Can we get back to being competitive again?

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1. Ireland's economic fortunes have changed dramatically

The changed economic realities which have transpired for the Irish economy, both globally and domestically, have placed the economy in an extremely weak position. The reasons are well known. Economic growth since 2000 was based on a credit induced bubble which was not sustainable. As a result we are left with a legacy of unprecedented private sector debt, which has been financing Government expenditure in recent years; so in some sense the reduction in public sector debt over the last decade has been to a fair degree delusory. The necessary deleveraging of this debt (by private households and businesses as well as banks) is unavoidable, which further complicates the recovery.

The deterioration in economic conditions at home during 2008 plus the severe contraction in the investment side of the economy and weak consumer sentiment levels will give rise to a further sharp contraction in economic activity this year and next. Difficulties in the banking sector mean less scope for consumer and businesses to secure credit to finance spending. The weakening Exchequer position has generated significant budgetary pressures for Government, while further job losses and fiscal retrenchment continue to dampen economic activity.

Following the publication of the report of the Special Group on Public Service Numbers and Expenditure Programmes last week, we can expect further cuts in Government expenditure in the 2010 and subsequent budgets. Thus it seems that most risks are on the downside. As a result forecasts for the Irish economy have been revised substantially downwards with the IMF, the OECD and the European Commission now suggesting that the Irish economy will have contracted, in GDP terms, by a cumulative 14% over the period 2008-2010. As recently as last October the consensus forecast for 2009 was only around +2%[2]. The past really is a different country!

Need a credible medium-term budgetary programme

The very weak position of the Irish economy has been receiving much attention over the past twelve months. In recent months, that attention has been dominated by the banking crisis and the measures to restore a properly functioning banking and credit system, most notably about NAMA. The focus now, following the McCarthy report, is correctly on setting out a credible medium-term budgetary programme that will ensure a sustainable return to economic stability by 2013. At the core of that plan must be measures to not just restore but to improve the long-term competitiveness of the Irish economy and sustain employment.

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[1] Although the author is a member of the National Competitiveness Council, the views expressed in this paper are her own personal views.

[2] The average GNP forecast for the Irish economy in DKM's November 2008 edition of the *Economy Watch* was 2.1% for 2009. This was based on 15 forecasts made over the previous three months. Available at www.dkm.ie

The restoration of competitiveness is the only way a small open economy like Ireland can benefit from the global economic recovery when it occurs. Getting back on track competitively will also help to restore our reputation overseas by boosting Irish exports and encouraging foreign direct investment.

2. Competitiveness has many dimensions

The National Competitiveness Council (NCC) was set up in 1997 to assess the factors that determine competitiveness and identify the actions most urgently needed to maintain and enhance that competitiveness. As a member of the NCC, the Council has always acknowledged that competitiveness is not just about costs and prices, although these are very important issues.

The NCC defines national competitiveness as

"all those factors that impact on the ability of the enterprise base in Ireland to compete in international markets in a way that provides the Irish population with the opportunity to improve their quality of life".

Successive annual reports from the Council have warned about competitiveness difficulties since the beginning of this decade. In its 2003 Competitiveness Challenge report the Council stated:

"Ireland's immediate competitiveness priority must be to slow the growth of prices and costs….there are also, however, more deep seated structural factors behind the cost escalation which if left unchecked pose a more fundamental threat to Irish national competitiveness……these include public sector inefficiencies and the legacy of a generation of government regulations in product and service markets that act to inhibit competition…."

