



An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta  
National Economic & Social Council

# Promoting Economic Recovery and Employment in Ireland

No. 125 January 2012

## National Economic and Social Council

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## Abbreviations

<b>AVC</b> Additional Voluntary Contributions	<b>EGFSN</b> Expert Group on Future Skills Needs	<b>IDA</b> Industrial Development Authority
<b>CE</b> Community Employment programme	<b>EI</b> Enterprise Ireland	<b>IMF</b> International Monetary Fund
<b>CIP</b> Competitiveness and Innovation Framework Programme	<b>EIB</b> European Investment Bank	<b>IQA</b> Increase for Qualified Adults
<b>CRO</b> Credit Review Office	<b>EIF</b> European Investment Fund	<b>IQCs</b> Increases for Qualified Children
<b>CSO</b> Central Statistics Office	<b>EMU</b> Economic and Monetary Union	<b>ISE</b> Irish Stock Exchange
<b>C&amp;V</b> Community and Voluntary Sector	<b>ESB</b> Electricity Supply Board	<b>JA</b> Jobseekers Allowance
<b>DES</b> Department of Education and Skills	<b>EU</b> European Union	<b>JASMINE</b> Joint Action to Support Microfinance Institutions
<b>GDP</b> Gross Domestic Product	<b>FÁS</b> Foras Áiseanna Saothair	<b>JB</b> Jobseekers Benefit
<b>GIF</b> High Growth and Innovative SME Facility	<b>FET</b> Further Education and Training	<b>LDR</b> Loan-to-Deposit Ratios
<b>GP</b> General Practitioner	<b>IBEC</b> Irish Business and Employers Confederation	<b>LMAF</b> Labour Market Activation Fund
<b>ECB</b> European Central Bank	<b>ICC</b> Industrial Credit Company	<b>LR</b> Live Register
<b>ECCE</b> Early Childhood Care and Education	<b>ICT</b> Information and Communications Technology	<b>NEAP</b> National Employment Action Plan
		<b>NEES</b> National Employment and Entitlements Service



**NIEC**  
National Industrial  
and Economic Council

**NPRF**  
National Pensions  
Reserve Fund

**NSS**  
National Skills Strategy

**OECD**  
Organisation for  
Economic Co-  
operation and  
Development

**PLCs**  
Public Limited  
Companies

**R&D**  
Research and  
Development

**RSFF**  
Risk Sharing Finance  
Facility

**SBA**  
Small Business Act

**SGP**  
Stability and Growth  
Pact

**SMEs**  
Small and Medium-  
Sized Enterprises

**SMEG**  
SME Guarantee  
Facility

**SOLAS**  
Seirbhísí Oideachais  
Leanunaigh agus  
Scileanna

**UK**  
United Kingdom

**US**  
United States

**VEC**  
Vocational Education  
Committees

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Ireland's implementation of a multi-annual fiscal consolidation and associated policies will not, on their own or as currently designed, be sufficient to promote an acceptable recovery of the economy and employment. For this reason, this report explores whether there are additional policy measures that Ireland could take to encourage domestic demand, enhance the flow of credit to business, increase employment, reduce unemployment and strengthen business development.

The report is written against the backdrop of an international economic recovery that continues to falter, and a deepening crisis in the euro area. The report begins, in Chapter 2, by briefly discussing the international crisis and the risks of co-ordinated austerity. It summarises the Council's earlier work on European economic and monetary union and the challenges that must be addressed at EU level. It notes that, at present, there is a spectrum of views on the crisis facing the euro and the risks to the international economy.

However, the dominant focus of the report is to consider policy possibilities in five areas: domestic demand, credit, employment and activation, tax and enterprise policy.

Chapter 3 describes the weakness of domestic demand and searches for measures that could be effective in increasing it. It concentrates on household balance sheets, savings and repayment behaviour and argues that there are resources that could potentially be used to increase domestic demand. It suggests that, contrary to the view that there is little or no scope to alter domestic demand, there are policy initiatives that could have an impact. These include extending current incentives for energy-efficient home improvements; consultation with pension funds as a potential source of investment; research on saving behaviour particularly among those under thirty five and over fifty; and, examining housing trends in particular a move towards higher levels of renting.

Chapter 4 explores the fear that a shortage of credit is limiting the ability of enterprises, especially small and medium-sized enterprises (SMEs), to undertake business projects. It suggests that there is evidence that the supply of credit is a problem but highlights that this provides little guidance as to possible actions. To assess the scope and nature of further policy action, the report argues that there needs to be a focus on work initiated in the past year, involving Enterprise Ireland, the Banks, the CRO and other actors. It is only such actions that can get to the bottom of the credit and finance constraint. An examination of these would also inform policy on the development of appropriate financial services and the creation of a state investment bank as recommended by the Programme for Government. NESCF views the proposal to establish a state investment bank as a key step to support business.

Chapter 5 provides an overview of labour-market policies and identifies which policies are most important in preventing the current high unemployment rate becoming structural unemployment and in ensuring that future jobseekers have the opportunities they deserve. It argues that intensive engagement with those unemployed and the quality of services and supports provided to them is key to reducing unemployment. The report reviews the major institutional, legislative and programme changes, specifically NEES and SOLAS, which are underway in how employment and further education and training supports are provided; and, in how social-welfare is administered to people of working age. In this context, it highlights the importance of public sector reform and transformation based on a stronger commitment to ongoing measurement, continuous monitoring and review in ensuring the delivery of high quality cost-effective services.

Chapter 6 considers ways in which taxation policy can best promote sustainable development and employment. It reviews the principles that should guide tax policy and tax reform in Ireland. It notes that starting with a narrow tax base, a policy of broadening the tax base while maintaining already low rates, would seem to be supportive of growth and employment. It notes the progress made by government but also the need to further alter the tax mix and broaden the base.

Chapter 7 addresses how enterprise policy and enterprise supports can respond to the changing circumstances and pressures facing enterprises and entrepreneurs. It argues that there is evidence that the enterprise agencies and parts of the wider public system—including local authorities, licensing authorities and others—are engaging in new ways with business. However, companies at times encounter a public sector that is not responsive enough. It suggests a number of actions that could be of assistance in the near term, in particular in relation to access to credit and investment; (as discussed in Chapter 4), greater use of pre-competitive public procurement; examination of business rates, and, using publically held data more creatively. In addition, it notes that the crisis places the spotlight on home-grown business and natural resources and suggests that the strategies of bodies with responsibility for Ireland's natural resources should be given heightened urgency at the present time.

The final chapter summarises the evidence and arguments. It groups possible policy actions into three categories—those which can be acted on immediately, those which require further consultation, and those that depend on greater public sector reform—in order to suggest how further policy analysis and development might proceed. The report concludes by locating this work within a perspective on Ireland's five-part crisis and the characteristics of an effective Irish response.



# Chapter 1

## Introduction



In late 2011, the Council focused on policy possibilities to strengthen economic recovery and address the major challenges of unemployment, social inclusion and sustainable development. The idea of searching for additional policy possibilities is motivated by profound anxieties about Ireland's future prosperity and the availability of employment and public revenue to meet individual and social needs.

