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Policy Lessons from Ireland's Latest Depression

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September 30, 2009

Abstract

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

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1. Introduction

I have an interesting book on my shelves called *Ireland's Economic Success*, edited by ICTU's Paul Sweeney and published in December 2007. It features chapters by a range of eminent figures, with each contribution putting forward reasons why we were so successful: Social partnership, sound management of the public finances, low corporation tax, good education policies. An empirical economist looking for explanations for the Celtic Tiger would find our success to be over-explained and would have to sift through to get at the root causes of the miracle.

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

In this paper, I want to provide a selective review of Ireland's economic performance of the last 20 years, from the early days of the Celtic Tiger, through to the housing boom and the recent slump, and then attempt to draw a few lessons from the period. I argue that some of the factors widely cited as contributing to our downfall, such the emergence of a "bloated" public sector and the idea that Irish consumers behaved in a wildly reckless fashion are, at best, exaggerated. However, serious mistakes were made in financial regulation and also in the failure to design a fiscal policy based on sustainable economic trends. Since Ireland is a small open economy, we would almost surely be in recession today no matter what actions had been taken by our governments in recent years. However, I would argue, based on a range of observations, that a substantial slowdown was looming for Ireland by 2007, independent of what was going to happen in the global economy, and much of this evidence was ignored in the implementation of economic policy. The result was a range of policies based on an unwarranted over-optimism which left Ireland terribly exposed to the international downturn.

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

2. The Good Times: 1987-2000

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

2.1. Initial Conditions

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

When the late 1980s saw Ireland stabilise its precarious fiscal situation—thanks in large part to a short, but crucial, period of cross-party consensus—the Irish economy was finally ready for growth. As Honohan and Walsh put it "inappropriate fiscal and perhaps monetary policies held Ireland back in earlier years, with the result that convergence, when it occurred, was telescoped into a short period." Luck also played a factor, as Ireland's commitment to the EU began to pay off more than could have been expected. The fiscal stabilisation took place against a background of other positive factors such as the introduction of EU structural funds for poorer member states, the strengthening of the internal market and, during the 1990s, a return to stable monetary arrangements leading to Ireland's participation in the Euro.

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

$$GDP = Pop * \frac{Emp}{Pop} * \frac{GDP}{Emp}$$

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

2.2. Employment and Productivity

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

$$\frac{Emp}{Pop} = \frac{WorkingAge}{Pop} * \frac{Lforce}{WorkingAge} * \frac{Emp}{LForce}$$

Ireland's underemployment partly reflected its exceptionally high unemployment rate. However, it also reflected demographic factors. Ireland's baby boom occurred in the 1970s and peaked in 1980, so the depressed Ireland of the 1980s was supporting a very large population below working age. This demographic factor gradually unwound over time so that by the late 1990s, Ireland had higher fraction of the working age population than either the US or the UK (see Figure 3). Ireland in the late 1980s also had a very low rate of labour force participation: While female labour force participation had increased steadily in other countries throughout the 1960s and 1970s, the increase in Ireland did not occur until the 1980s and still left Ireland far behind (see Figure 4). However, when the economy recovered, there was a large female labour supply ready to enter the workforce.

With good fundamental policies in place, the combination of macroeconomic stability and a starting point of severe underemployment meant that the Irish economy became an incredible employment creating machine. Employment rose steadily from 1.1 million in the late 1980s to 2.1 million in 2007.

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

in the mid-1990s). As a result, for most of the 1990s, the average unemployment rate remained quite high, remaining as high as 10.4% as late as 1997. Only by the year 2000 had the boom generated enough jobs for the economy to reach effective "full employment" with the measured unemployment rate reaching 4.3% (see Figure 5).

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

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

3. The Housing Boom and the Inevitability of Slowdown

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

They were right of course. It had to end. And it did. But it took longer than almost anyone could have imagined.

3.1. The Housing Boom

By 2000, Irish people had far higher incomes than they had been during the 1980s. However, income is not wealth and there are a number of aspects of the economy that still reflected our poorer past. Public infrastructure such as roads and public transport were poor by international

standards and the current decade saw a substantial program of public investment.

More importantly, however, even by the early part of this decade, Ireland still had a relatively small housing stock, the smallest stock per capita in the European Union.[2] Our higher incomes and lower unemployment rates were bound to lead to smaller average household sizes, as younger people started to be in a position to buy their own homes at a younger age.

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

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

One might have expected the huge increase in the supply of housing to have cooled off house prices. Most likely, if the economy hadn't had the substantial supply response, house prices would have gone higher. However, the supply response was still not able to keep up with the growing demand and the increase in ability to pay generated by income tax cuts and the low interest rates

[2] See Somerville (2007).

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

regime that came with our membership of the Euro.

The result was an astonishing combination of rising house prices and an increasingly construction-dependent economy. Figure 7 shows that the rise in house prices far outstripped the increase seen in the US that were widely seen as remarkable: While US house prices doubled between 1996 and 2006, Irish house prices quadrupled over the period 1996-2007.

An obvious reaction to Figure 7 is to declare that it was patently obvious that Irish house prices were driven by a speculative bubble. However, it's not quite so simple. Comparisons with the US need to account for the huge increase in disposable income for Irish households, which far outstripped anything that occurred in other countries with housing booms. One way to see control for this is to graph the average house price relative to per capital disposable income. Figure 8 does this by graphing house prices relative to the average disposable income per person aged over 15, the latter used to proxy for demographic pressures on housing demand.

Perhaps surprisingly, during the first ten years of the Celtic Tiger, house prices only rose in line with increases in disposable income and the ratio of prices to income remained at a relatively low level. However, over the period 1997-2007 this ratio rose above any levels seen previously. This on its own isn't necessarily a sign that prices had lost links with reality because interest rates shifted to a lower average level than prevailed prior to EMU making housing more affordable. However, almost every careful analysis did suggest that by 2006-2007, Irish house prices were significantly over-valued, perhaps by as much as 30 percent.[4]

3.2. The Slowdown was Coming

My reason for documenting the evidence on Ireland's economic performance up to 2007 is to make one simple point: Any reasonable analysis of the economic circumstances in early 2007 would have suggested that a substantial economic slowdown was imminent.

- The factors underlying the long expansion in our employment-population ratio had run out. Labour force participation rates had reached the high levels that had been sustained by the UK and US and further growth was unlikely.[5] Unemployment could hardly go lower.
- Demographic factors, often cited as a positive underlying factor for growth in Ireland, were no longer working in our favour. In fact, the CSO were projecting that the share of the population that was of working age had peaked and was set to fall.

[4] See, for instance, McQuinn and O'Reilly (2006).

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

- The composition of recent growth had fundamentally changed: Figure 1 shows that productivity growth had slacked off during the later construction-dominated years of the boom, as the room for catch-up growth fell off (see Figure 6). Indeed, population growth driven by immigration had become the key factor driving growth. These patterns were not consistent with sustaining a high growth rate.
- Both house prices and the level of construction activity were unsustainable. With house prices very likely to fall, much of the development and construction business was going to become unprofitable leading to the sector shrinking. The economy was going to have to be re-oriented away from construction and such economic re-organisations are rarely easy to undertake quickly.

The landing was almost certainly going to be bumpy. Underlying economic growth in most other countries in the EU had been in the region of 2 percent per annum (see McQuinn and Whelan, 2008) and we had largely run out of room in relation to those factors that would let us grow faster than comparable economies.

However, despite this economic background, our leading political party, Fianna Fail, was re-elected to government in 2007 on the basis of an election manifesto whose underlying assumption was that growth over the following five years would average 4.5% per year. And rather than challenge these assumptions, our opposition political parties largely agreed with this assessment.

This endemic over-optimism was, I believe, the fundamental source of a range of different policy mistakes which left Ireland badly placed for coping with the economic slowdown to come. Then we had a global financial crisis and the most severe global recession since the Great Depression.

4. Consequences of Over-Optimism

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

4.1. Fiscal Policy

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

While tax revenues had continued to rise throughout the boom, Figure 9 shows that composition of these revenues had substantially changed. Income tax rates, which had been very high in the 1980s, were repeatedly cut. The substantial increases in income meant that the income tax take still rose every year but income taxes as a share of GNP fell from 20 percent in 1988 to around 13 percent in the later years of the boom. In addition to rate cuts, exemption points were raised to a level that took significant numbers out of the tax net altogether. The result was that the income tax burden that was exceptionally light, particularly for those on low to middle incomes. Table 1 uses calculations from the OECD publication, *Taxing Wages* to illustrate how light the income tax burden had become by 2007. For example, the combined PAYE and PRSI average tax rate for a single earning married couple with two children, taking home the average wage, was 6.7 percent in Ireland, compared with an EU-15 average of 23.7 percent and an OECD average of 21.1 percent.[6]

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

Because these tax revenues were dependent on activity in the housing market which had reached extraordinary levels by international standards, it was as clear in 2007 as it is now, that the government could not continue to rely on housing-related tax revenues. However, it appears that policy was based upon the assumption that the housing market, and by implication the rest of the economy, would glide towards the now-infamous soft landing. The government seems to have been expecting the huge revenues from the housing boom to disappear only gradually, with strong growth allowing other sources of tax revenues to be found to replace them.

From today's perspective, the soft landing scenario for the housing sector now seems faintly ludicrous but it is less so if one remembers that there was cross-party agreement that the economy could continue to grow at somewhere in the four to five percent range. If the economy could continue to grow at that pace, with nominal incomes perhaps growing between seven and eight percent per year, then it seemed possible that even if house prices were as over-valued as economic models had suggested, that the over-valuation could have been worked off slowly over time without requiring a decline in nominal house prices. Indeed, a similar pattern had already occurred during

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

2000-2001 when the government had introduced various measures to cool the housing market, after the first Bacon report: Economic models showed the market to be substantially over-valued at the start of this period, with most of this over-valuation being worked off by a period of flat prices.