The NCC has developed a *Competitiveness Pyramid* which acknowledges the complex nature of competitiveness (Figure 1):

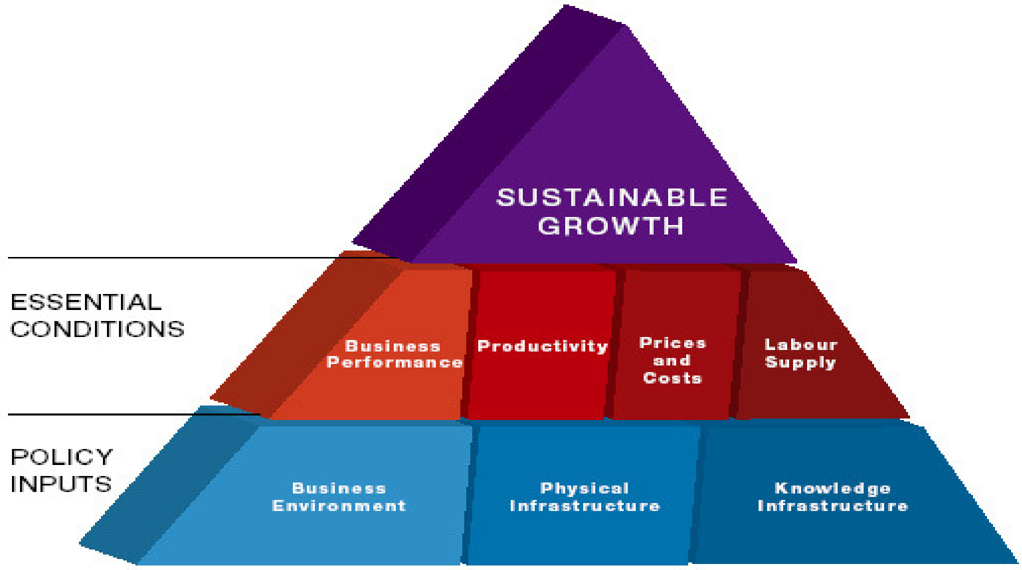
- At the bottom of the pyramid are the *three policy inputs* identified as the main pillars of future competitiveness, namely the business environment (taxation, regulation, finance and social capital), physical infrastructure and knowledge infrastructure.

- Above these are the *essential conditions for achieving competitiveness*, including business performance (such as trade and investment), productivity, prices and costs and labour supply. These comprise the metrics of current competitiveness.

- At the top of the pyramid is *sustainable growth in living standards* and a high quality of life for all citizens of Ireland – the ultimate reason for our policy makers to pursue competitiveness as a national objective.

But critically, at the core of the Council's assessment of the challenge facing us is the necessity to restore the competitiveness of our exporting sectors and our attractiveness for inward investment.

Figure 1: The NCC Competitiveness Pyramid



3. Loss of competitiveness an issue since 2000

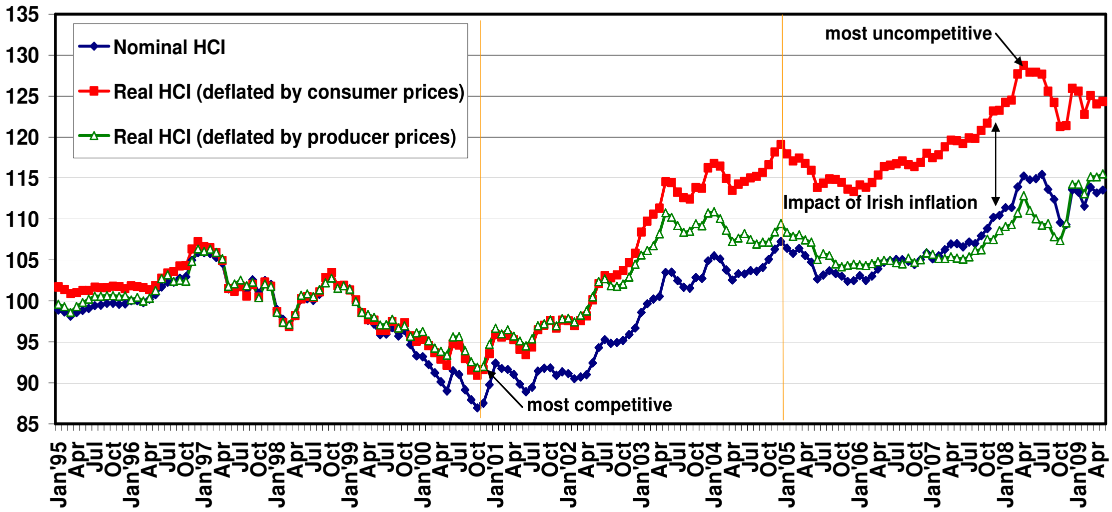
Much of the Irish economy's current problems stem from our loss of competitiveness which has been around for much longer than the economic recession. Both the IMF and the OECD have acknowledged in their respective reports on the Irish economy that Ireland faces a significant competitive disadvantage. The IMF Report (June 2009) calculated that Ireland's competitiveness is about 15% above its long-term average when the real exchange rate, allowing for modest improvements in productivity, is taken into account. Both believe that competitiveness can (and must) be restored by lower wages and stronger competition, particularly in the non-traded sector, which will lead to reduced costs.