There is no doubt that some of these anxieties concern the prevailing framework of policy at national and EU level. Consequently, Chapter 2 briefly discusses the international crisis and the risks of co-ordinated austerity. It summarises the Council's earlier work on European economic and monetary union and the challenges that must be addressed at EU level. We note that, at present, there is a spectrum of views on the crisis facing the euro and the risks to the international economy. These include a minimalist view, centred on simultaneous fiscal consolidation, and a view that more comprehensive redesign of the euro is necessary. They also include a fear that the massive expansion of debt worldwide in the past decade may give rise to extended global instability.

The remainder of the report reflects the belief that Ireland's implementation of a multi-annual fiscal consolidation and associated policies will not, on their own or as currently designed, be sufficient to promote an acceptable recovery of the economy and employment. It explores whether there are additional policy measures that Ireland could take to encourage domestic demand, enhance the flow of credit to business, increase employment, reduce unemployment and strengthen business development.

In exploring the possibility of additional policy action within the prevailing fiscal framework, this report is structured as follows. Chapter 3 describes the weakness of domestic demand and searches for measures that might be effective in increasing it. Chapter 4 explores the fear that a shortage of credit is limiting the ability of enterprises, especially small and medium-sized enterprises (SMEs), to undertake business projects. Chapter 5 provides an overview of labour-market policies and identifies which policies are most important in preventing the current high unemployment rate becoming structural unemployment and in ensuring that future jobseekers have the opportunities they deserve. In Chapter 6, we consider

ways in which taxation policy can best promote sustainable development and employment. In Chapter 7 we consider whether there are ways in which enterprise policy might be adapted and widened to better support business development. Finally, in Chapter 8 we summarise the evidence and arguments.

The report does not give equal space to the issues of domestic demand, credit, the labour-market, taxation and industrial policy. This is because some of these themes were discussed in considerable detail in recent NESC work, particularly *Supports and Services for Unemployed Jobseekers* (NESC, 2011a) and *Ireland's Economic Recovery* (NESC, 2011b). Accordingly, the most extensive discussion is on domestic demand (Chapter 3) and the issue of credit to small and medium-sized enterprises (Chapter 4). In seeking possible additional policy measures in these areas, we have found it necessary to briefly document existing policy responses to the crisis; indeed, in some areas we find that the policy initiatives we are inclined to suggest are, to a degree, already in train. Where this is the case, NESC may still provide a valuable policy input by affirming these initiatives and, more importantly, drawing attention to the links and parallels between diverse policy actions and the need for consolidation of the new institutional relationships that are often created by innovative policy responses.

The discussion of labour-market activation, welfare reform and employment, in Chapter 5, draws on *Supports and Services for Unemployed Jobseekers* but extends the analysis by considering in somewhat more detail the challenge of building a better system of further education and training and of policies to create direct-employment. But, as emphasised in our conclusion, this does not mean that policy reforms in activation, welfare, training and further education are less important or less urgent. Indeed, we find that these major reforms are the actions that we can be most sure of in enhancing employment and preventing long-term unemployment. We do not discuss education reform in this document, but there is reason to believe that educational reform, to enhance the approaches to monitoring of learning, quality teaching and continuous improvement, is among the most important actions needed to address both economic and social goals.

In adopting this approach, we cast the net fairly widely in the first instance. We name problems—such as weak domestic demand, credit and finance, unemployment and business weakness—which are all evident now, but which might also exist in the medium and long term. We identify possible lines of policy action—on demand, credit, unemployment and enterprise policy—which might be feasible and necessary immediately or only in the medium term. Later, it will be necessary to think more systematically about the short- or long-term nature of each problem and the short- or long-term nature of possible policy actions. Indeed, the latter is dependent, in part, on the kind of policy action that might be effective in

addressing each problem: changed taxes and transfers, modified regulation, improved administration, investment (of various kinds) and institution-building. In Chapter 8, we group possible policy actions into three categories in order to suggest how further policy analysis and development might proceed in each case. We conclude by locating this report within a perspective on Ireland's five-part crisis and the characteristics of an effective Irish response.

# Chapter 2

## Perspectives on the Euro and the Global Economic Risks

## 2.1 Introduction

There is a need to search for additional policy possibilities and this is motivated by profound anxieties about Ireland's future prosperity and the availability of employment and public revenue to meet individual and social needs. The principal focus of this report is to support the search for new possibilities.

However, this report is written against the backdrop of an international economic recovery that continues to falter, and a deepening crisis in the euro area. This chapter discusses the international crisis and the risks of co-ordinated austerity. In Section 2.2 we summarise the Council's earlier work on European economic and monetary union and the challenges that must be addressed at EU level. In Section 2.3 we note that, at present, there is a spectrum of views on the crisis facing the euro and the risks to the international economy. These include a minimalist view, centred on simultaneous fiscal consolidation, and a view that more comprehensive redesign of the euro is necessary. They also include a fear that the massive expansion of debt worldwide may give rise to extended global instability.

## 2.2 The Council's Work on European Integration and the Euro

### 2.2.1 NESC's 1989 Report, Ireland in the European Community

In its 1989 report, *Ireland in the European Community: Performance, Prospects and Strategy*, the Council analysed the place of monetary integration in the overall project and process of European integration (NESC, 1989). This underlined the close link between deep economic integration, of the type then being created in the

internal market programme, and monetary integration. That report also examined analytical and policy approaches of economic and monetary union (EMU). This revealed that, both historically and analytically, there are close, if complex, relationships between monetary union, fiscal union and political union. The Council's work surveyed thinking on the implications of deep economic union and currency union for the development of small, peripheral, historically less developed, regions and member states. It argued that economic, financial and monetary integration need to be accompanied by policy mechanisms to manage the macroeconomy at EU level, address asymmetric shocks and promote real economic convergence.

### 2.2.2 NESC's 2010 Report, The Euro: An Irish Perspective

In 2010, the Council undertook a study of Ireland's experience in the euro and the challenges facing both national and EU policy (NESC, 2010b). The study traced the origin and design of the euro, highlighting the strong, long-standing, widely held, diverse and increasing **economic** motivation for EMU. The close link between deep economic integration and currency union suggests that the difficulties largely reflect the **political** complexity of creating monetary union in European circumstances.

The 2010 report outlined the basic design of EMU, drawing attention to its most prominent features: the strong division of labour between the ECB (with responsibility for monetary policy) and the member states and social partners (with responsibility for macroeconomic surveillance, fiscal policy and structural reform). At the heart of this regime was the reluctance to take any step that would engage the ECB in 'ex ante co-ordination' and thereby in a political process that might push it to compromise its independent pursuit of price stability. The overall successes and failures of the euro can be expressed and discussed in terms of this core design feature. Two broad conclusions seem hard to avoid.

First, in its own terms, the design did not work well to produce the outcomes that were hoped for. In a technical sense, this is confirmed in studies of fiscal policy co-ordination and reform and in various evaluations of the Lisbon Strategy undertaken since 2003, including the Commission's own review (European Commission, 2010a). In a more elementary sense, it has to be true, given the severe economic, financial, banking and fiscal crisis that confronts the member states of the euro area and the EU as a whole. The NESC 2010 report suggested that the less than optimal combination of independent monetary policy and 'implicit co-ordination' may have resulted, in part, from the limited policy buy-in to, and social identification with, the euro as a project; indeed, this, in turn, may have been an unintended consequence of the strong division of labour that characterised the overall design.