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

The implications for our budgetary situation were profound. Tax revenues, which had been running somewhat ahead of expenditures for a number of years, suddenly slumped far behind: Total government revenue declined from 68 billion in 2007 to a projected 60 billion this year as revenues from stamps and capital gains dropped from 6.3 billion to a projected 1.6 billion (see Figure 10) These figures underestimate the effect of the housing sector collapse on tax revenues since the sector contributed further direct revenues in the form of VAT as well as the income taxes from construction employment, which has collapsed from 270,000 in early 2007 to 184,000 in 2009:Q1, and likely has further to fall. The associated increase in unemployment has necessitated a substantial increase in spending, with transfers rising from 18.7 billion in 2007 to a projected 23.5 billion this year. Within the space of two years, the budget went from being in surplus to having a deficit in the region of 20 billion.

We will never know how badly the Irish fiscal situation would have deteriorated without the world recession. However, it can plausibly be argued that an abrupt weakening was going to follow any decline in house prices and this event preceded the global crisis. What we can say for sure is that the over-optimism that pervaded economic policy making in Ireland in the years up to 2007 left the economy in a very percarious position.

4.2. Banking and Credit Policy

The other key aspect of Ireland's current economic problems is the banking crisis. It is undeniable now that in Ireland, as with elsewhere, there were substantial financial regulatory failures. However, we should be wary of false equivalences between the banking collapse in Ireland and events elsewhere.

For example, it is now commonplace to argue that the emergence of complicated financial instruments and their lack of regulation played a key role in the international financial crisis. In Ireland, however, despite the presence of a large number of international financial firms in the IFSC carrying out various intricate financial operations, complicated financial instruments have played little or no part in our banking crisis.

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

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

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

The focus on capital adequacy, Pillar One, of the Basle framework, appears to have come at the expense of a lack of emphasis on the second pillar, which relates to the supervisory process. It's worth quoting the Basle 2 document at length on the issue of "credit concentration risk" (see pages 179-180 of the PDF file):

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

> Risk concentrations are arguably the single most important cause of major problems in banks.
>
> 772. Credit risk concentrations, by their nature, are based on common or correlated risk factors, which, in times of stress, have an adverse effect on the creditworthiness of each of the individual counterparties making up the concentration. Such concentrations are not addressed in the Pillar 1 capital charge for credit risk.
>
> 777. In the course of their activities, supervisors should assess the extent of a bank's credit risk concentrations, how they are managed, and the extent to which the bank considers them in its internal assessment of capital adequacy under Pillar 2. Such assessments should include reviews of the results of a bank's stress tests. Supervisors should take appropriate actions where the risks arising from a bank's credit risk concentrations are not adequately addressed by the bank.

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

The failures in Irish banking regulation thus did not relate to financial innovations or regulatory arbitrage but to a failure to enforce the Basle recommendations about supervisory oversight of credit concentration risk. By 2008, AIB had made 48 billion in property-related loans: This represented over one-quarter of its total assets, and over half of the 92 billion that it obtained in the form of customer deposits.[7] With the widespread belief that the housing market was heading for a soft landing, insufficient attention was paid to the extreme concentration of property development risk that could cause huge losses. Furthermore, because much of the funding for rapid expansion in property loans came from wholesale funding from abroad (for instance, AIB have run a loan-to-deposits ratio of about 150% in recent years, while the corresponding figure for Irish Life and Permanent is about 300%) any hint of a threat to solvency was going to trigger a withdrawal of funding. So, the Irish banks were left precariously positioned with respect to both solvency and liquidity.

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

Of course, when thinking about future financial regulation, we also need to careful about

[7] Source: AIB 2008 Annual Report.

fighting the last war. For example, stung by a serious of high-profile scams ripping off Irish consumers, the Irish Financial Regulator devoted large amounts of resources to consumer protection and regulation, when we know that a stricter focus on prudential regulation would have been more helpful.

Financial regulation should and will be tighter in future: The recent G20 declarations on this issue are a welcome sign that steps will be taken in the right direction. However, just because an over-concentration of property development loans was the problem this time doesn't mean that it will be the problem next time; in fact, it almost certainly won't be. I suspect that general but simple rules such as strict limits on credit growth at individual banks may end up working better than complex capital adequcy rules in protecting the financial system from future unforseen sources of risk.[8] As Honohan (2009) has noted, even if supervisors were unable or unwilling to intervene to prevent reckless lending patterns, such rules would have at least curbed excessive lending growth at Anglo Irish Bank.[9]

5. Some Myths

The previous discussion has made clear that serious errors were made in the formulation of Irish economic policy in recent years. Over-optimism about the growth capacity of the economy affected key decisions about fiscal and financial regulatory policies and left Ireland in a poor position to deal with a global economic slowdown. However, I noted above that popular discussion of the boom and subsequent bust regularly overstate or misrepresent the roles played by other factors. Here I'll focus on two.

5.1. The Bloated Public Sector?

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

In truth, I think this characterisation is somewhat misleading. Consider, for instance, Figure 11, which shows the share of non-interest public spending in GDP. For most of the Celtic Tiger period, the share of public spending declined and by 2000 was well below the European average. The share moved up somewhat up until 2007. The last datapoint in the chart is for 2008 and by

[8] Turner (2009) is an excellent review of the sources of the recent financial crisis and suggests a range of rule-based measures aimed at making the financial system more stable in the future.

[9] See Honohan (2009).

this time falling GDP and increasing welfare costs caused the ratio to jump and it is projected to increase further this year as well.

This series includes government spending on transfers, capital programs and other items. However, the focus in public discussions of our bloated public sector tend to be on the number of public sector employees and their pay. Perhaps surprisingly, Figure 12 shows that the share of GDP spent on public sector pay and pensions in Ireland has consistently remained below the EU15 average. It is certainly true of course that public sector employment has increased substantially. But, as was discussed above, employment in the private sector of the Irish economy also increased substantially. In fact, the public sector's share of total employment in Ireland has declined significantly in Ireland over the past 20 years (see the left panel of Figure 13). Also, despite the common focus on the bloated and bureaucratic nature of the public sector, the right panel of Figure 13 shows that the share of public sector employment accounted for by administration has barely changed over the past 20 years.

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

In addition, the argument that the *size* of our public sector is standard says nothing about the *quality* of what it provides and it is hard to escape the feeling that the substantial increases in public sector spending have not delivered as much as we might have hoped. There can be little doubt that the boom-era environment in which recent public spending decisions were made did not lend itself to extracting efficiency improvements from the public sector. Countries where public spending can only grow by 2 percent per year are effectively operating under mini-Board-Snip conditions at all times: Since new spending initatives often have to displace old ones under such condition, this keeps pressure on program managers to deliver in an efficient pattern. There is robust evidence that Irish public sector employees earn a substantial premium over their private sector counterparts, suggesting room for savings there also.

So, without doubt, there is some room to cut Irish public spending in ways that minimise delivery of services and the recent report of An Bord Snip will prove invaluable in highlighting the areas requiring cuts. However, by most of the usual metrics, the characterisation of policy prior to 2008 as producing an outsized public sector doesn't quite fit the facts. And once the lower-hanging fruits such as the proliferation of new agencies introduced in recent years with weak justifications and the elimination of various restrictive public sector practices, it is likely that further reductions in public expenditure will involve serious cuts in the delivery of popular public services.

5.2. The Credit Binge?

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

In truth, there is little merit in this theory. Those who propose it usually focus on statistics for debt (drowning in it we usually are). However, it is generally misleading to just focus on statistics for debt without looking at the other side of the balance sheet, i.e. looking at household assets. The evidence shows that, while the boom period saw a substantial build-up in Irish household debt, it also saw an even bigger increase in assets. A recent Central Bank article by Mary Cussen, John Kelly and Gillian Phelan shows that household net worth (assets minus liabilities) rose from 640% of net disposable income in 2002 to a peak of 800% in 2006.

This substantial increase in the value of assets was, of course, mainly due to increases in the value of the Irish housing stock. However, it is worth noting that Irish households maintained moderate savings rates during this period and these savings also contributed to asset accumulation. For instance, during the booming period 2002-2005, Irish consumers saved a relatively healthy six to seven percent of their disposable income: See Figure 14. So rather than behaving irresponsibly, Irish households continued to save and despite the increased levels of debt, their net worth increased considerably.[10]

None of this is to say that all was perfect with the savings and investment decisions of Irish households during the waning years of the Celtic Tiger. Much of the increase in net worth has now been eroded as house prices have fallen (the Central Bank article only captures the start of this process as it ends at 2007) and the average figures for debt and asset levels likely hide enormous cross-sectional variations. Older people with houses purchased long ago saw huge increases in the valuation of their homes. Now they are seeing these "paper wealth" gains eroded but, by and large, they did not go on spending sprees during the boom and did not accumulate large debts. Younger people, however, ended up purchasing assets (houses to live in) at over-valued prices and paid for them with debt that still has to paid off. So, the composition of recent changes in assets and debts likely differed substantially across demographic groups and it is the younger cohorts that are most likely to be in trouble now. But, to the best of my knowledge, we have very little data to put numbers on this story.