A 30.5% loss of competitiveness since January 2000

The generally accepted measures of competitiveness are the Central Bank's Harmonised Competitiveness Indicators[3]. The data show that the overall competitive position of the Irish economy deteriorated by **35%** between January 2000 and April 2008 reflecting a combination of higher consumer price inflation and an appreciation of the euro against our trading partners. Ireland's current price deflation has improved matters somewhat with the loss in competitiveness reduced to **30.5%** between January 2000 and May 2009. However, what is interesting from Figure 2 is that when the measure is deflated by producer prices, it is evident that producer prices moved in line with those of our trading partners since 2005. The real issue concerns the impact of Irish consumer price inflation since 2005 which moved way out of line with our trading partners. This reflects the impact of labour market pressures which led to wage rates and other prices rising very rapidly since that time.

[3] Calculated by the Central Bank of Ireland. The *nominal* measure isolates the effect on competitiveness of exchange rate movements and takes a weighted average of the bilateral exchange rates with 56 trading partners. The consumer price deflated HCI (*real HCI*) takes into account changes in domestic inflation relative to price changes in the 56 trading partners along with exchange rate developments. The index deflated by producer prices covers 36 trading partners due to more limited data.

Figure 2: Measures of the Competitiveness of the Irish Economy: Harmonised Competitiveness Indicator for Ireland 1995 to May 2009 (1999 Q1 = 100)



Source: Central Bank of Ireland

Looking at wage costs, for example construction earnings per hour increased by 6.1% per annum on average between 2000 and 2008[4]. Average unit labour costs across the economy increased by an average of 5% per annum between 2000 and 2008 compared with 3% in the EU 15 area[5]. The Irish Harmonised Consumer Price Index increased by 3.2% on average per annum over the same period compared with 2.3% in the Euro area[5]. It is clear that reversing our disadvantaged position requires a substantial reduction in nominal wage rates and other prices in Ireland relative to its trading partners.

Some progress on wages and prices has been achieved

However, it is important to acknowledge that some progress has been made in respect of some indicators as a result of the recession:

- The growth in labour costs in 2008 in Ireland (+3%) was below the average of the Euro area (3.3%[6]).

- We know from a number of surveys undertaken by business organisations (IBEC, ISME, Small Firms Association) and professional organisations (RIAI, IPI) that the deterioration in the labour market has generated reductions in private sector pay since the end of 2008. While difficult to be precise as there is no official up to date data on earnings in the private sector, this downward adjustment could be close to 7%[7]. With unit labour costs in the Euro area expected to rise this year by around

[4] Source: Central Statistics Office.
[5] Source: Eurostat.
[6] Source: European Commission, Spring 2009.
[7] Irish Times 18th July 2009 'Ireland moving to a level playing field in labour costs', Garret FitzGerald.

3.4%[8], we could see an improvement in our relative labour cost competitiveness of around 10% by the end of this year.

- Consumer price inflation has declined by 5.4% in the year to June 2009 with some components, notably Clothing and Footwear (-12.2%), Energy Products (-11.3%), Transport (-6.1%) and of course Housing Costs, due to reductions in Mortgage Interest (-46.2%), down by more than the average. The corresponding reduction in the Harmonised CPI measure was 1.7% in Ireland in the year to May 2009 compared with 0% in the Euro area.