Second, despite some real strengths, the design itself was too narrow in treating all unemployment as structural, all shocks as supply-side and all necessary adjustment achievable at the national, sectoral and firm level. It thereby denied the possible significance of genuinely macroeconomic problems at the European level and of macroeconomic imbalances within the euro area.

The 2010 report documented the reform measures in place and those under discussion to address the problems facing the euro. It endorsed the broad thrust of a suite of measures—legal, procedural and analytical—to greatly enhance the scope and quality of mutual economic policy surveillance and adherence to sustainable fiscal policies. Most of these have now been passed into EU law and it is these that seem to constitute the most important element in ensuring that the euro area does not repeat the accumulation of imbalances—in trade, payments and fiscal policy—that gave rise to the current crisis.

In our later report, *Re-finding Success in Europe: The Challenges for Irish Institutions and Policy* (NESC, 2010a), the Council noted the determination of the EU to strengthen its approach to co-ordination. It noted that it was too early to say what kind of regime will emerge from the measures already adopted and the further changes proposed. A number of possibilities could be identified:

- In the area of economic policy, the EU *may* be advancing to a regime of real benchmarking, systemic and diagnostic monitoring peer review, learning and system revision—in which the hard law elements enforce engagement and searching self-examination—like that found in other more successful areas of EU policy; or
- It is possible that, having had a weak regime in which member states flouted the Stability and Growth Pact (SGP) rules and resisted real benchmarking, for which a big price has been paid in the past three years, the EU will turn to a regime that relies too heavily on precise rules, fixed targets and strong sanctions.

The latter, NESC argued, would be a worrying development, not because it would be too strong, but because it could fail even in the task of achieving immediate fiscal consolidation and long-term fiscal discipline. This could arise if the precise rules did not capture the underlying weaknesses, as was the case in the SGP (*ibid.*). What is needed, the Council argued, is that the kind of governance mechanisms that the EU has already developed and made effective in many other spheres are now brought to bear in economic surveillance and especially euro area co-ordination.

In that regard, the Council argued that it is necessary to implement both the stronger new approach to economic co-ordination and the EU 2020 Strategy.

Despite the temptation to marginalise the EU 2020 Strategy, both substantively and procedurally, each needs the other if smart, sustainable and inclusive recovery is to be achieved.

Writing in mid-2010, the Council advanced the view that, notwithstanding the important steps taken since 2008, the euro faces severe challenges:

- The effectiveness of the financial support provided to Greece, and available to other countries (of which Ireland became one in late 2010);
- The recovery of the whole European economy in the context of fiscal austerity, which ‘poses the risk of cutting off the fragile economic recovery by excessively depressing demand’ (*ibid.*: 82); and
- The continuing risks to the financial system at European and global level, given the exposure of European banks to both sovereign debt and the private-sector in countries experiencing economic contraction, the possibility of further global financial imbalances and the overhang of excessive levels of debt (*ibid.*: 83).

Given this analysis, it was argued that the EU needs to adopt an open-minded approach to discuss and agree a pragmatic combination of measures that protects the euro, addresses the deficit and debt problems, supports macroeconomic recovery and responds to the risk of further financial-sector and exchange-rate turbulence. Ireland has a strong interest in the success of such a process.

## 2.3 Views on the Current European and Global Economy

Since the Council’s 2010 report on the euro, international economic recovery has faltered and the crisis in the euro area has deepened. There remains a spectrum of views on the nature, causes and solutions to these difficulties. This spectrum runs from a minimalist view, focused on sovereign deficits and debt, through advocacy of a more comprehensive redesign of the euro, to a more profound anxiety about how the global level of debt arose and will be resolved.

One view, which remains the stated position of many euro area policy makers, is that because the crisis is characterised by increased fiscal deficits and debts, it was essentially caused by lax fiscal policy. With this view, the essential short-term solution lies in fiscal correction by all EU member states that have significant deficits



and debts above the 60 per cent SGP ceiling, supported, in some cases, like Ireland, by EU/IMF support programmes; and, the essential long-term solution lies in stricter budgetary rules and automatic sanctions in euro area countries, plus tighter euro area financial supervision by the newly created EU financial institutions. In addition, within this perspective, the role of the ECB is to provide liquidity to the banking system and an element of support to the sovereign bond market through sterilised bond purchases. The apparent thinking is that simultaneous fiscal austerity will restore business and household confidence that government finances are sustainable, thereby prompting a recovery in consumption and investment.

This perspective has had to accommodate the need for a second Greek support package, and most who adhere to the essence of that view of the crisis now add to it a recognition that European banks remain vulnerable and require recapitalisation.

In the Irish context, the NESC Secretariat, in July 2011, identified some pressure for convergence between two competing views over the past three years. On the one hand, those who had emphasised the burden of accumulated debt and the importance of early stabilisation of the debt/GDP ratio were prompted by events to also recognise the advantages that would flow from an early, more comprehensive EU resolution of the public finance and banking problems. On the other hand, those who emphasised the negative feedback loops from fiscal adjustment were confronted with Ireland's inability to access finance in the bond markets and acknowledge that, under any speed of fiscal correction, Ireland needs to close the gap between revenue and expenditure (NESC, 2011b).

Further along the spectrum, there is a view that fiscal consolidation, where necessary, and bank recapitalisation will not be sufficient without the ECB becoming a classic lender of last resort, not only to banks, but also to sovereigns. This view is widely held by financial-market analysts and is reflected in the bond-market pressure evident in the past year. In addition to widening the role of the ECB, some advocate that there needs to be stronger common action on the fiscal side, through creation of a euro bond, which would share the guarantee of euro area member-state debts.

This position is the basis for one widely held, perspective on Ireland's strategy and recovery: that the correct elements for recovery are in place, but the success of Ireland's strategy is dependent on a stronger European recovery, which requires the actions by the EU, ECB and larger member states, described above.

Others argue that a more comprehensive redesign of the euro is required. This reflects a view that the euro area is institutionally flawed and more rigorous enforcement of the existing rules will not solve the problem. The demands of collective responsibility have been asymmetric, leading to self-defeating austerity in

debtor countries, while problems in creditor countries have been allowed to fester (Tilford & Whyte, 2011). Too much virtue has become a collective vice, creating excessively tight fiscal policy overall, and weak growth. In this view, a currency shared by fiscally sovereign member states will always be vulnerable to losses of confidence because macro imbalances are transformed into sovereign debt crises. This is especially so when, despite an integrated financial market, bank guarantees remain at member-state level; this creates a poisonous feedback loop between banks and sovereigns. Tilford and Whyte argue that the crisis is 'as much a tale of excess bank leverage and poor risk management in the core as of excess consumption and wasteful investment in the periphery' (*ibid.*: 5). With this view, to succeed the euro needs far-reaching reforms on four fronts: a partial mutualisation of sovereign borrowing by means of euro bond; a euro area backstop for a common banking sector (such as pan-European deposit insurance); growth-oriented policy (including a broader mandate for the ECB and a fiscal regime with a symmetric imbalances procedure); and deeper market integration to create better shock absorbers through price flexibility, structural adjustment and factor mobility.