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

6. Boston versus Berlin: For Real This Time.

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

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

Figure 15 shows that, even prior to the collapse in construction-related revenue, the Celtic Tiger left Ireland with a tax take relative to GDP that is well below the European average. Such comparisons are undoubtedly odious (and difficult) given differences across countries in the need for military spending and in the treatment of pensions. However, my assessment of the evidence is that Ireland's tax take is still relatively low by European standards, even after controlling for such factors.[11] After the various tax levies that were introduced in recent months, the idea that we have no further room for income tax increases has gained much currency. However, the OECD calculations reported in Table 1 show that, even after accounting for the new levies, income tax rates for average families in Ireland are still very low by international standards and a decision to keep these rates at such low levels will have clear consequences for spending options.

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

7. Conclusions

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

[11] Another argument is that GNP rather than GDP should be used for such comparisons. I disagree with these arguments because all income produced in Ireland is eligible for taxation by the Irish government.

If the Irish economy stabilises in 2010 with an unemployment rate in the mid-teens, then Ireland will again be starting from a point of having a significantly underemployed population. If our major macroeconomic and financial problems are dealt with successfully in the coming years and the world economy picks up again, then this starting point will allow room for a period of growth above what will be sustainable over the longer run. It will be essential, however, that future periods of fast growth not be interpreted as a return of the Celtic Tiger. Analysis based on a clear understanding of our demographic profile, labour market structures and productivity performance are unlikely to justify such a conclusion.

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Table 1: Income Tax plus Employee Contributions, by Family-type and Wage Level, 2007 (as percentage of gross wage earnings)

Family-type :	single	single	single	married[1] 2 ch
Wage level (% of Average wage):	67	100	167	100
Australia	19.1	23.4	28.8	23.4
Austria	27.9	33.6	37.9	31.8
Belgium	35.8	42.3	49.1	31.0
Canada	19.4	23.2	26.8	16.6
Denmark	38.8	41.0	49.6	35.8
Finland	23.3	30.1	37.4	30.1
France	25.8	27.8	33.1	21.7
Germany	37.3	43.1	46.1	24.2
Ireland	6.7	14.4	26.6	6.7
Italy	24.2	29.0	35.5	21.2
Japan	18.4	20.2	24.2	16.4
Netherlands	31.2	35.8	40.8	32.4
New Zealand	19.1	21.5	27.3	21.5
Portugal	17.1	22.9	30.0	15.0
Spain	16.2	20.5	25.3	12.5
Sweden	24.9	27.6	37.8	27.6
Switzerland	18.9	22.0	26.9	16.6
United Kingdom	23.9	26.9	30.6	25.2
United States	21.8	24.2	29.9	10.9
Unweighted average:				
OECD	22.2	26.7	32.3	21.1
EU-15	24.8	29.9	36.5	23.7

1. One-earner family.

Figure 1: A Decomposition of Irish Economic Growth

Three-Year Moving Average Growth Rates, 1982-2008

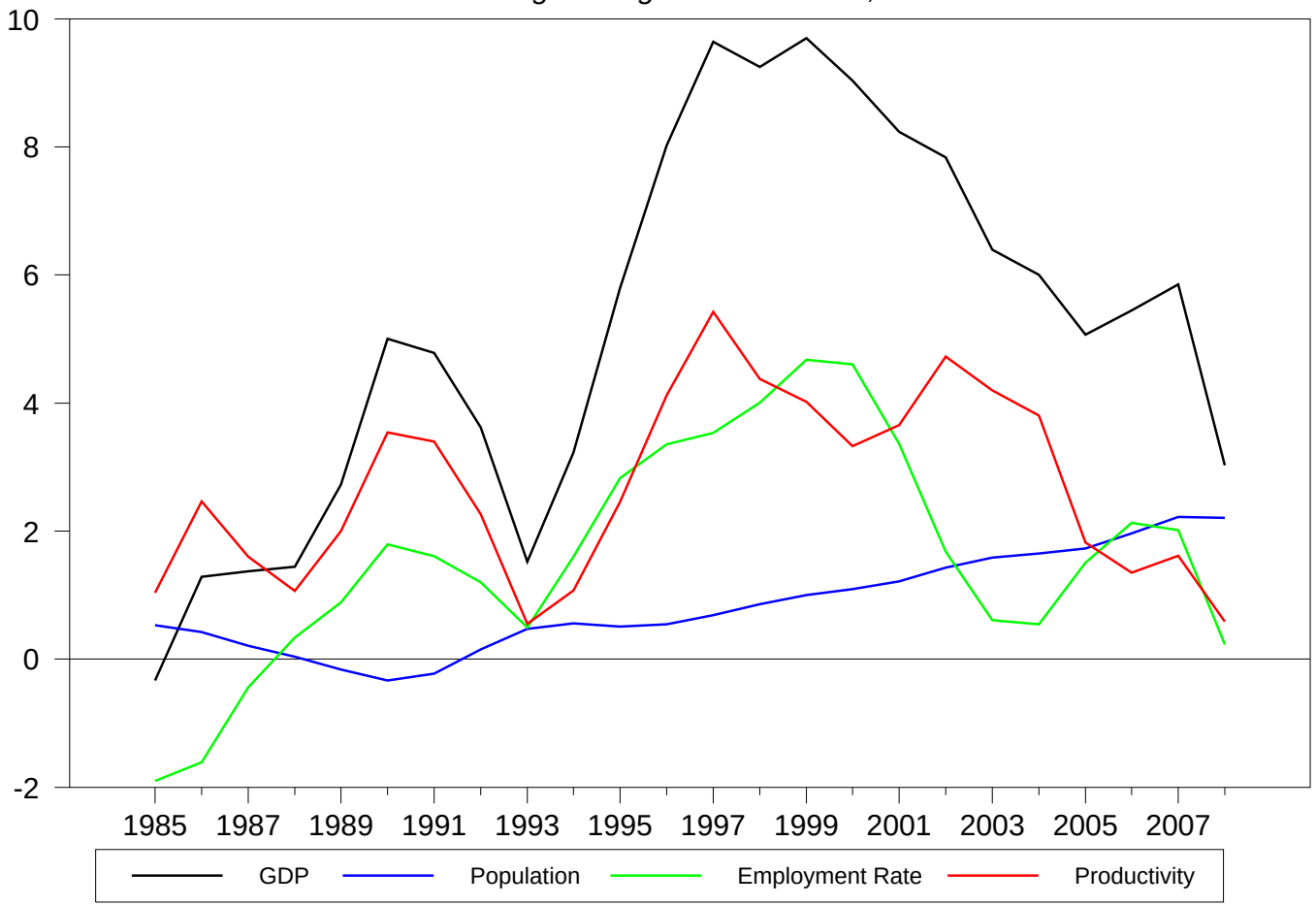

Figure 2: Employment-to-Population Ratios (1956-2007)

