relaxation of lending criteria by the banks was fuelling rising prices. Our survey did indeed show that the traditional income limits of 2.5 times the main income and one time the second had been changed in a significant number of cases to reliance on net income. Indeed, it was not long before a focus on net income became Government policy in the qualifying conditions for affordable housing. The Bacon Report proposed a number of measures to address the problem which included a dampening effect on investor activity but at the core of the proposed solution were a concentration on increasing supply. This led to the construction sector reaching an unsustainable 24.5% of GNP in 2006 (NESC No.118, 2009). No measures were taken on the demand side to control prices, and indeed this would have been viewed as Keynesian and contrary to the prevailing orthodoxy. We issued media comment about the dangers for the economy and wrote to the Taoiseach expressing concern about the impact on the moderate pay model that high house price rises would have for general inflation in the context of membership of the Euro.

*If this problem is not successfully addressed (price rises), it could destroy our economic success story either through a housing market collapse or because workers will perceive inflation to be in their interests* (CPSU Press release 1998) (Appendix 1)

We also pointed to the long run relationship dating back to the 70s between prices and average gross income. The prevailing view in the late 90s however was that the rise reflected the fundamentals of the Irish economy, with many references to housing needing to be viewed as an asset and not just a home. The focus was entirely on the market with no attention to the social value of housing. At the time some contributors at housing seminars pointed to the land cost (50%) in the composition of a then average house worth €100,000 but there was no official appetite for tackling this issue. (Farrell, 1998)

From our input to the first Bacon Report it was clear that the changing bank lending criteria was not perceived as a problem as the focus at that point was on net pay and the Government was committed to improving this even further. Expert commentators such as the ESRI did point to the dangers of the rapid rise in house prices but it was also somewhat qualified by evidence they set out on the user cost of new housing where prices related to mortgage interest and capital value were reported to be falling since 1992. Building at one third of UK construction was presented as clearing a backlog. (Bergin et al, 2003) *“New houses, although highly priced were relatively cheap to live in because of low real interest rates and expected capital gains”*. (Fitzgerald et al, 2005)

In essence it was widely accepted as primarily a problem of supply, with increasing net income levels largely justifying prices. In a recent commentary, John Fitzgerald has pointed out that the ESRI had no capacity to monitor the effectiveness of bank regulation. (Fitzgerald 2009) This misses the point in my view. It is now accepted that access to external borrowing by banks on the inter bank market was a key factor in the eventual collapse here. This was well known and never seen as a problem. The current Governor of the Central Bank, Patrick Honohan, in his review of the role of finance as a potential driver of the Irish economy identifies the extent of the increased reliance of the Irish banks on external funding as increasing from 10% of GDP in 2003 to 41% in 2005. However, he does not raise any particular concerns in relation to it (Honohan 2006). This in essence was because the global financial system was seen as integrated and a stable facilitator of growth. Economists who warned of the inherent dangers of casino capitalism were never as relaxed.

It was accepted economic thinking that the Irish economy had strengths in relation to labour supply, demographics and reducing dependency ratios that made it unique. The low tax model was seen as equally applicable to the export and domestic sectors as sustainable drivers of growth. In retrospect, it is clear that the relationship between house prices and net income was a self reinforcing bubble

#### 4. MEMBERSHIP OF THE EURO

The new Minister for Finance Charlie Mc Creevy in his first Budget speech in December 1997 emphasised the importance of framing policy in the new circumstances that membership of the Euro would entail, as Ireland ceded control of two of the three levers for managing the economy. To be eligible to join the single currency inflation in Ireland had to be maintained within 1.5% of the three best performers among perspective members. This was achieved and indeed inflation was only 1.2% in July 1999 six months after joining. The strength of the economy and export performance also allowed the Minister to revalue the punt by 3% on joining the Euro. However by November 2000 inflation was running at 7%, a level that would have disqualified Ireland from membership.

**Table 4: Inflation 1999 – 2000**

July 1999	1.2%
November 2000	7%

Central Statistics Office – Consumer Price Index

This never received much adverse comment with the notable exception of former Taoiseach Dr Garret Fitzgerald writing in his column in the Irish Times. Indeed the ESRI was relatively sanguine about it putting it down principally to the fall in the value of the Euro with respect to sterling and the dollar, while noting the loss of competitiveness. (Bergin et al, 2003). Currency fluctuations also took place in the 80s and 90s without such a severe impact on inflation. The domestic factors driving inflation were seen as related to external pressures, and inflation was not presented as a critical issue for urgent attention. The CPI during this period shows increases of 28% for housing, 4% for services, 4.7% for food and drink along with 17.4% for Tobacco. Both services and taxation policy decisions were major contributors to inflation (ICTU, 2004).