A less sweeping, and perhaps more institutionally subtle, version of this view can also be identified. While accepting the economic analysis of the euro area's current predicament, this position would attach greater value to ECB independence for two reasons: because of its importance in German commitment to the euro and because there are real advantages to the low inflation and stability that central bank independence can yield. Advocates of this view argue that, like every political community, the EU needs to identify and acknowledge unusual and extreme conditions in which normal rules are temporarily suspended (NESC, 2010b: 84-99). The current crisis, with deathtraps for debtor countries and the risk of a further credit crunch across the global financial system, constitutes such an extreme or ultimate cause. Allowing the ECB (in combination with the IMF) to act as lender of last resort in the current crisis need not imply permanent abandonment of ECB independence and a reversion to fully politicised monetary policy. This position is, of course, open to the idea that the EU should also deepen its arrangements for 'solidarity' between member states through euro bonds.

A final position on the spectrum is one that sees the EU in a global context and is extremely anxious about the prospects for the international financial system and real economy. This perspective is informed by an analysis that suggests that economic and monetary policy has been based on doctrines that greatly underestimate the inherent instability of the financial system (Minsky, 2008). Informed by mistaken macroeconomic and monetary theory, governments and central banks have allowed, sometimes encouraged, a massive extension of debt across the world. In such an extension of debt, borrowing is increasingly repaid by new borrowing, for projects whose return is dependent on continuously rising asset

prices. The crisis is the moment when the unreality of these borrowings and investments has been revealed, but is only the start of a process in which debt is shrunk (Keen, 2011). This perspective would share doubts about the effectiveness of the co-ordinated austerity being undertaken in the EU. But this line of thinking might also emphasise the need for the EU to rapidly reach a more unified approach to the euro and the management of the financial system. If the global economy has a long way to go in reducing the massive build-up of debt, and if it contains further financial bubbles that have yet to burst, then the EU needs to have its own house in order as it faces into a turbulent decade, or more, in the global economy.

# Chapter 3

## Domestic Demand

### 3.1 Introduction

Current forecasts for recovery rely on export-led growth and do not envisage a positive contribution from the domestic market until 2014 (Department of Finance, 2011). Given the continuing need for fiscal consolidation and international uncertainty in financial markets, it is hard to disagree with this forecast. However, given the degree of uncertainty that also attaches to prospects for growth in international markets, it seems prudent to search for ideas that might, in the near or medium term, help to bring forward a contribution from domestic demand.

This chapter argues that there is some scope for policy action. It concentrates on household balance sheets and savings and repayment behaviour and argues that there are resources that could potentially be used to increase domestic demand. In the final sub-section it argues that, contrary to the view that there is little or no scope, there are policy initiatives that could have an impact on domestic demand. Work in these areas could be used to support development of targeted instruments for consideration in 2012.

The chapter is structured as follows: Section 3.2 examines the components of domestic demand. Section 3.3 highlights the resources that might support an increase in demand. Section 3.4 considers policy possibilities that could bolster demand.

### 3.2 Analysis of Domestic Demand

Between 2007 and 2010, domestic demand declined in volume terms by over one-fifth, which is a very significant decline. Boosting domestic demand is important for three reasons:

- First, the sectors that cater to domestic demand tend to be more labour intensive and more likely to create significant numbers of jobs;
- Second, its decline has been such a feature of the Irish experience of this recession;
- Third, economic recovery in the past, in Ireland, was based on both export and domestic growth.

This section 3.2 examines the three components of domestic demand: personal consumption, investment and public consumption.

### **3.2.1 Personal Consumption**

The biggest component of domestic demand is personal consumption. In 2010, for example, personal consumption accounted for almost 65 per cent of domestic demand, public consumption 20 per cent and investment 15 per cent. In 2007, near the height of the building boom the corresponding percentages were 54, 15 and 29.

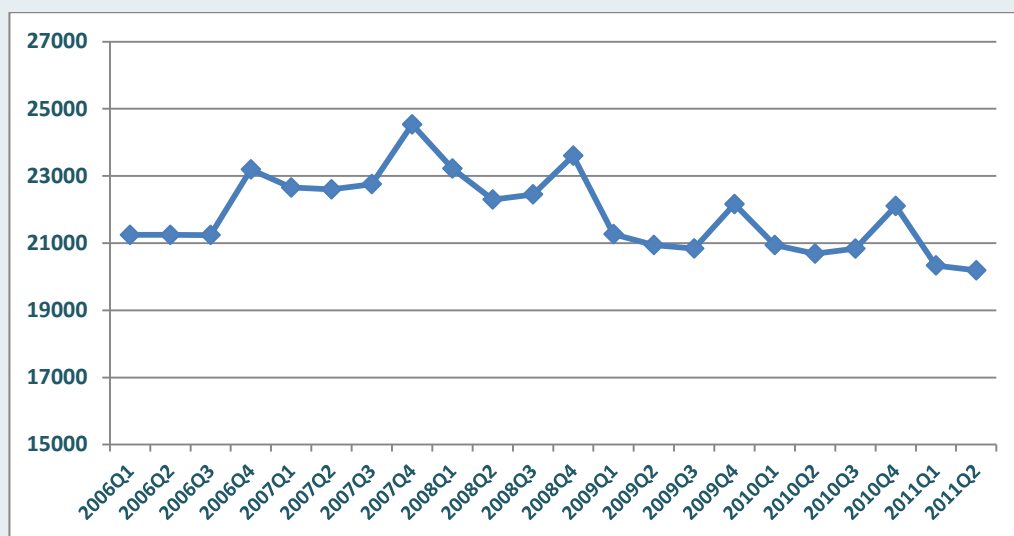
There are two main ways in which individuals contribute to spending in the domestic economy: consumption and investment. This section looks at personal consumption and section 3.2.2 describes investment.

Personal consumption includes consumption on household and personal items such as clothes, food and fuel. It has contracted during the recession, though by less than the overall rate of decline in the economy and by less than investment:

- In 2007, consumers spent €92.5bn in Ireland. In 2010 they spent €84.5bn or 8.6 per cent less. Consumer spending reached a peak in the final quarter of 2007;
- The volume of retail sales fell by 18.6 per cent between 2007 and 2010. This, however, was driven by the volatile motor trade where volume fell by over half between 2007 and 2009 before recovering by 17.0 per cent in 2010;
- Excluding the motor trade, the volume of retail sales fell by 11.0 per cent between 2007 and 2010;
- The quarterly national accounts show that personal consumption continued to decline during the first quarter of 2011, falling by 1.9 per cent on a seasonally adjusted basis.

The fall in personal consumption has been more gradual than other indicators (Figure 3.1). However, given its scale relative to the other components of domestic demand, it has a major bearing on the overall level. There is also likely to be variation across and within product and service categories. Further research on this could help to inform future budgetary policy.

**Figure 3.1 Quarterly Personal Expenditure on Consumer Goods and Services - (Constant Market Prices Euro M)**



Source CSO Quarterly National Accounts, October 2011

### 3.2.2 Investment

The fall in domestic demand is driven by the dramatic fall in investment, which fell by over 57 per cent in volume terms between 2007 and 2010. The decline in investment—by private individuals and business—has been particularly severe (Figure 3.2).