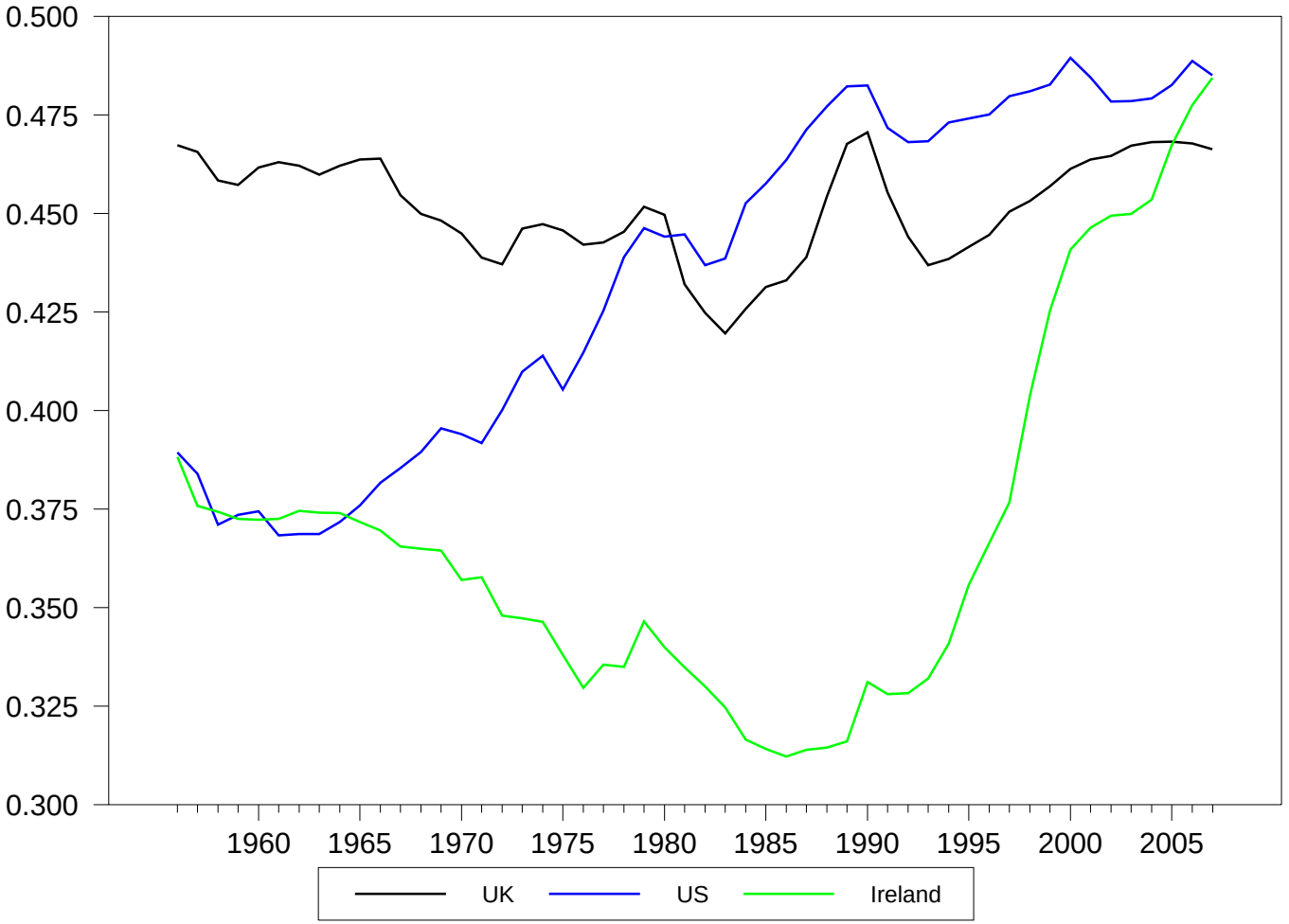

Figure 3: Fraction of Population Aged 15-64

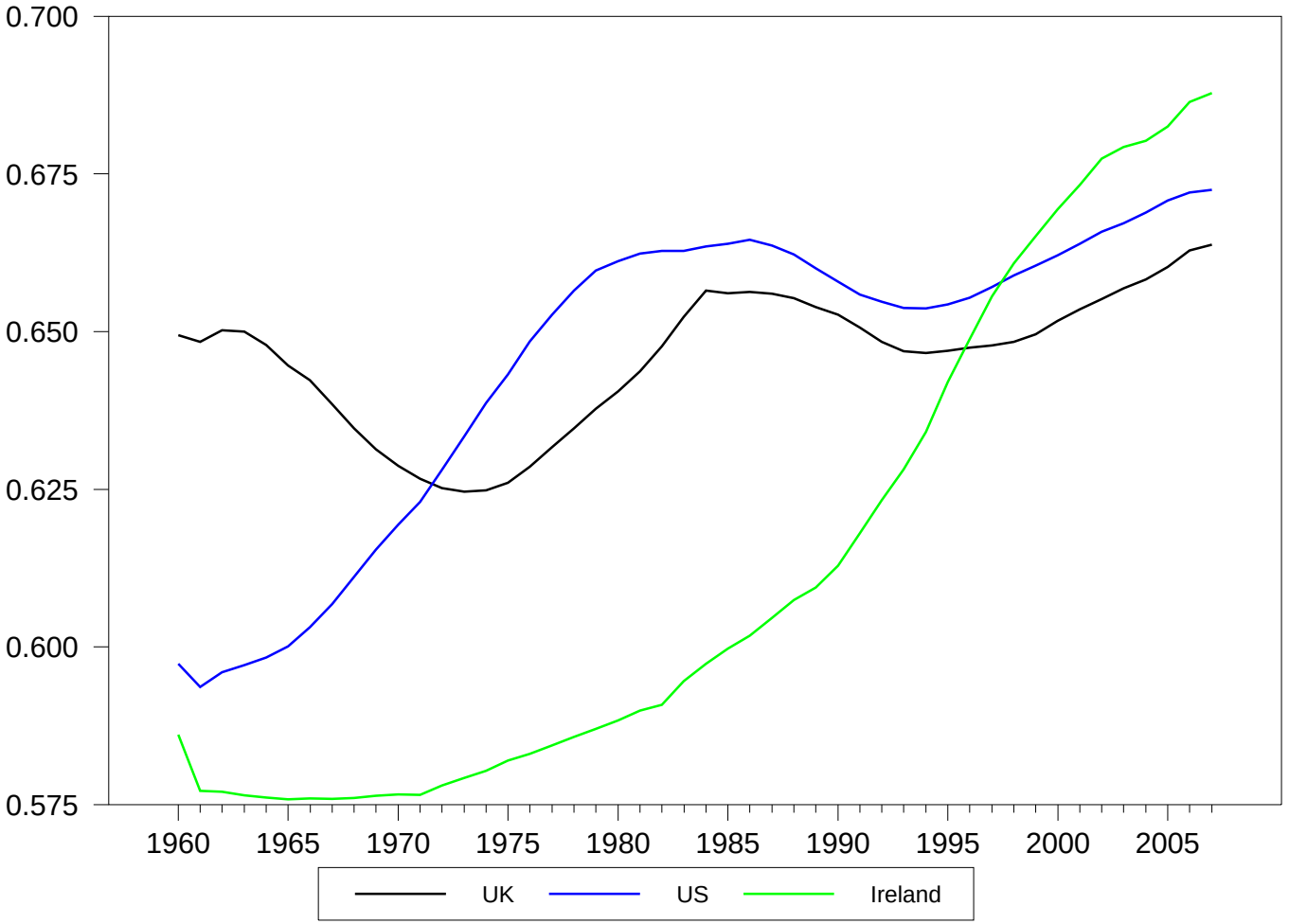

Figure 4: Labour Force Participation Rates

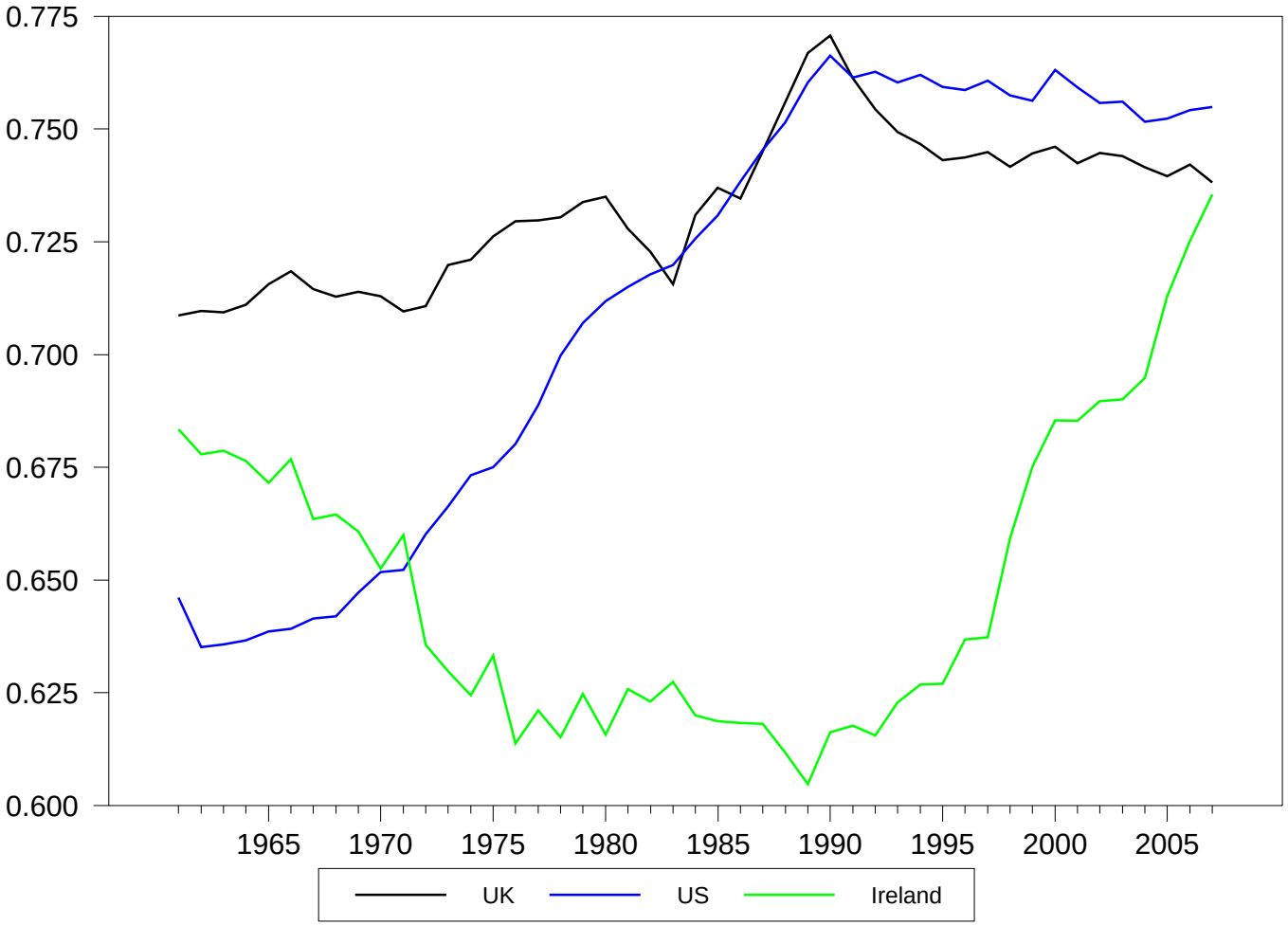

Figure 5: Unemployment Rates