Clearly there were domestic factors that were independent of currency movement also driving inflation. It is notable that inflation having reduced in 2004, increased again over 2006 even though the Euro was strengthening at that point. It seems that no more than in the case of inflation in house prices it was not perceived as an issue in a rapidly expanding economy. Insofar as the external component of inflation could not be controlled it raises questions as to why more attention was not given to a domestic fiscal policy that would at least not add to inflation. Instead, all the levers of domestic policy were in fact geared towards increasing inflation. High year on year spending increases, house prices rising at a rate that encouraged existing home owners to acquire new debt, along with significant income tax cuts all contributed to the domestic drivers of inflation. It all again points to a widely held belief among the economic establishment that there were unique features to the Irish economy that allowed the discipline required by membership of the Euro to be completely ignored.

The consequences of this relaxed attitude to both sky rocketing house prices and general inflation within the Euro did have an impact on wage bargaining. However, unlike some of the experience of the 70s when there was validity to the argument that some wage bargaining was inflationary, on this occasion wage bargaining largely followed monetary induced inflation. The irony is that had the punt been retained, the economy would most likely have been severely punished by the currency markets. Instead, Euro membership facilitated a lack of economic discipline, and masked imbalances in the economy.

#### 5. WAGE BARGAINING 1987 TO 2008

Both the 1970s and 80s had a pattern of high wage settlements alongside similarly high inflation. This changed with the advent of Social Partnership in 1987 when a new era of moderate pay rises linked to tax policy improving take home pay was established. During the 90s the tax cuts were funded primarily from economic growth, which allowed the increased tax take due to the 1980's recession to be reduced. By the mid 90s general wage settlements of 2% to 2.5% per annum had become accepted and combined with low inflation were not difficult to get union members to accept. That changed dramatically over the winter and spring of 1999 into 2000 when the negotiations on the Programme for Prosperity and Fairness (PPF) took place. A strong underlying current of these negotiations was the need to achieve a dividend for workers from the Celtic Tiger in the form of inflation plus a share of economic growth. In my view, the perceived boom in the economy most dramatically reflected in house prices was the main reason for this sentiment. The problem was that inflation was already rising rapidly unrelated to wage bargaining. The impact of the rise in nominal pay and inflation while the real

pay outcome remained largely unchanged over the two decades since 1987 can be seen clearly in Tables 5 and 6.

**Table 5: Pay Agreements 1990s**

Agreement	Pay Terms	Inflation	Real Pay Per Annum
PESP	14.5%	7.6%	2.3%
PCW	8.2%	6.8%	0.5%
P.2000	9.6%	7.1%	0.8%

**Table 6: Pay Agreements 2000s**

Agreement	Pay Term	Inflation	Real Pay Per Annum
PPF	18%	15.9%	0.7%
SP	13.2%	7.1%	2.0%
T.16	10.4%	11.1%	- 0.2%

Indeed, the extent to which the 1990's model of Social Partnership had altered fundamentally became evident when the stated objective of a "Celtic Tiger dividend" evaporated through inflation under the Programme for Prosperity and Fairness. A cumulative three year increase of almost 16% had to be renegotiated in 2001 to increase it to 18%. This was the first agreement negotiated following the adoption of the Euro, even though the general expectation among senior trade union officials in the mid 1990s was that the single currency would embed low inflation and low pay settlements in the economy. If the general increase in pay and inflation was a function of sustainable growth in the economy as many commentators reflected at the time, then we would not need to reflect now on what went wrong. Instead, government economic policies contributed to inflation, and to achieve the same real pay outcome as the 90s involved a higher level of nominal pay increases. It should be noted however that price levels have exceeded EU prices by a greater margin than wages exceeded EU wage levels. (NESC No.118, 2009) Also the increased inflation level under the Towards 2016 Social Partnership agreement set out in Table 6 above was at a time when the Euro was appreciating. While there was a clear political decision to join the Euro, the economic discipline that membership required was neglected. When the European Commission expressed concerns in 2001 about fiscal policy, it was perceived in some quarters as an unwarranted slight on a better performing economy that had discovered the secret of economic success that was missing in mainland Europe.