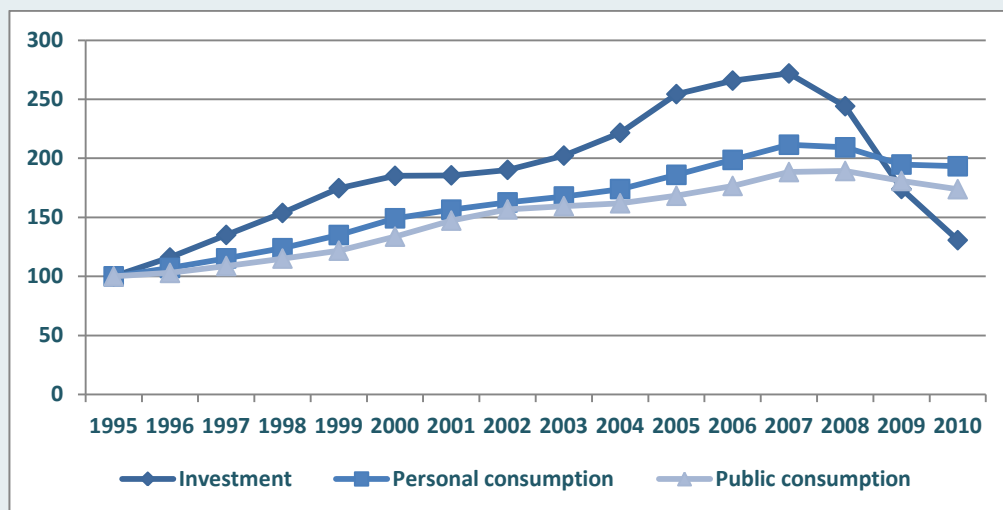
Investment fell by over 57 per cent in volume terms between 2007 and 2010. Government projections are for investment to move from a reduction of 11 per cent in 2011, to a reduction of just -1.0 per cent in 2012 (Department of Finance, 2011) Even this degree of improvement will be challenging and more so in the context of ongoing concerns about international growth. However, given the bottoming out in

the rate of contraction of housing the overall level of investment is slowing and is likely to continue to do so.

The main components of investment are dwellings; other buildings (non-residential); transport equipment; other machinery and equipment roads; software and exploration.<sup>1</sup> There have been falls in all categories. However, the fall in investment related to construction accounts for 73 per cent of the decline in overall investment.

Construction and building include two main components and one smaller one. The main components are dwellings (private residential buildings) and other buildings (offices, factories, shops etc.). There is also a smaller category linked to costs associated with transfer of land and buildings.

**Figure 3.2 Trend in Real Volume of Personal Consumption, Investment and Public Consumption 1995—2010, 1995=100**



Source CSO, National Income and Expenditure, June 2011

<sup>1</sup> The rest of this section focuses on non-government public capital spending. Government public capital spending also has an impact on job creation and employment but is beyond the scope of this chapter.



In 2005 and 2006, investment in construction and building accounted for around 70 per cent of all investment activity in the Irish economy. Between 2007 and 2010, it reduced by almost 60 per cent—accounting, as noted, for almost three-quarters of the overall fall in investment. In 2006 there were 93,019 new house completions; in 2010 there were 14,602; while in the first 9 months of 2011 the number was 7,917<sup>2</sup>. The collapse in other buildings was less severe than the residential housing market.

Survey work by DKM (DKM, 2010) for the Department of Environment, Community and Local Government shows that while the decline is dominated by new construction, it also reflects a decrease in repair and maintenance. The DKM data shows that the total volume of new construction investment fell by 67 per cent between 2007 and 2010, while repair and maintenance fell by 32 per cent over the same period. Private residential repair and maintenance is estimated to have fallen from €4.7bn to €2.3bn in 2010, that is, a decline of over 50 per cent.

Home improvements, especially those that improve the energy efficiency of the housing stock, are an area where further incentives might be considered. There are a number of reasons. First, home improvements generally require high levels of labour and have low-import content. Second, it is likely that much investment in this area is taking place in the informal economy. To see this, note that between 2009 and 2010 investment under the heading of ‘dwellings’ declined by a further 35 per cent in Ireland; other buildings by 26 per cent; and both combined by 31 per cent. During the same period, turnover at one of Ireland’s largest builder providers (selling to both trade and retail) declined by only 11.5 per cent.<sup>3</sup> It is very difficult to reconcile the full amount of the difference between this and the overall contraction in the sector. This suggests that a significant level of construction activity is taking place in the informal economy.

### 3.2.3 Public Consumption

Public consumption refers to current public spending on goods and services including the public-service pay bill.<sup>4</sup> Public consumption has fallen by less than the

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<sup>2</sup> These figures are new house completions based on ESB connections and were derived from the online data base hosted by the Department of Environment, Community and Local Government.

<sup>3</sup> Company Annual report 2010, Chairman’s Statement. Figures refer to sales across sixty-seven merchanting locations. Merchanting outlets sell to builders and the plumbing trade.

<sup>4</sup> Direct government payments including social-welfare payments, interest expenditure and subsidies, are not included in public consumption.

other components of domestic demand, with a fall of 4.4 per cent between 2007 and 2010. The peak year for public consumption was 2008: from that year to 2010, the volume of public consumption fell by 6.5 per cent. In 2010, public consumption fell by 2.2 per cent, which exceeded the fall in private consumption of 1.2 per cent. Under the government's projections, as set out in the *Medium-Term Fiscal Statement* of November 2011, this element of demand is expected to decline in each year to 2015.

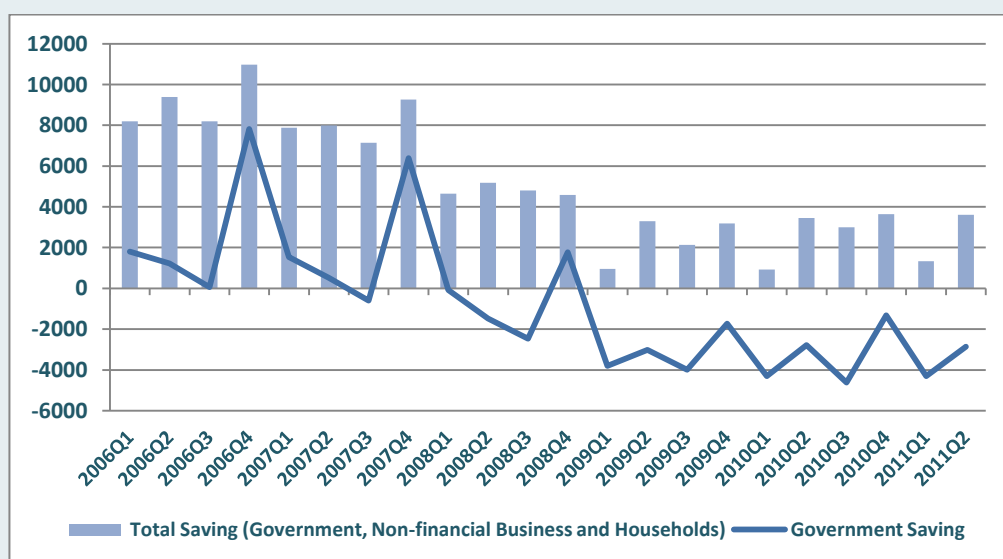
Given the need to reduce the gap between government revenue and expenditure there is little scope to increase this element of domestic demand. However, there may be scope to consider domestic demand when selecting among possible expenditure cuts. It seems likely that most welfare transfers, such as JA and JB, are fully spent. On the other hand, there are items of expenditure, such as child benefit, that a significant proportion of citizens may not be spending immediately. Of course, domestic demand can only be one criterion, and welfare and other policies need to be guided by sound principles, such as those of the Developmental Welfare State. For example, it can be argued that reductions in the child-support payments to parents should be channelled towards targeted improvements in the quality and supply of early childhood education. Further moves in this direction would not only enhance early child development, which has long-term benefits for both individuals and society, but would also create employment. This happened when the early childcare supplement was terminated in 2009 at a time when the free pre-school year of Early Childhood Care and Education (ECCE) for all children between the ages of three years three months and four years six months was introduced.