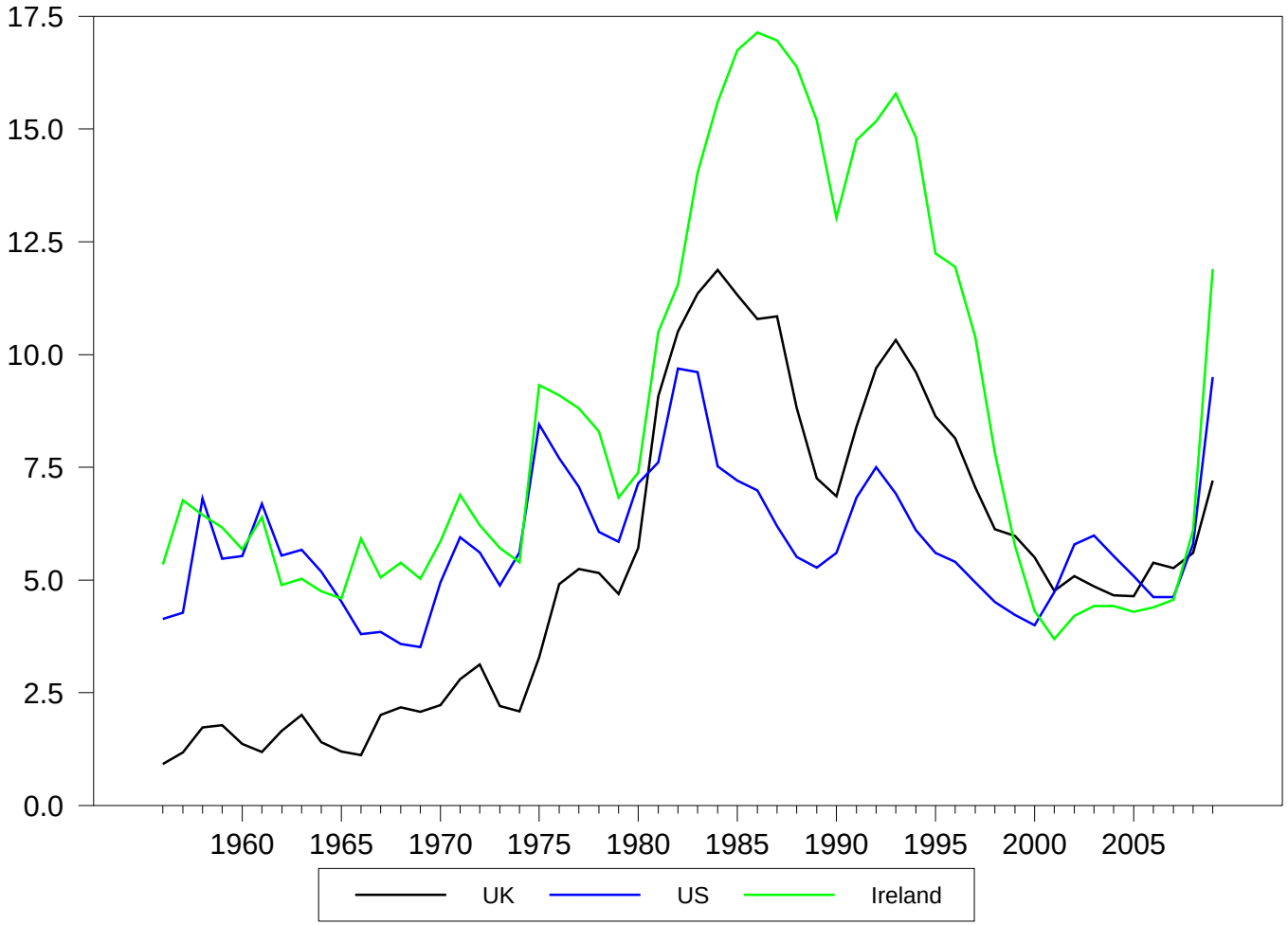

Figure 6: Log of Real PPP-Adjusted GDP Per Capita, 1970-2007

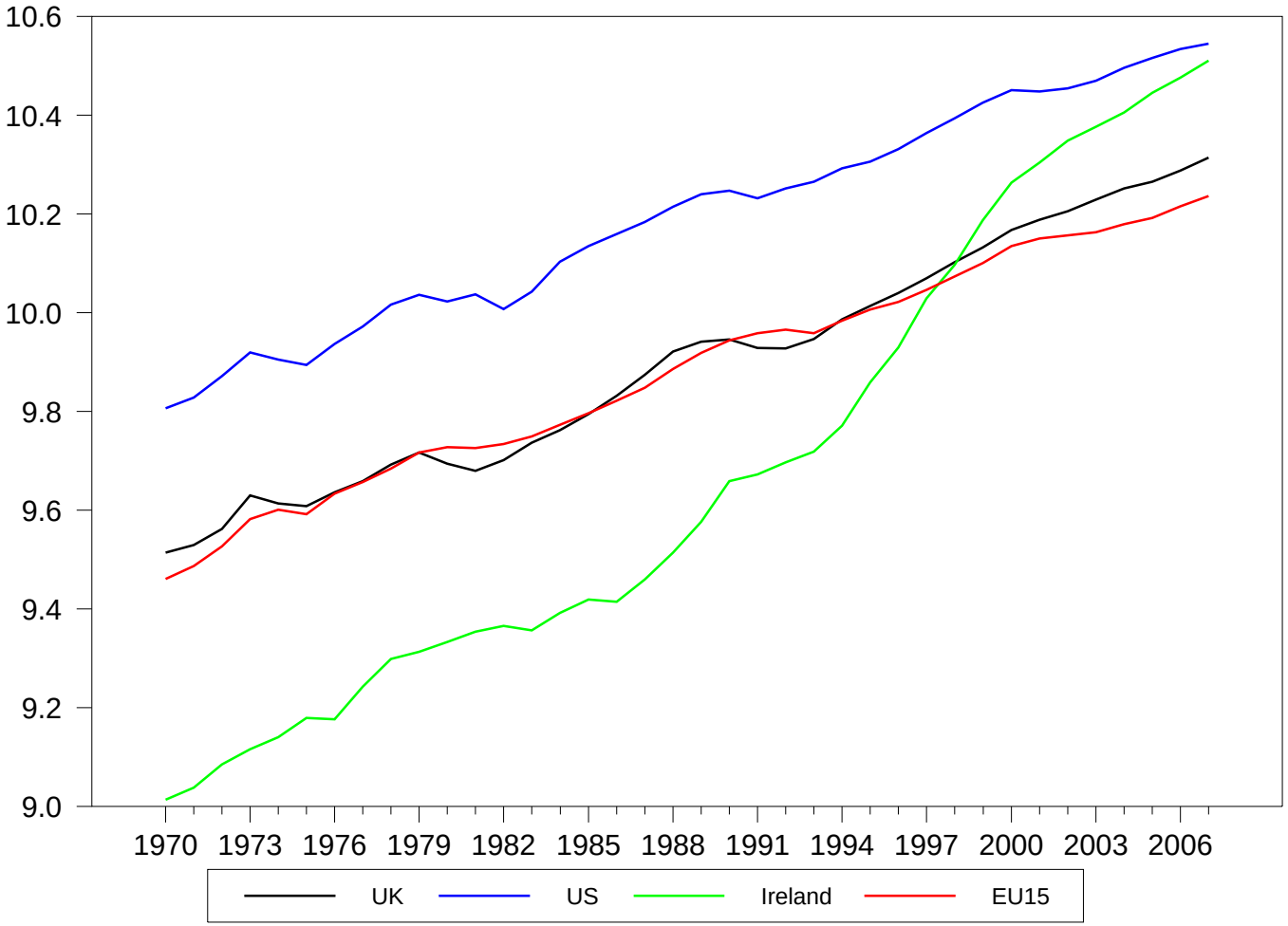

Figure 7: US and Irish House Prices

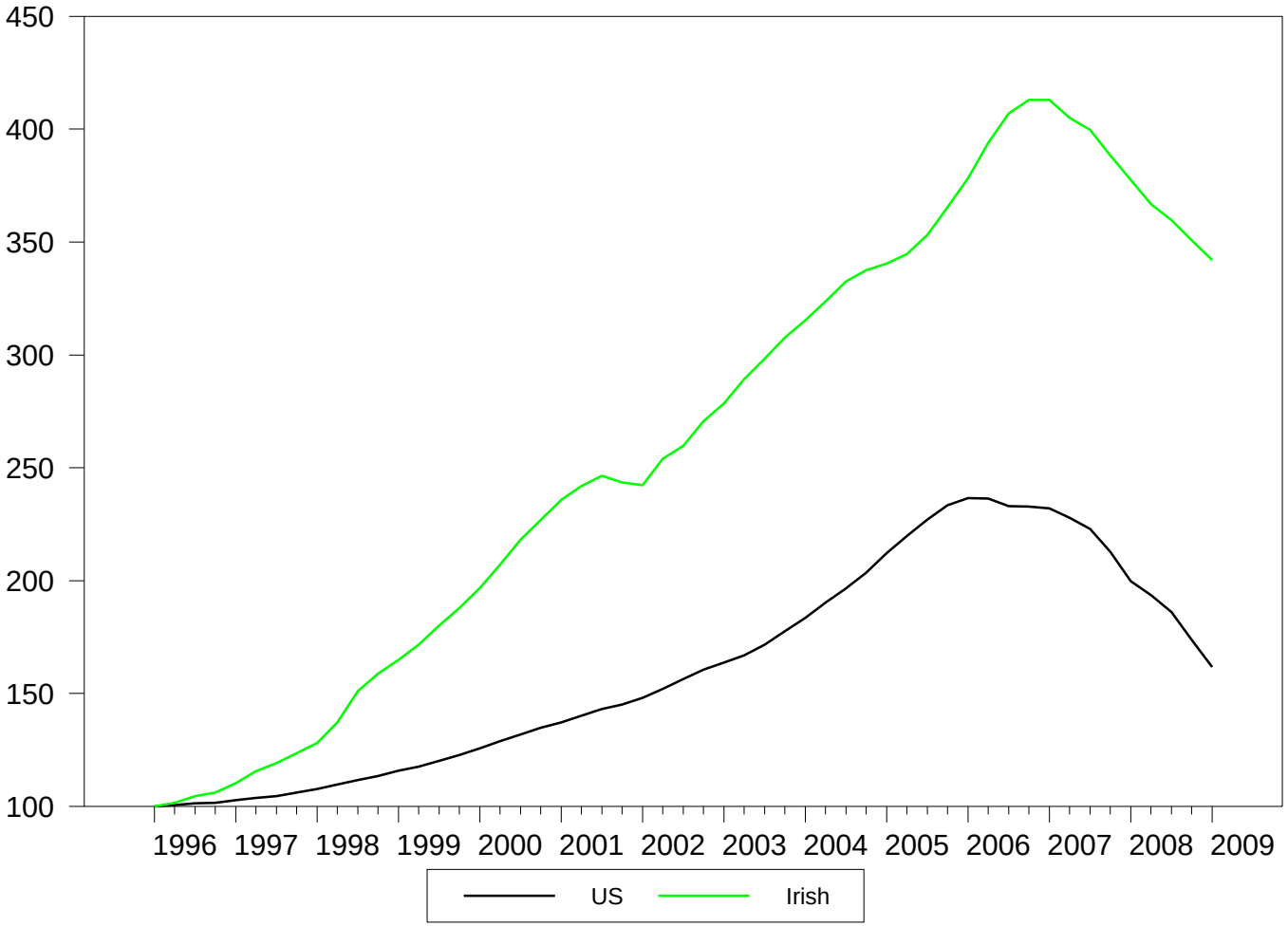