The Benchmarking Report in 2002 has been presented in the media as an unwarranted pay increase for public servants. This was facilitated by the lack of transparency regarding the outcome which will have to be addressed in the future. However public sector pay has generally been set with respect to the private sector and it should be noted that the Programme for National Recovery in 1987 provided for a special public service pay round. The evidence shows that it was a labour market shortage in a rapidly expanding economy that drove up private sector rates in 2000 and 2001. For example, a normal recruitment pattern of around 500 Clerical Officers in the Civil Service increased dramatically to over 2000 in 2001. Recent studies on the public versus private sector pay gap are of limited use as they primarily look at individuals and their experience and qualifications rather than job content.

## **6. FISCAL POLICY FOR 2010 ONWARDS**

There is no doubt that the economic crisis is extremely serious and action is required to both restore economic growth and repair the gaping hole in the tax base. Tax revenue has reduced in the space of only two years from around €47bn to probably only €32bn, while unemployment benefits, bank recapitalisation and debt service is increasing expenditure. Growth in GDP has collapsed overnight and is likely to be around -12% over the period 2008 to 2010, before a modest recovery resumes. Other Euro zone countries are likely to lose around 4 to 5% of GDP, with Ireland closer to the Baltic States in terms of lost output. I do not think that it is a coincidence that both espoused the low tax model. The ESRI estimate that the structural deficit may be as high as 8% of GDP. This would mean that up to €11bn of tax revenue related mainly to property and coming from VAT, Capital Gains Tax, and Stamp Duty is permanently gone from the economy. The Commission on Taxation Report gave estimates of the likely reductions in tax revenue for each tax head based on an estimate of €34bn for 2009 as set out in Table 7 below.

**Table 7: Estimated Loss of Tax Revenue**

<b>Income Tax</b>	<b>€1.13bn</b>
<b>Corporation Tax</b>	<b>€2.66bn</b>
<b>VAT</b>	<b>€3.08bn</b>
<b>Stamp Duties</b>	<b>€2.22bn</b>
<b>Excise</b>	<b>€1.37bn</b>
<b>Capital Gains</b>	<b>€2.47bn</b>
<b>CAT</b>	<b>€0.1bn</b>

The underlying assumption in all the Budgets since 1997 prior to the onset of this crisis was that the low tax model was a sustainable basis for growth in the Irish economy. Indeed, the idea that Ireland was following a successful strategy of low income tax that other countries should emulate was promoted not just by Government but generally by economic commentators. There was a sense that the Irish economy was invincible and uniquely endowed with factors of favourable demographics, falling dependency ratios and rising educational attainment. The success of the low corporation tax regime in facilitating inward investment after the EU internal market was established in 1992 was probably also a factor in the belief in the low tax model as a sustainable basis for economic growth. Tax reductions from the 1998 Budget onwards were significantly in advance of the 1990's norm of around €400 per annum with the Minister increasing the P.2000 agreement amount of €1.2bn closer to €2bn, and the Taoiseach noting for the 2000 Budget that while the Unions had sought around €600m they had delivered €1.5b. No more than wage negotiations adjusting to a higher rate of inflation, the next trade union tax demands responded to the higher norm set by the Government itself. The levels of tax relief available for property and other reliefs availed of by higher income groups, required Unions to ensure that workers also benefited. While lower income rates were never a focus for Unions, increased credits and wider bands along with removing more people from the tax net were regularly sought. The successful 1990s model was modified to reflect the "Celtic Tiger," so that tax policy delivered the income gains that gross pay rates could not at the prevailing higher rate of inflation.

Income tax was 37.3% of total tax revenue in 1997 but it had reduced to only 28.7% by 2007. (Lane, 2008). The balance of taxation had switched to property related taxes and this proved unsustainable. We had expressed public concerns about a property bubble up to around 2003, but thereafter confined our comments to Budget submissions. By that stage the bankers were the "poster boys" who could do no wrong. There was a general assumption that the Department of Finance and the Regulators were competent managers of the economy. It appears now that they were captured by the prevailing ideology. The Irish Congress of Trade Unions, however, consistently argued against the level of special reliefs awarded in successive Budgets.