- Property prices (residential and non-residential) have fallen sharply since the end of 2006 as have rents and the costs of construction.

However there are still many areas where substantial imbalances need to be addressed. Other factors also contributed to our loss of competitiveness, notably the increase in non-pay costs in Ireland (notably property, utilities, waste and certain business and professional services) and the lack of competition in key areas of the economy (see Section 4.6). Our failure to address the loss of competitiveness over the past decade is the main reason why our unemployment rate is currently 10.2%, up by 125,000 persons in just two years, and heading towards 15% by the end of 2010. The cost to the Government of every 100,000 persons out of work is €3.6bn in terms of tax foregone and social welfare costs.

4. The priorities for making Ireland competitive again

The most recent report from the NCC[9] identified a number of policy priorities, some of which appear in my list of priorities below.

4.1 Restore stability to the public finances

This task will take a number of painful years. While this process has already commenced it is essential that Government continues to take the necessary decisive action on cutting expenditure as identified in the report from the Special Group on Public Service Numbers and Expenditure Programmes, starting with the 2010 Budget. With revenues projected to account for almost 35.6% of GNP and Government current expenditure expected to represent 43.4% of GNP in the April Budget for 2009[10], this situation is not sustainable.

4.2 Broaden the tax base

In view of the severe decline in tax revenue in 2008/2009, there is a need to broaden the tax base which has been progressively narrowed over recent decades. Any review of the tax base needs to ensure first and foremost that the current system is optimal, fair and equitable. Having done so, if you start from the premise that a successful economy requires high quality public services, then faced with fewer /scarce resources, there is a need for some combination of increased taxes, wage cuts or productivity increases to finance those public services. The report for the Commission on Taxation is expected to recommend a

[8] Source: European Commission, Spring 2009.

[9] Getting Fit Again: The Short Term Priorities to Restore Competitiveness, National Competitiveness Council, Forfás, June 2009.

[10] Figure taken from the Report of the Special Group on Public Service Numbers and Expenditure Programmes, July 2009 (Volume 1, Page 1).

restructuring of the tax system although some tax increases are also expected to be recommended. The NCC has consistently recommended the introduction of a property tax based on capital values. The latter would also serve to address the serious gap in the revenue base of local authorities which has arisen due to the recent dearth of development contributions as a result of the lack of new construction activity around the country. However the introduction of a property tax system needs to be well thought out and planned before it is introduced and must be fair and equitable.

Further methods of raising revenue should also be considered based on charges for all users of services (e.g. water, third level education). In this regard proposals for third level fees are being considered while the Commission on Taxation is reported to be considering a carbon tax.

In regard to income tax, the NCC would strongly support the retention of a competitive tax wedge on labour - the difference between the take home pay of employees and the costs to the employer - which is essential to encourage employment growth across all income categories and to attract and retain highly skilled mobile workers. This implies that income taxes should not increase further.

4.3: Current expenditure adjustment must start with the largest components

In respect of current expenditure the largest elements of the current expenditure programme are the public service pay and pensions bill, at almost 39% of the total projected revenues this year and Social Welfare (€21bn), at almost 41% and rising. If real progress is to be achieved on cutting expenditure and restoring stability to the public finances, both of these areas have to figure prominently in the measures put forward. Moreover there is a need to recognise that the competitiveness of the economy is a function of both the public and private sectors. Thus there is a need now to carry out an up to date benchmarking exercise comparing wages in the public and private sectors and with public sector wages in our competitors. The recent National Employment Survey[11] reported that hourly earnings in the public sector were 48% higher on average than in the private sector. This gap may have widened further since the survey was undertaken (October 2007) notwithstanding the introduction of the public pensions levy this year, given reductions in private sector pay in the meantime. This suggests there is a justification for pay cuts in the public sector.

4.4: Capital expenditure – need to focus on productive investment

I would agree with the NCC view that there needs to be a serious review of the investment priorities identified in the 2007-2013 NDP. That review should be based on proceeding only with capital projects which:

1) earn an economic rate of return above their costs,
2) add to the productive potential of the economy,
3) are employment intensive, and
4) minimise the external leakage of funds.