Figure 8: House Prices / Disposable Income Per Person Over 15

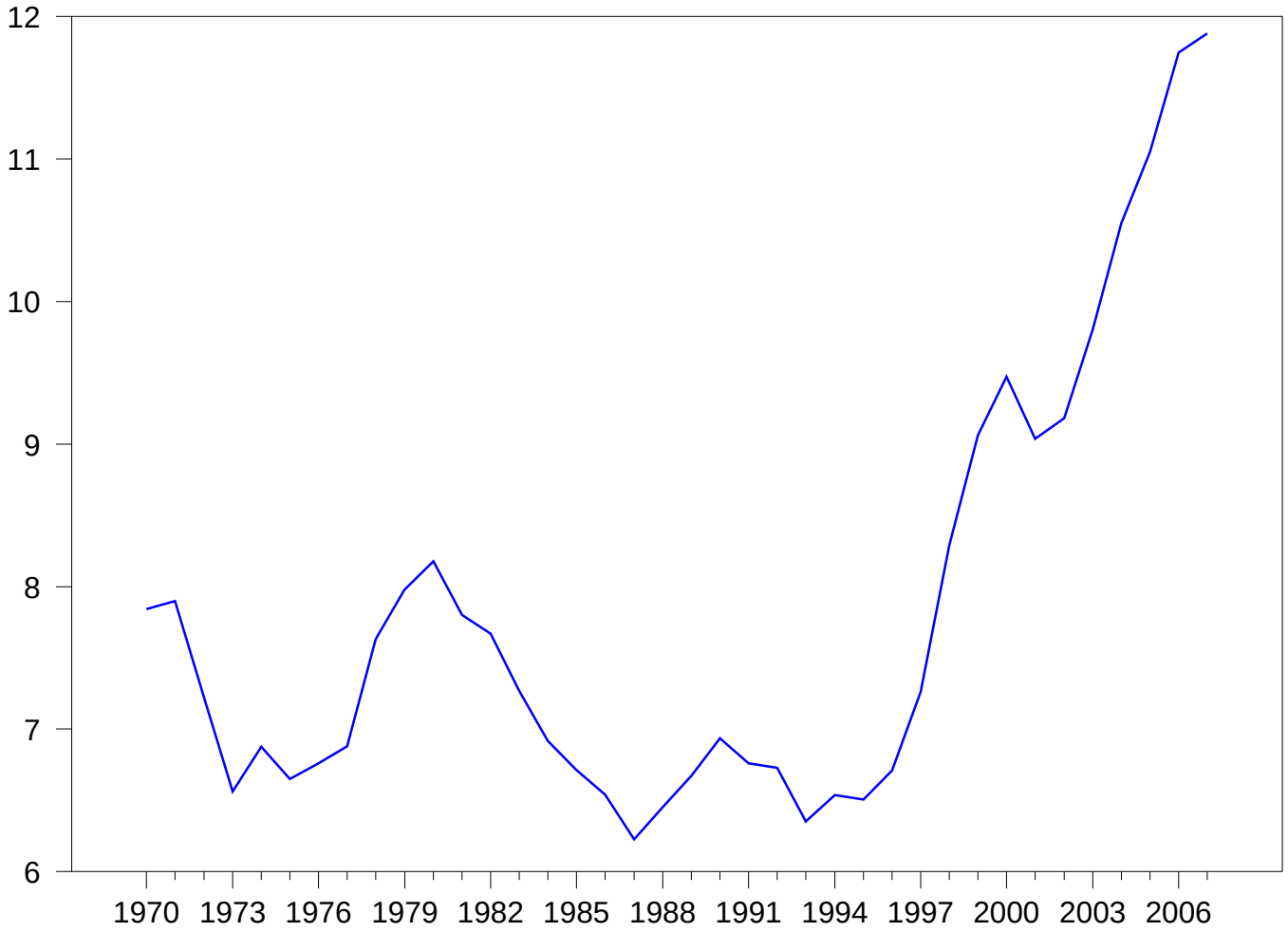

Figure 9: Composition of Tax Revenues

Left Scale is Income Taxes, Right Scale is Stamps and Capital Gains

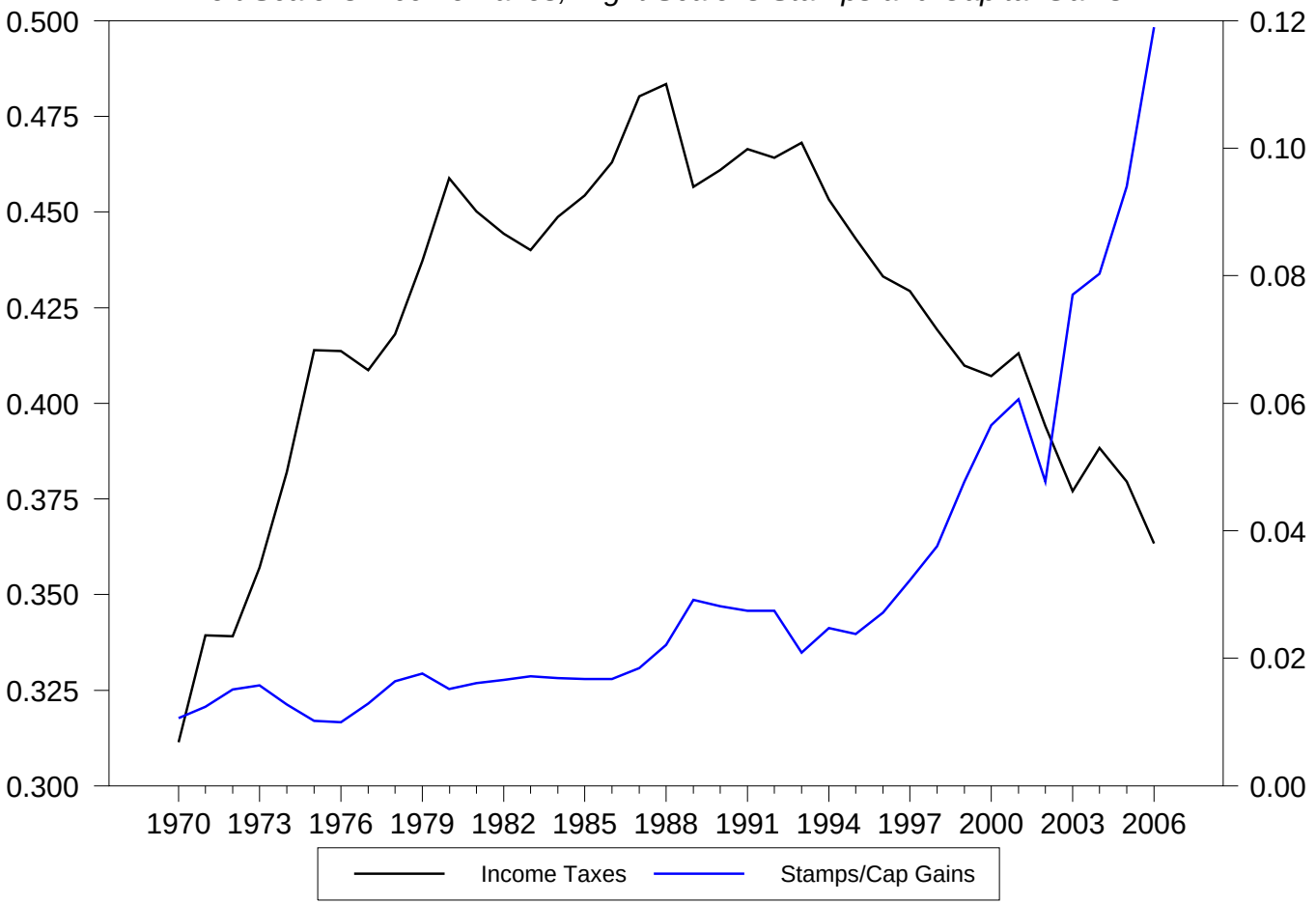