The result of a decade of hopelessly misguided indeed reckless economic and fiscal policy is a gap of around €20bn next year on top of the corrective measures already taken and planned. A portion of this is additional spending on unemployment benefit and debt service along with loss of cyclical revenue and which can be addressed as growth resumes. The priority is the structural budget deficit and that must be addressed by a combination of spending cuts and taxation measures. The big question is what the balance should be.

According to the NESC, to date the range of measures taken in the October 2009 Budget and April 2009 Budgets have produced savings/revenues of the order of €10.4b (NESC No 120, 2009). The public sector wage bill was reduced by €1.2bn through the pension level, the forgoing of the pay agreement is a notional saving of €1.2bn and it is estimated that suppression of posts will produce further significant savings.

In April the Minister for Finance indicated a range of measures to save €4bn in 2010 involving Taxation measures of €1.75b, €0.75b from the capital budget and expenditure reductions of €1.5bn. Since then the Minister has changed course and indicated the bulk of the adjustment would be on the expenditure side with €1.3bn to come from public service pay. Currently this is being resisted, but negotiations have resumed.

There is little doubt that the disappearance of windfall taxes has major implications for the public service pay bill. There is a degree of confidence that within a reasonable timescale this adjustment can be made. The difficulty is the Minister's plan to effect a major adjustment in 2010. It is unclear to what extent there might be an attempt to engineer pay cuts across the economy. Private sector earnings in the

second quarter show little evidence of private sector pay cuts. I see no basis for questioning CSO data as some commentators have done, as it accords with experience that workers will strongly resist pay cuts unless they are faced with the loss of employment. Apart from the deflationary effect of pay cuts there is an equity issue that arises in a single currency that did not apply to currency devaluations.

#### ***What should be done in 2010?***

Congress has set out a very firm position that the adjustment period should be extended beyond 2013/14, on the assumption that the Commission would accept it given the unique difficulties for Ireland within the Euro zone. Based on our low debt ratio, a surplus on the current account next year, and NAMA off the balance sheet it is possible to work within this longer timescale. The potential for a fiscal stimulus which the US and some Euro zone economies are implementing is restricted here due to the scale of the deficit but extending the adjustment period lessens the deflationary effect.

My view is that if the Minister intends to proceed with a €4bn adjustment then he should stick broadly to the mix between expenditure and taxation that he outlined in April.

#### ***Capital Budget***

There is a general view that the €.75bn reduction in the capital budget could be achieved without actual programme cutbacks due to lower construction costs. There is a case for not reducing the planned capital spending and using the savings to good effect in areas such as a programme of Buildings insulation which would generate both a stimulus, employment and a medium term return.

#### ***Taxation Measures 2010***

There is in my view an unanswerable case for the return of the top rate of tax of 1997 of at least 48% on incomes over €100,000 while this crisis persists. For the longer term the issue of Taxation policy and a third rate needs to be addressed in the context of what level of public services are desirable and what level of income tax we wish to have in the context of alternatives such as Carbon, and Property.

The ceiling on PRSI should be removed permanently. In current circumstances the debate between tax and insurance is of little relevance, and for most PAYE higher earners it is a temporary boost to income when the ceiling is exceeded which disappears when the new tax years begins.

The area of tax reliefs should be critically examined with a view to both temporary and permanent elimination as appropriate. There is a case for suspending the tax breaks used by high net worth individuals while the crisis persists. Congress have argued that the minimum rate should increase to 30%.

Capital Gains Tax was reduced to 20% in Budget 1998. It probably helped to inflate the property bubble. There is no basis for unearned income being taxed at a lower rate, and the rate should be restored to 40%.

There is in my view a case for revisiting the issue of Corporation tax as a temporary measure. Given the scale of the problem, a mechanism to at least partly restore the tax take should be explored even if there is a commitment not to change the rate. The industrial strategy for the future will have to move beyond the low tax model if sustainable economic and employment growth is to be secured.

Notwithstanding the Border issue there may be no alternative to looking at further excise increases.