Investment in productive infrastructure is a key element of building a competitive economy and supports the indigenous sector while also helping to attract inward investment.

[11] National Employment Survey, 2008 CSO. Annual earnings were reported to be 32% higher in the public sector.

In this regard we worked with the Construction Industry Council (CIC)[12] earlier this year in coming up with a proposal to Government[13] which involved a plan to save 70,000 jobs with minimal state borrowing, which would deliver necessary infrastructure for the public benefit and maintain a highly skilled productive workforce. The CIC submission estimated that every €1bn saved in the PCP costs the Government €510m in terms of the tax revenue foregone and the increased cost of social welfare while no infrastructure is provided for this level of expenditure. It is worth pointing out that the Exchequer capital provision this year is less at €388m for Hospitals and €423m for Primary Schools.

By investing in infrastructure, say €5bn, would create 70,000 (direct and indirect) jobs[14] resulting in an increase in tax revenue of €1.3bn and a saving in social welfare of €1.3bn. Thus the avoided cost for the Exchequer would be €2.6bn plus the infrastructure is put in place, jobs are protected and the competitiveness of the economy is improved. In addition, the positive effects persist in the economy long after the money is spent.

Using Pension Funds to fund infrastructure

The source of the remaining funds - the €2.4bn[15] - is a combination of private pension funds and other "off balance sheet" structures. With up to 90% of pension funds invested outside Ireland, these funds could provide much needed infrastructure and a new asset class for pension funds. I understand that Irish Pensions Funds are very much behind this proposal and that it is being considered by Government.

The key aspect of such a proposal is that with this €5bn stimulus proposal jobs are protected, much needed infrastructure is provided and there would be further ***induced*** employment impacts which would include all of the jobs created by those directly and indirectly employed in providing such infrastructure spending their wages and profits throughout the wider economy. We estimate that every additional €100m spent on construction generates €67m in wages and profits and a further €37m of induced expenditure impacts[16]. Such an initiative would appear to make more sense than a 'job subsidy scheme' that is problematic as to how it is to be applied and could be open to distortion.

Just to digress for a moment. I note that Government has rejected the stimulus option because of the leakage effects, suggesting that the benefits would leak out to other countries with no real benefit to the Irish economy[17]. Government seems to have decided that cutting expenditure rather than having an economic stimulus is the way to go. However the further cutbacks expected on foot of the McCarthy report will deflate the economy again in 2010 and beyond. Many countries (notably UK, Spain and Portugal) have introduced

[12] The Construction Industry Council was established in February 1991 with the objective of dealing with issues of common interest across the construction industry for its member organisations.

[13] Jobs and Infrastructure – A Plan for National Recovery, Submission to Government from Construction Industry Council, March 2009. Available on www.scs.ie and www.dkm.ie

[14] The estimate of 70,000 jobs is based on research which suggest that every €1m generates 10 construction jobs plus a further 40% in indirect jobs. This €5bn would generate 50,000 direct jobs plus 20,000 indirect jobs, implying a total of 70,000.

[15] The total stimulus of €5bn less €2.6bn = €1.3bn in taxes raised less the saving on social welfare €1.3bn.

[16] Based on CSO Input-Ouptut Tables.

[17] Irish Independent 21st July 2009 and Irish Times, 'Adviser warns of fixation with GDP limit', Dr. Alan Ahearne, 25th March 2009.

stimulus packages and these are contributing to their economic recoveries expected as early as 2010. A stimulus package along the lines suggested above would generate additional economic activity and retain jobs with limited short term implications for the Exchequer finances.

4.5: Ensuring the banks channel credit to viable businesses

In regard to the banking crisis a number of recent surveys suggest that the flow of credit to business continues to be restricted notwithstanding the range of measures to support the financial sector over the past ten months:

- ✓ The Small Firms Association - one in four SMEs are not getting enough credit with the refusal rate highest (30%) for firms with less than 10 employees[18].