Figure 10: The Emerging Budget Crisis

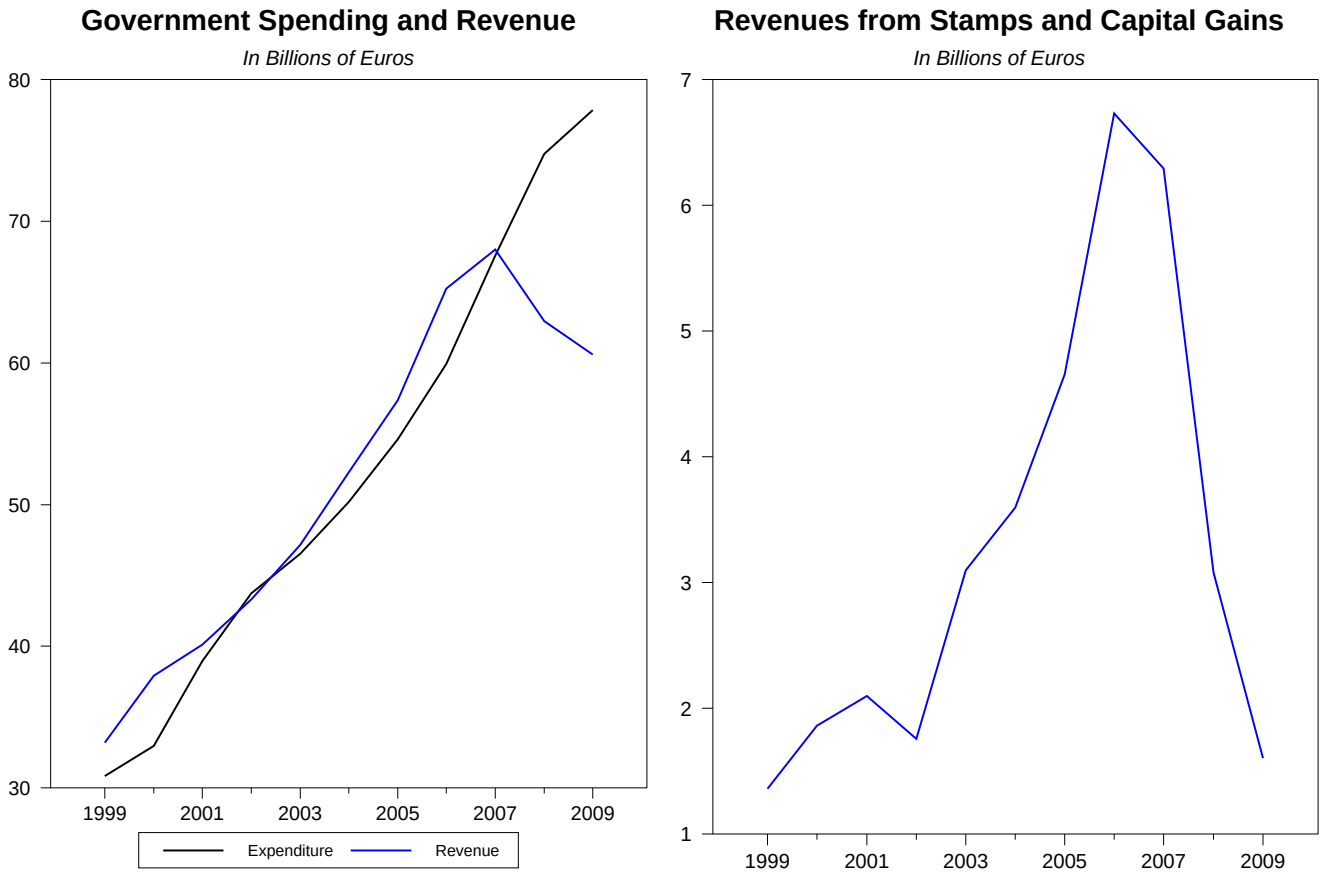

Figure 11: Share of Non-Interest Public Spending in GDP

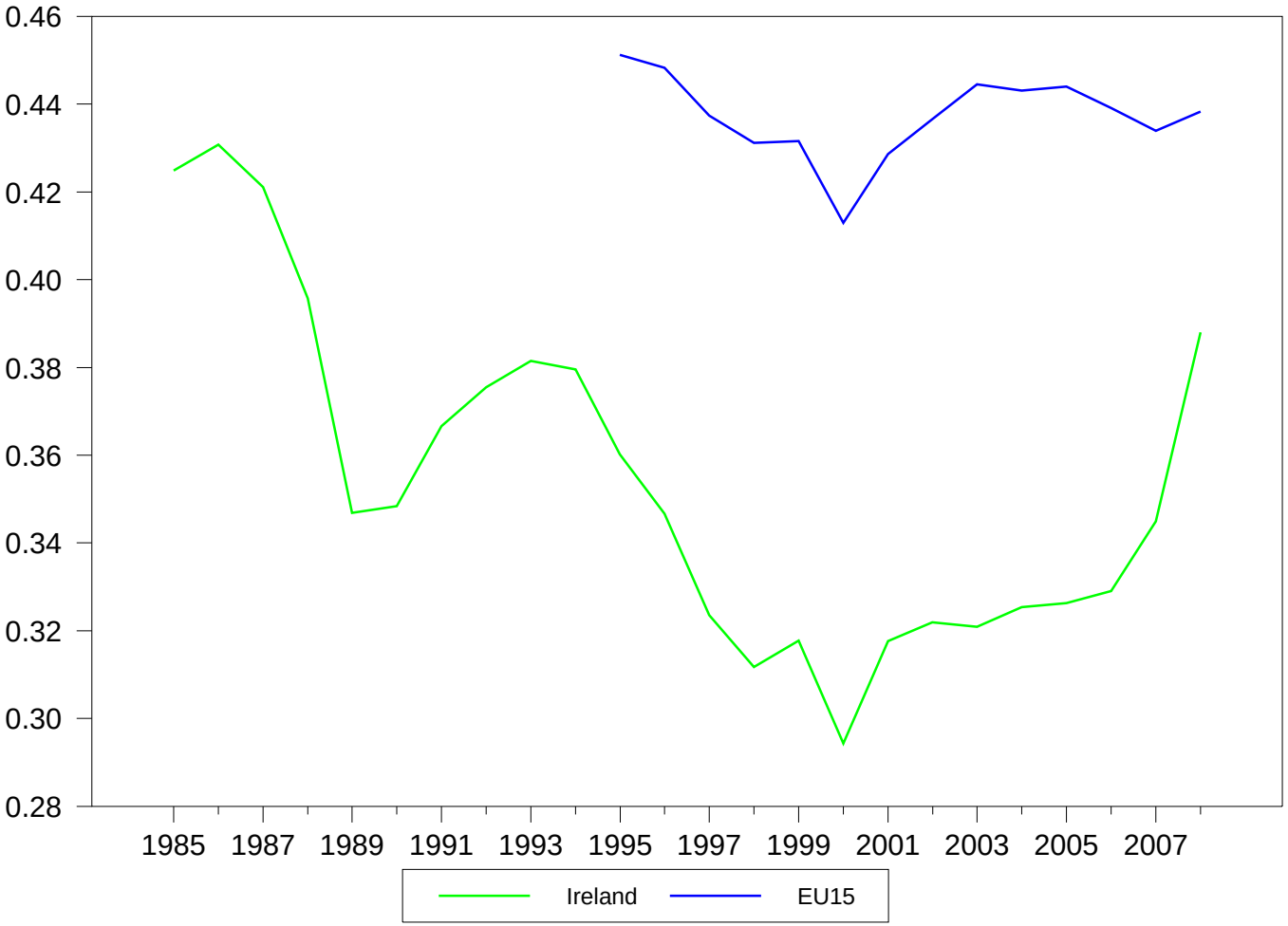

Figure 12: Share of GDP Spent on Public Pay

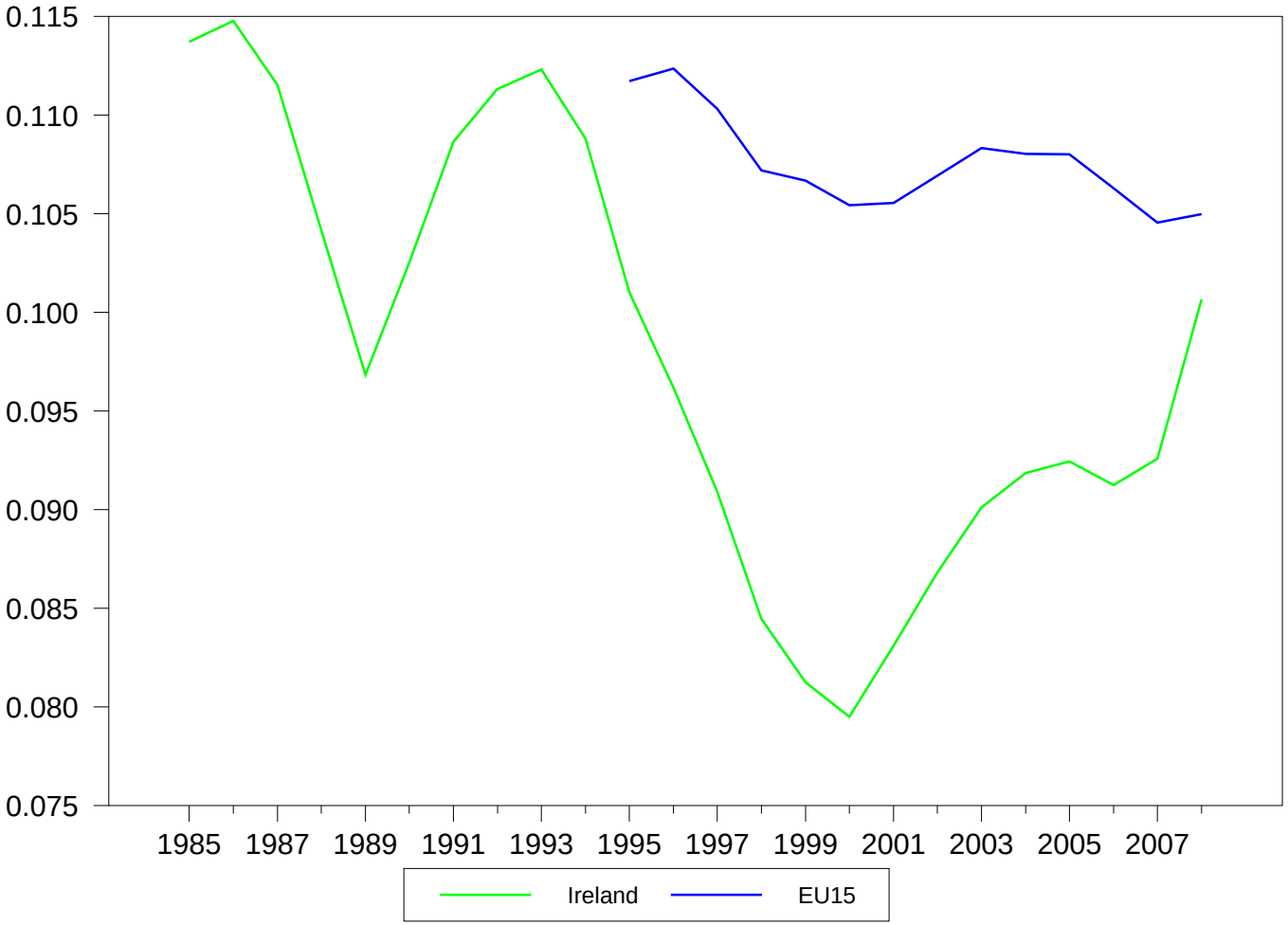