#### ***Expenditure Reductions***

The size of the Public Service pay bill is such that it looms large in any consideration of expenditure reductions. A pay cut is achieved by either a cut in gross or net income or a pay freeze. To date the Government has applied both through the Pension Levy and the deferral of the pay agreement. Numbers reductions on a significant scale are likely out to 2013/14. If the Government takes this as its timeframe I would be confident that the Public Service pay bill and structure can be reset. There are issues regarding differentials that will need to be resolved. At top level pay awards of up to 40% above the norm were awarded. The basis for this was a successful and sustainable economy, when the opposite was in fact the case. A key part of the McCarthy report was related to reducing numbers. Shared services were also identified as an area for savings and in general Unions would support this while being against outsourcing of areas such as salary functions. A feature of the past decade or more was creating agencies where functions of salary, IT and HR were duplicated. We never supported this

and now it will likely reverse with significant savings accruing. The Report also identified a significant expansion at senior levels in the Civil Service that is no longer justified or necessary. Choices in relation to other expenditure reductions are largely about political decisions that it appropriate for a Government to take in line with its policy programme.

#### ***Future Tax policy***

The April Budget figures show that the tax take as a percentage of income is still lower than in 1997. The windfall taxes from Stamp Duty, Capital Gains Tax and VAT on Construction are never going to return to 2007 levels.

**Table 8: Tax Take as % of Income**

<i>Income</i>	<b>1997</b>	<b>2009</b>
€15,000	23%	0%
€20,000	28.5%	6.4%
€25,000	33.7%	10.3%
€30,000	37.1%	16.9%
€40,000	40.6%	22.1%
€60,000	43.9%	31.7%
€100,000	46.5%	39.2%
€120,000	47.1%	41.1%

Budget April 09: Note Wage increase 97 to 09 not taken into account

The reality is that unlike the 1990's tax reductions, which were built around sustainable growth, income tax reductions in this decade were replaced by temporary taxes. Once expenditure is reset to a sustainable level consistent with the share of tax revenue to GDP that is decided by this or a future Government, then choices will have to be made on taxation policy between, Carbon, Property, Income and other taxes. In my view, the low tax model has been a failure and some resetting of the income tax structure is inevitable. By definition this cannot just focus on just higher earners though I think it should be confined to them in 2010. Also there is a particular problem for the lower paid. Certainly younger lower to average income earners are hard pressed by the higher cost structure of the boom in areas such as housing and childcare and have less of a capacity to bear the income tax levels of the 1990s.

The idea that lowering income tax rates was in itself a route to sustainable economic prosperity has been disproved graphically by the gaping hole in the tax base. The 1990s model was a sensible adjustment to assist an export orientated growth strategy. The key failure was to assume that it was an easy route to economic prosperity.

#### ***Future Economic Policy***

Since the late 1950s Ireland's economic policy was structured around an export orientated growth strategy with foreign direct investment a key component of our successful approach. In the late 90s this approach was consciously or unconsciously abandoned as domestic consumption took over as the main driver of the economy. The extent of the change can be readily seen in the difference in exports between the 1994 and 2007 as set out in the table below

**Table 9: Exports 1994 to 2007**

Exports 1994 - 2000	17% p.a.
Exports 2001 - 2007	3% p.a.

NESC Report No. 118, 2009

The balance of payments on the current account going into deficit was not perceived as an issue in the context of high growth rates and the Euro. A view seemed to emerge that increased labour supply, lower dependency ratios and high educational attainment were key drivers of the economy and the focus on merchandise exports was no longer as important. In its reports the ESRI questioned the spending on R&D in Science and Technology in relation to manufacturing, began to query the value of merchandise exports compared to services due to their high import content, and even suggested an increased reliance on business and financial services. (Fitzgerald et al, 2005: 102,7; Fitzgerald et al 2008: 18). It seems that at policy level it was accepted that services and domestic consumption could



takeover as the mainstay of the economy. Services were also increasing as a proportion of exports, and the general view was that the fundamentals of the economy were sound.

In the 1990s the so called Washington Consensus emerged as a theory of development, in response to the economic failure in Latin America. The World Bank Report of 1992 on the Asian Tigers raised a debate on the merits of state led development against a market led approach within a sound macro economic framework. There was a widely held view that it was sound neo-liberal fiscal and macro economic policies including free capital movement that allowed these economies to benefit from globalisation in contrast to the import substitution policies in Latin America. The 1997 Asian crisis took place when a depreciating Yen reduced the export performance of their economies while strong inflows of portfolio capital overheated their domestic economies. Their peg to an appreciating dollar exposed them to a currency crisis. Since then they have reinvigorated their export growth strategy and indeed their build up of large currency reserves as self insurance was a factor in the current global crisis. It does not appear that any of the policy makers here or economic commentators saw any lessons to be learned from the Asian experience. Membership of the Euro ruled out a currency crisis here, but the clear lesson is that imbalances in the economy will in time still have to be addressed.