- ✓ IBEC - businesses are suffering badly from the financial crisis and the sharp devaluation of sterling. 31% of respondents in a survey of 278 companies indicated that the availability of working capital in their company had decreased while 38% reported that the cost of finance had increased[19].

- ✓ The Construction Industry Council - inability to secure finance the main reason for the delay/postponement of projects.

The core issue here is to restore a properly functioning credit market so that businesses can get access to finance at a reasonable cost.

4.6: Restoring cost competitiveness

In order to restore the competitiveness of our exporting sectors policies need to focus on getting Irish costs and other charges down to or below the levels of our trading partners if Irish firms are to improve their relative position in regard to cost competitiveness.

The NCC has done much work in the area of costs over recent years and is currently working on its fourth assessment of the costs of doing business in Ireland[20]. Four key inputs are examined - labour, land/property, utilities and business services (e.g. accounting and legal services) – across a sample of firms covering eight sectors of the economy. Across these eight sectors labour costs account for 59% of total costs.

The ongoing analysis by the NCC highlights a number of areas where our cost competitiveness is improving, notably on the moderation in the growth in labour costs relative to the average in the euro area, which has already been referred to, and a decline in the cost of office rents by 25% in 2008. However, in other areas the costs faced by Irish firms are reported to be persistently high.

- ➢ In terms of pay levels, Ireland had the *third highest minimum wage* across 10 countries benchmarked. When compared across eight separate occupations, wage levels in Irish firms were found to rank around the 5th or 6th most expensive out of 16 countries benchmarked.

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[18] Report of the Independent Review of Credit Availabiity - Review of Lending to SMEs, Mazars, June 2009.
[19] IBEC, Survey of Credit Conditions, November 2008.
[20] NCC Statement on the Costs of Doing Business 2009 (work in progress, unpublished).

- In regard to *property costs*, although prime office rents in Dublin had declined by 25% between December 2007 and December 2008, Ireland remained the 8th most expensive of 16 locations benchmarked (down from 5th in the NCC 2007 cost survey). This reduction in rents is an interesting finding given the recent debate about upward only rent reviews. Further reductions are likely given high vacancy rates.

- The area of most concern is other *non-pay costs* such as Irish *electricity* costs - the second highest in the EU-25 - and *waste disposal* costs which are among the highest of the benchmarked locations.

  A number of reforms are required if these costs are to be brought into line with our competitors. These include reviewing the regulatory process for sanctioning investment and the determination of electricity and gas tariffs so as to ensure that customers are not overly burdened with excessive price increases.

  In regard to waste management there needs to be a revamping of regulation of the sector, which is fragmented, contradictory and imposes an economically sub-optimal structure on the sector. At a minimum greater consideration needs to be given to the economic and competition implications of planning and environmental decisions. A case can be made for specific economic regulation of the sector although I am loathe to recommend a further expansion of the public sector but I believe that regulation of the sector should be incorporated into one of the many existing regulation agencies, which incidentally should all be rationalised generating significant savings for the Exchequer .

- On business costs, Dublin is the **most expensive location** of 9 cities benchmarked for *legal fees* and the third highest of 9 locations benchmarked for *health insurance* costs.

It is essential that competition in non-traded services sectors of the economy is encouraged, as this will be the best way of bringing down costs to business and consumers. In this regard the recommendations of the Competition Authority in regard to a number of sectors, such as professional and legal services, should be used to increase competition and support the adjustment needed on prices and wages.

5. Need an immediate coordinated plan of action

While many solid recommendations have been made over the past decade by the NCC and indeed by other agencies, there is an urgent need now to bring about a greater coherence and coordination of actions to support national competitiveness and the transition to the next phase of Ireland's economic development. We have many policy priorities covering the ambit of financial, fiscal and competitiveness issues. There is a real urgency now to tackle each one of them. That requires all parties to be on board, namely trade unions, employers and politicians. If we delay in tackling the underlying problems responsible, we could see an even more protracted economic downturn.