### 3.3 Resources to Increase Domestic Demand

The scope people have for discretionary expenditure and investment depends on the balance between income and spending commitments and the overall balance between what they own and owe. The decisions people make are also influenced by their confidence, expectations and attitudes about both domestic and international economic developments. This consumer behavioural dimension is not well understood in Ireland, at least in terms of how it is affecting current behaviour. In Section 3.4.2 we propose that additional work in this area could help in the development of policy.

The remainder of this section considers whether there are private-sector financial resources in Ireland that could be used to increase domestic demand.

**Figure 3.3 Gross Quarterly Savings (Euro M): 2006–2011**



Source Quarterly Institutional Sector Accounts, October 2011

### 3.3.1 Savings, Liabilities and Assets

Savings is income (from wages and profits and net of transfers and taxes) less spending on final consumption. The figure that remains is termed gross saving—that is what is left when spending on consumption is subtracted from disposable income. This could be placed on deposit or used to repay debt. Figure 3.3 tracks the evolution of saving during the recession. It shows the overall quarterly level of saving and the level of government<sup>5</sup> saving. It shows that since 2009, households and businesses have been largely adding to saving while government has been largely reducing its savings.

<sup>5</sup> Government savings is the difference between what it receives in taxes on income and wealth and other transfers and expenditure. It includes central and local government and is a measure of the balance between what government is receiving and what it spends on a quarterly basis.

When government is excluded, the overall level of saving in the rest of the economy is seen to be increasing. Households are increasing their level of savings. They are doing so by reducing the amount of income they are spending (rather than because of increased disposable income). The trend in the level of savings since 2007 has largely been upwards. In the first half of 2011, households had savings of €7.58bn, which was about the same as during this period in 2010. Over the full year 2010 the savings were €12.2bn. As a per cent of gross disposable income, the quarterly saving rate reached 18.5 per cent in the second quarter of 2011. These savings are being used, primarily, to deleverage or repay debt rather than to add to assets.

### ***Household De-leveraging***

A key feature of the Irish boom was the dramatic explosion in private-sector credit (Figure 3.4).<sup>6</sup> Figure 3.4 provides an overview of how credit expanded over the last decade. It shows that households increased their liabilities significantly. In early 2002, private-sector credit was just under €200bn. This increased to over €500bn in early 2009. It is now reducing as both business and households are reducing their liabilities. In early 2011 total loans outstanding were €457bn.

International research suggests that in the aftermath of a financial and credit-fuelled crisis, a de-leveraging process is commonly observed (O'Leary & Walshe, 2011). That research finds that a period of de-leveraging, equal in length to the period of boom, takes place during which the expansion in credit is almost reversed. O'Leary and Walsh argue that this means that Ireland could be in the early phase of a period of household de-leveraging that could last for four years (*ibid.*).<sup>7</sup> De-leveraging by households has been underway since late 2009.

Concentrating on households, it is evident that there are significant levels of debt repayment taking place. In the first quarter of 2007, households had total liabilities (long- and short-term loans) of just over €176bn, which increased to just over €201bn by the first quarter of 2009 (Central Bank, 2011). These liabilities have since been reduced to €185bn in the first quarter of 2011. There has also been some restructuring: in 2007 short-term loans accounted for 7.8 per cent of total loans; in 2011 these made up 4.7 per cent. The CSO estimates that approximately €10bn, from gross savings of €12.2bn, was used to repay debt in 2010 (CSO, 2011a:7). Savings used to repay debt are not available to support consumption or investment.

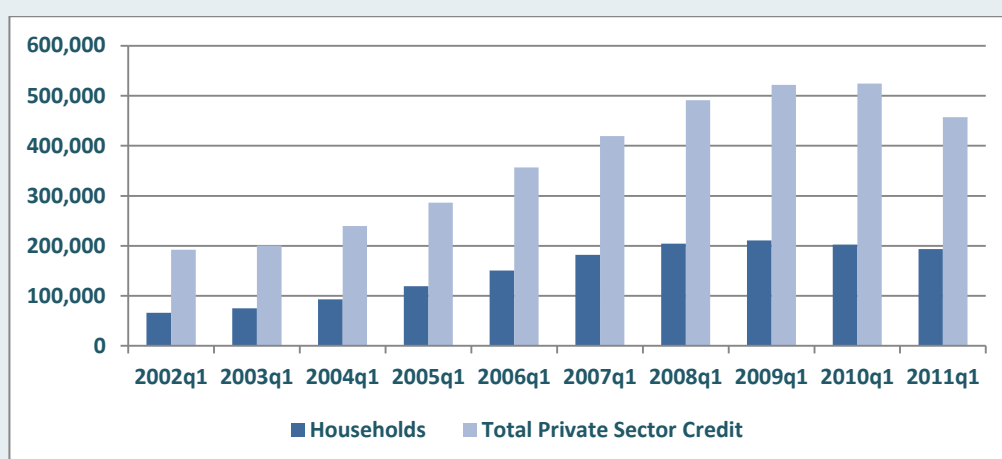
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<sup>6</sup> This excludes financial corporations. These are corporate bodies producing financial services on a commercial basis such as the Central Bank, banks and insurance companies.

<sup>7</sup> This is based on assuming that the boom lasted twenty four quarters, beginning in 2003.

It should be recognised that in many respects this is welcome behaviour. The liabilities of Irish households need to be reduced; relative to disposable income, liabilities increased dramatically during the boom. At the end of 2002, liabilities were 117 per cent of disposable income. By the end of 2006, this had increased to just over 200 per cent and continued to rise to 221 per cent in 2009. Of course, Irish households have also significant financial assets, and this is considered in the next section.

**Figure 3.4 Private-Sector Credit 2002–2011 (€ Million)**



Source Central Bank, Quarterly Financial Accounts for Ireland (May 2011)

However, there is also evidence that saving behaviour—and the need to repay debt versus build deposits—varies significantly with age. Data compiled by IBEC from the main financial institutions show that deposits increased on average by 15 per cent between January 2009 and July 2011 (Table 3.1). The largest increase in savings is among older people and those between eighteen and thirty-four. In the 35–49 age group, deposits have increased by just 5 per cent over the period.

Thus, while in overall terms the majority of savings are being used to repay debt, there is evidence that two cohorts—those under thirty five and over fifty—are adding to their deposits. This may represent a source of potential additional domestic demand. Further research is necessary to understand why people are saving so much. Among young people, it is not clear how many are saving because

they cannot get mortgages, or because they are waiting for house prices to fall further, or if they are uncertain about job prospects. Among older people, reasons may include losses to pensions or concerns about providing for their future. Examination of these issues would help to define policy options.