It is far from certain that a resumption of growth will easily bring down the 13% to 15% unemployment that will arise even when the adjustment to competitiveness takes place. We have had jobless growth before. Just as the low tax model for the domestic economy has failed, there is a need to look beyond the low tax Corporation tax regime and foreign direct investment as the driver of export led growth. The indigenous sector needs to be the focus for future export led growth as both goods and services in particular must utilise the currency stability that comes with the Euro. This requires innovation and investment and will also require some level of state direction.

## **7. CONCLUSION**

The reasons behind the failure of economic and fiscal policy are complex and varied and the two areas I have focussed on are of course only part of the picture. A doubling of house prices in three years cannot be explained away by “economic fundamentals”. Speculation regarding future gains was facilitated by easy credit and tax changes. The change to net income for loan approval along with the sole focus on supply produced a self reinforcing relationship between increasing prices and net incomes. The relaxed attitude to inflation when we joined the Euro, and the failure to focus on the balance of payments were serious policy errors that led to the conclusion that insufficient attention was given to the discipline that membership required. But the biggest failure was the idea that the focus could switch to domestic consumption and that low income tax rates were a panacea for sustainable development. A complete rethink is now required on future industrial, economic and fiscal policy.

*Civil Public & Services Union*



An Taoiseach  
Mr. Bertie Ahern T.D.  
Department of Taoiseach,  
Government Buildings, Dublin 2.

April 6, 1998

Dear Taoiseach,

I am writing to express the serious concern of my Executive Committee at the soaring house prices in Dublin, and also increasingly in provincial cities. This is such a serious problem and one that will affect the model for economic success developed under social partnership that I would like to set out our views on the matter.

The housing crisis particularly affects younger people on modest incomes that we represent and they have a strong sense of being let down by the policy makers. The social contract provides for workers to deliver moderate nominal wage growth and in return for employers and Government to deliver low inflation and tax cuts to boost take home pay. This "formula" has worked exceptionally well for the economy overall and while we in CPSU would argue about the unfair income distribution, our members have nonetheless supported each successive programme.

Our concern now is it may be impossible to continue with that formula, when inflation for the single biggest purchase that workers make in their lifetime, easily exceeds the worst inflation of the late '70s. Then at least it was in line with general inflation and incomes followed suit. It will be very difficult indeed to talk in terms of a continuation of 2/3% nominal wage growth per annum, with house price inflation in the 30% bracket, and starter homes in Dublin now seven times average "industrial earnings. While it is being said by some that the problem is caused by demographic factors increasing demand over supply, if true, this is a serious planning and policy failure. In our view the disproportionate income distribution of the past decade, very similar to that in the UK has been a significant factor. Initially, I felt this may not be as big an issue for Unions other than my own, given that it is obviously not as important for workers who already own a house. However, a brief look at the population statistics illustrates just how central the issue will be in the wage bargaining arena over the next few years. There are 900,000 people in the 15 to 30 age cohort compared to 1.4 million in the 30 to 65 age bracket. Thus, the proportion of workers who will need to acquire property compared to existing owners is exceptionally high, and this is a good indicator of the importance that house prices will assume in the wage bargaining arena. A situation where workers on moderate

incomes could perceive general inflation to be in their short-term interest at least, is something that needs urgent attention.

I have no doubt whatsoever that with the advent of the Euro next year, a continuation of the economic model we have developed under social partnership is of even -greater importance. The consequences for our economy if this problem is not successfully addressed will be very severe indeed.

I know that your Government is awaiting Mr. Bacon's report, but we would nonetheless urge you to ensure that very speedy decisions are taken by Government to tackle this problem. It is in our view essential that house prices are stabilised and controlled and that assistance is given to those on moderate incomes who need to enter the property market. Since the '80s price control has given way to competition as a means of regulating the economy, but clearly the housing market now represents a policy failure that requires Government intervention. In proposing that investor activity be curtailed, we do so not from any ideological stance or with punitive intent, but simply to protect the economy for all our sakes and as a means of funding tax relief for people on modest incomes.