Figure 13: Irish Public Sector Employment in Context

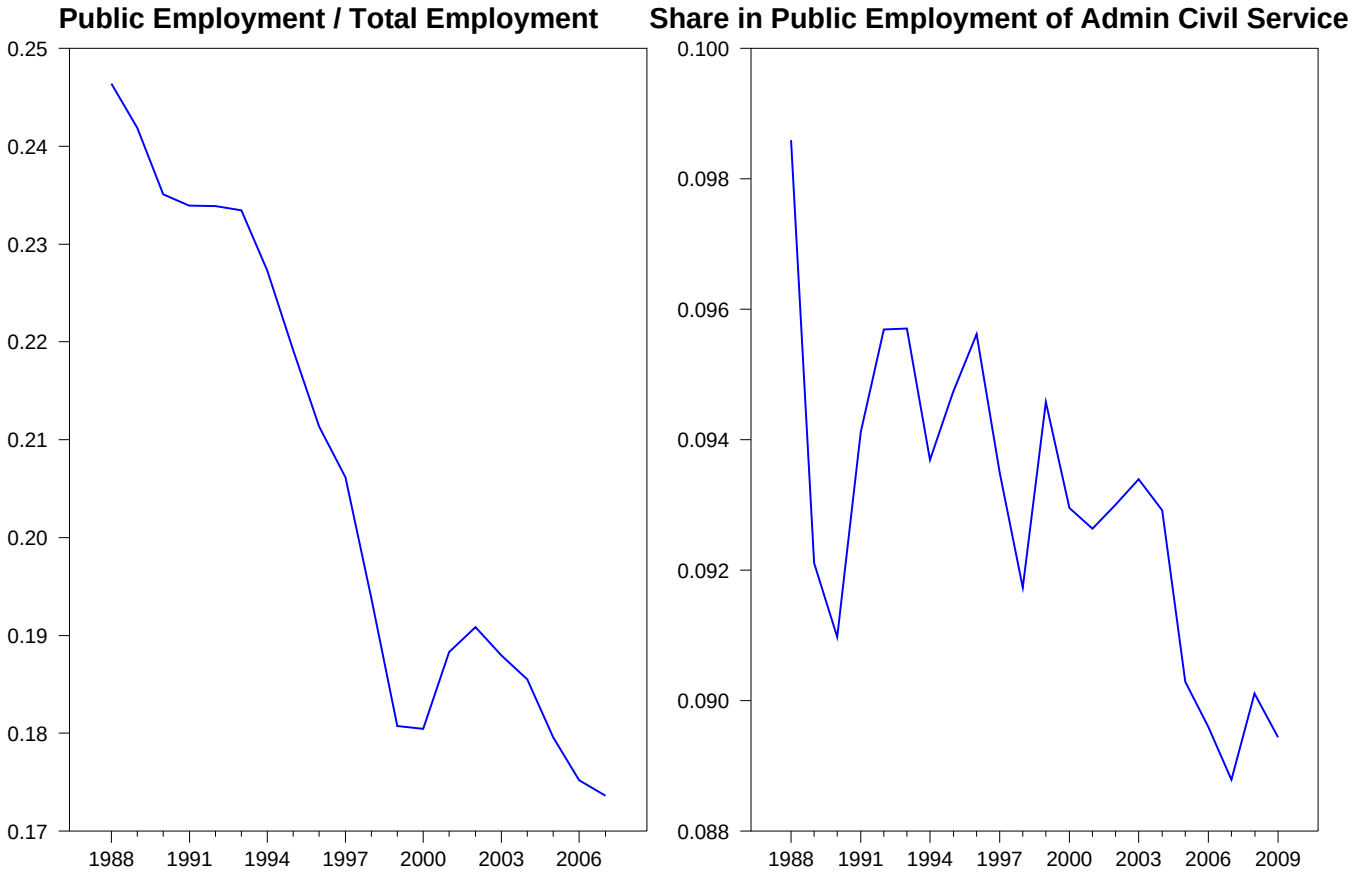

Figure 14: Irish Household Savings Rate

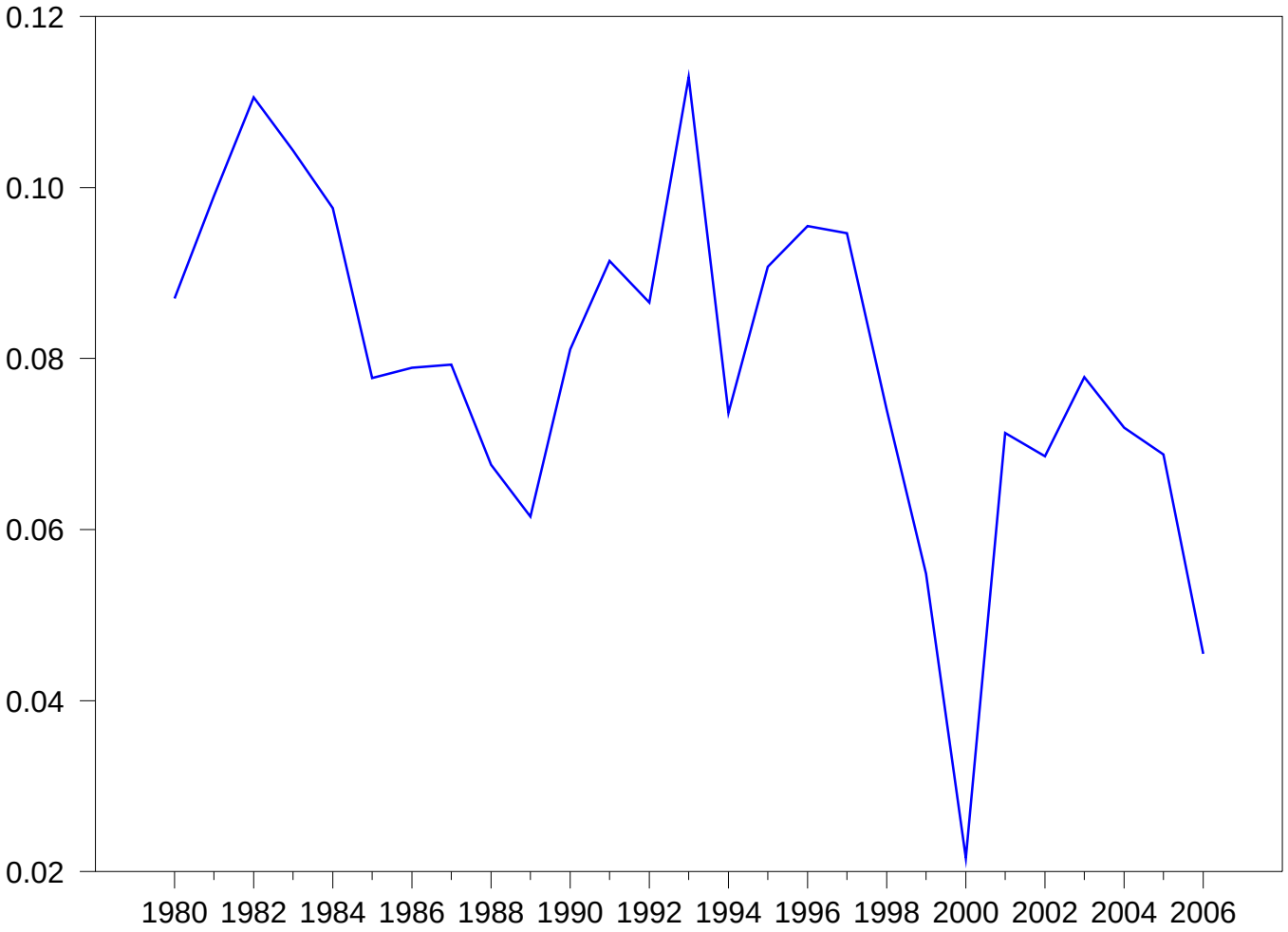

Figure 15: Share of Government Revenue in GDP