**Table 3.1 Changes to Deposit Account Balance (January 2009–July 2011)**

Age Category	Percentage Change
Less than 18	-30
18–24	15
25–34	12
35–49	5
50–64	10
65+	22
Average	15

Source IBEC 2011

### ***Household (Financial) Assets***

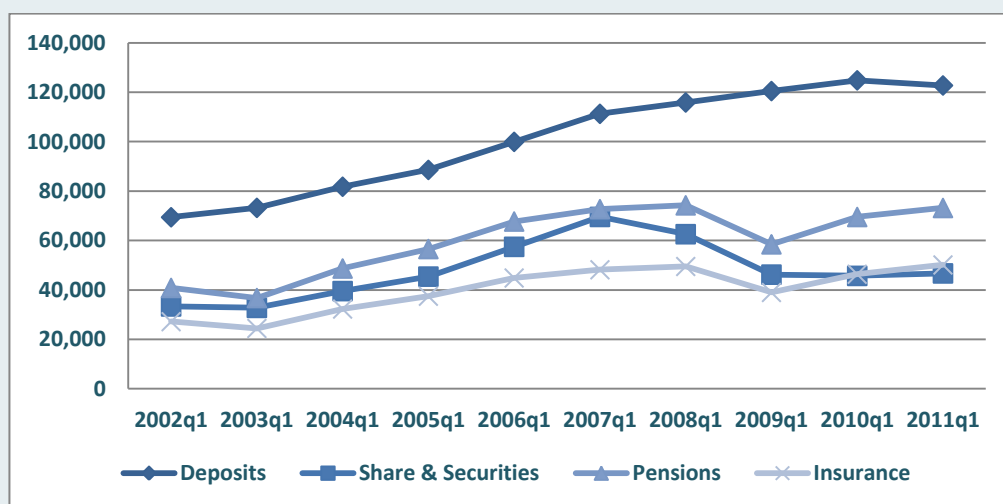
Irish households continue to hold significant net wealth. In the first quarter of 2011, total liabilities were €193bn, most of which was loans (€185bn). Total assets held were €298bn. This included:

- Deposits—€123bn
- Shares—€46bn
- Pensions<sup>8</sup>—€73bn
- Life insurance<sup>9</sup>—€53bn

<sup>8</sup> Net equity of households in pension reserve funds.

The asset position of households was improving in the run-up to the crisis (Figure 3.5). The crisis resulted in a significant drop in the value of shares and in pensions and insurance reserves. The value of deposits continued to increase in the early part of the crisis. Since early 2009, the recovery of stock markets means assets values have regained some of their value. Households also continued to increase deposits in 2009 and maintained them in 2010.

**Figure 3.5 Change in Financial Assets of Irish Households 2002–2011 (€ Million)**



Source Central Bank, Quarterly Financial Accounts for Ireland (May 2011)

The change in financial resources held on deposit suggests that there are households that have access to resources and have not needed or chosen to use this to reduce their liabilities. There are, of course, many dimensions—how concentrated is this wealth?; what uses might it be intended for?; what is the prevalence of off-shore liabilities and assets?—which, we argue in Section 3.4, should be the focus of ongoing work.

<sup>9</sup> Net equity of households in life insurance reserves and pre-payment of insurance premiums and reserves for outstanding claims.

The value of these assets is significant. OECD data on a limited sample of developed economies suggests that the Irish ratio compares well with other nations (Table 3.2). For example, financial assets as a percentage of disposable income are at the levels reported for the US, UK, France and Germany. Where the Irish situation compares less favourably is in relation to liabilities. In all of the comparator countries, liabilities as a percentage of disposable income are significantly lower.

Nonetheless, the data suggests that there are household resources that might potentially be directed towards improving domestic consumption and investment. In addition, if pensions are factored in as a source of investment then there is further scope. This may be important. It seems likely that some in the 35–49 age cohort have limited deposits, but have created pension assets via AVCs and other means over the last decade. Care is required in considering policy measures that would allow access to pension assets, given concerns about the level of funding for future provision of pensions. Further research on pensions and the coverage of specific cohorts could inform possible policy measures.

**Table 3.2 Financial Assets and Liabilities As Percentage of Disposable Income, Selected Countries and Ireland (2009)**

Country	Assets	Liabilities	Net Financial Assets
France	308	106	201
Canada	359	148	211
Germany	300	98	202
Italy	364	87	276
Japan	501	125	375
UK	457	170	286
US	399	127	272
Ireland <sup>10</sup>	314	221	94

Source OECD Economic Outlook No. 89, OECD Economic Outlook: Statistics and Projections (database)

<sup>10</sup> NES Secretariat Calculations.

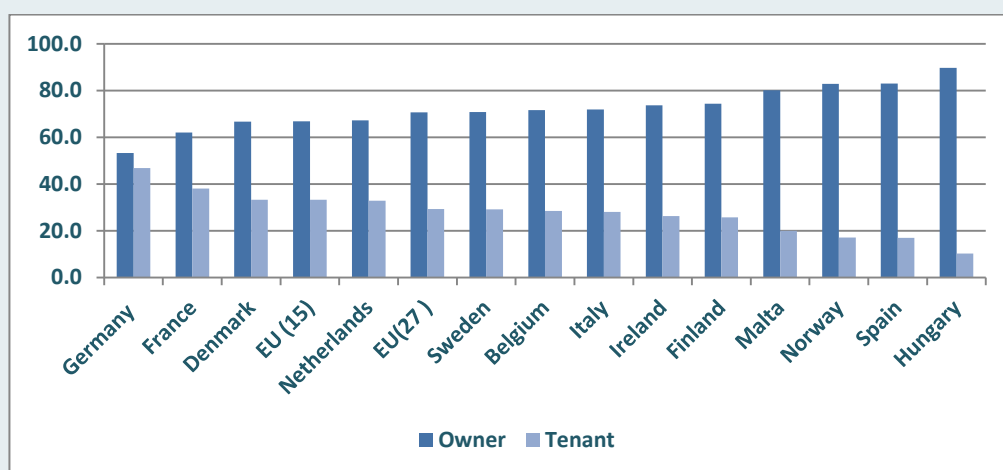


### ***House Prices and Household Balance Sheets***

If house values are included in this analysis, then the picture changes significantly. Measures of net worth that include houses have declined significantly in relative terms. Research by O’Leary and Walshe shows that, in aggregate, Irish households experienced a fall in their net worth in the region of €180bn between the final quarter of 2006 and the first quarter of 2011. This estimate is based on a reduction in house prices of 47 per cent. They argue that house prices are likely to fall further (a peak-to-trough ratio of 60 per cent), resulting in an overall decline in aggregate net household wealth in the region of €250bn. Losses of this scale, even if they are paper losses, act as a major drag on households’ willingness to make further investments, particularly in housing. Losses also impinge on people’s mobility: if a house is sold for less than the outstanding value of the mortgage then negative equity becomes a ‘real’ liability for the seller. This can severely affect the possibility of being granted a new mortgage. The impact of both—a large fall in net worth across the population and dealing with negative equity for some—on consumer behaviour is significant and likely to limit people’s willingness and/or ability to make future investments.