We believe therefore that there must be a three strand approach to the housing crisis.

- Address the supply issue.
- Stabilise and control prices particularly at the lower end of the market.
- For low to modest earners to include housing costs in the "formula" we have developed under social partnership.


To expand a little on the latter two points we would suggest that effective Government intervention is required to control prices through a combination of:

- Active price controls using the certificate of reasonable value system.
- Stamp duty to be abolished on homes below a certain price to encourage builders to stay within that price.
- Capital gains tax adjustments and/or windfall profits tax on investors.
- Reintroduction of rates or a property tax on non family homes.

In respect of measures to assist low to modest income families to purchase houses in moderate price brackets we would propose that while the anticipated 2% interest rate reduction will assist if effective price control is achieved, nonetheless, additional measures will be required to help people on moderate incomes to purchase houses in the £100,000 and below house bracket. Additional mortgage interest relief similar to the relief given under the designated areas scheme must be considered. In effect this would involve applying the existing social partnership formula of moderate nominal wage increases along with tax cuts to the housing market and would help to ensure that for the first round of wage bargaining in Euros that we could remove house prices from the agenda.

I know your Government will have a difficult task addressing this issue but I trust you will give due consideration to the points I have set out in this letter.

Yours sincerely,



**BLAIR HORAN,**  
General Secretary

**This Press Release was issued in March 1998**

**PRESS RELEASE**

**HOUSING CRISIS A THREAT TO IRELAND'S ECONOMIC SUCCESS**

The Civil and Public Service Union today warned that the housing crisis in Dublin was a threat to our economic success developed under social partnership in the past decade. Blair Horan, General Secretary of the Civil and Public Service Union and member of the Executive Council of the Irish Congress of Trade Unions said today, "that Ireland's economic success based on low inflation guaranteed by moderate wage increases linked to real income growth through tax relief had worked extremely well. However, the current housing crisis was a major policy failure on the part of successive Governments".

If this problem is not successfully addressed it could destroy our economic success story either through a housing market collapse or because workers will perceive inflation to be in their interest. For young couples in their 20s and 30s house price inflation is the single most important price indicator they are concerned with. Currently starter home prices in Dublin are £100,000 and over which is seven times the average industrial earnings of £15,000 per annum. House prices in Dublin have increased by close to 90% in the past five years compared to inflation of 8%. This has a disturbing resonance with the UK in the late 80s boom-bust cycle when the housing market collapsed (with negative equity for six years) having increased by 90% in four years. While the missing ingredient here is an unlikely interest rate increase nonetheless the current market is unsustainable when couples on average incomes can no longer afford to enter the property market.

The Government must tackle the crisis urgently if we are to sustain our economic success. While supply and investor activity are factors the unequal income distribution of the past decade is also a major cause.

The economic model of the past decade has in reality been Scandinavian style social partnership with UK style unequal income distribution. There is little doubt that the disproportionate share out of our national wealth in terms of profits, higher income earners compared to low income earners has been an important factor in driving up prices in the middle to higher levels of the housing market and in the level of investor activity. A comparison of income share out in the Civil Service which is common throughout the public sector illustrates the point.

**INCREASES FROM 1987 TO 1997**

House Price	GDP	Secretary Government Department	Clerical Officer Government Department	Average Industrial Earnings	Inflation
128%	120%	113%	56%	45%	28%

To continue our economic success story house price inflation must be controlled while allowing people on average incomes to enter the property market. The Government must therefore urgently consider the introduction of a range of measures to achieve this which should include:-

1. Addressing the supply problem;
2. Changing tax structures for both stamp duty and capital gains tax to stabilise prices. Abolition of stamp duty for houses in Dublin below £100,000 for first time buyers below set income levels would assist this.
3. Social partnership delivered low inflation based on moderate income growth linked to tax cuts. This formula should now be applied to the housing market to give people below set

income levels additional mortgage tax relief (similar to the designated area scheme) for house purchase below certain price levels.

- New house prices Dublin Department Environment
- GDP CSO
- Average earnings CSO
- Pay scales Civil Service

March 19<sup>th</sup>, 1998.

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