Indeed, it is possible that Ireland will not return to an owner-occupied-led model of demand. Younger cohorts who have not purchased homes may behave differently. They may view housing primarily as a productive rather than speculative investment. In this context, ‘productive’ means an asset that produces value for an individual—a quality place that allows one to live, learn or work at a particular moment in time. Their concern would be with the cost of accessing this housing service and its quality—more so than the rise or fall in its market value. It would be useful to examine countries in which owner-occupation is lower (e.g. Germany and France—see Figure 3.6). An initial examination suggests home ownership is still seen as desirable in these countries, but it often takes place at a later stage (early 40s), as earnings and inheritance transfers increase and the need for labour mobility would seem to lessen. In Ireland, there is some tentative evidence of a decline in the rate of owner-occupation: in 2008, 77 per cent of homes were owner-occupied; in 2009 it had fallen to 73 per cent. During the early 2000s, the rate was approximately 80 per cent. This trend could have far-reaching implications for housing and housing policy.

**Figure 3.6 Household Tenure in Selected EU Countries (2010<sup>11</sup>)**



Source: Eurostat Data Explorer, based on SILC, data extracted 30 November 2011

### 3.4 Policy Implications

This section considers the policy implications of our analysis in relation to consumption, investment, savings, assets and liabilities. It argues that there is a danger that policy may accept a 'no scope' to act view, based on the idea that there is little that can be done in Ireland to influence domestic demand. It challenges this view on the basis that Irish households hold significant financial assets and some cohorts are increasing their financial assets. It may also be the case that bank deleveraging limits the ability of households to access credit.

This subsection argues that there are a number of areas that could be looked at with a view to increasing domestic demand in the short and medium term.

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<sup>11</sup> Data for Ireland relates to 2009.

### 3.4.1 Beyond a 'No Scope' to Act

Banks in Ireland are reducing their loans-to-deposit ratios. Households are repaying debt. Public expenditure is being reduced and tax increased. O'Leary and Walshe<sup>12</sup> argue that these factors constitute a 'trilemma', meaning it is impossible to pursue all of these strategies at the one time and increase domestic demand.

Bank restructuring, and specifically the need to achieve loan-to-deposit ratios (LDR) of 122 per cent by end of 2013, is a condition of the EU/IMF programme. This means that banks must either reduce lending and/or dispose of assets. The impact of the former will be to reduce credit available and, therefore, dampen domestic demand.

As noted above, private-sector debt repayment is taking place. The crisis has affected people's financial position and they are seeking to repair this by either reducing liabilities and, to a lesser extent, adding to their assets. This is largely rational and appropriate behaviour for individuals, but collectively it means demand is reduced.

In addition, the size of the fiscal deficit and the conditions in the EU/IMF programme of assistance mean that further expenditure cuts and tax increases are required in 2012. This will further dampen domestic demand, both directly (to the extent that it reduces public consumption and public investment), and indirectly (to the extent that it reduces the disposable income of households). As in recent years, it is important to seek measures that will have the least damaging effect on the economy, society and environment in the long term.

From their analysis, O'Leary and Walshe reach the view that the only scope for action is in relation to credit and the pace of restructuring (O'Leary & Walshe, 2011:30). They advocate greater foreign ownership of Irish banks, further European support and extending the period by which the banks have to achieve the loan-to-deposits targets. It is hard to disagree with the general assessment of the need to examine the question of credit and the flow of resources to business and households. In addition, the recent creation of the Strategic Investment Fund, and the planned establishment of a State Bank, could help to ensure that credit flows towards significant infrastructural projects and other strategic projects. The issue of credit is considered further in Chapter 4.

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<sup>12</sup> They also describe an additional external trilemma, namely; lack of policy autonomy, capital mobility and fixed exchange rate.

The impact of the recession on household wealth has been very severe and combined with continuing uncertainty, this means that stimulating domestic demand will be very challenging. However, this chapter has shown that households have significant financial assets and it is conceivable that:

- Both a process of debt repayment and deposit draw-down could occur—meaning that while some may reduce their level of debt, there are other cohorts who could increase their spending by drawing on their deposits; and,
- That other sources of funds (such as pensions, subject to the results of further research) could be used.

The next section outlines a number of policy possibilities that merit further consideration.

### **3.4.2 Policy Areas for Consideration**

This section considers six areas which could help to support domestic demand in the near and medium-term.

- Demand for housing;
- Household assets and savings;
- Investing in energy saving;
- Pension funds;
- High-profile local projects;
- Housing and housing policy.

#### ***Demand for Housing***

It may be possible to further stimulate demand for housing. Budget 2012 maintained mortgage interest relief for first-time buyers in 2012 but this will not be available after 2012. It also introduced a new incentive relief for properties bought between December 2011 and the end of 2013 and held for seven years. These measures may have the effect of bringing forward demand. It is important that other policy candidates are considered. These could include the introduction of similar credit targets for individuals, to those in place for lending to SMEs, and other

measures such as discounts from future household charges for those purchasing houses. Any consideration of such measures should take account of the need to rebuild the tax base and limit tax expenditures.

### ***Household Assets and Savings***

It is necessary to look more systematically at household balance sheets and savings. It would be useful to research further the size and distribution of financial assets and savings and their availability to support further investment and consumption. This could include examining survey data on consumer expectations but also carrying out more detailed work on consumer behaviour and spending patterns. Doing so might support more targeted policy instruments that would be more effective at incentivising households and at directing investment/consumption towards activities with positive wider economic, societal and environmental impacts. It would also be useful in this context to consider the advantages and disadvantages of allowing people make a temporary withdrawal of pension funds.

### ***Investment in Energy Saving***

There is a need to find ways to stimulate higher levels of investment in energy efficiency. Up to 1 million homes need to be retrofitted by 2020. This investment is being encouraged by financial incentives at present. There is some research which suggests that some of these incentives—in this case those for biomass and wood gasification boilers— have had less impact on the level of investment in energy efficiency than was expected or hoped for (Leahy & Toll, 2011). This does not rule out the roll of incentives in the short term. However, it does suggest a need to explore non-financial barriers facing households and groups of households or communities—such as information asymmetries, missing markets, economies of scale and tipping points—and how these might be addressed. In this context, the Medium-Term Exchequer Framework notes that reliance on State funding is not a sustainable model; while government supports have helped develop the market and promote awareness of the benefits of action, the market must be weaned off Exchequer funding. The introduction of energy-saving obligations on energy suppliers in 2011 will provide a sound basis on which to move to new models for realising energy savings. While the government will continue to provide a significant level of support in 2012 and 2013, it is committed to a transition to a non-Exchequer-based funding model no later than the start of 2014. The Council endorses this position and adds that, given the potential impact on construction-related employment, work on evaluating, testing and initial roll-out of pay-as-you-save-type schemes needs to begin in 2012. These may provide a more direct means of addressing market failures related to finance, particularly for lower-income households, and information and understanding in relation to investment in energy

saving. Such schemes have significant potential to create employment as the average investment per house, to bring it to A-rated energy standard, is likely, based on experiences in the UK, to be in the region of €25,000 to €30,000.

In the short term, a two-year expansion of the existing incentives for households to undertake investments in their homes should be considered. A key aim of this measure would be to bring activity from the informal to the formal economy. This expansion should target a broader range of home improvements, such as those contained in the standard Building Energy Rating form and covered by grants in other countries, such as Canada. This more comprehensive approach, in terms of the range of improvement included, could also support the transition to pay-as-you-save-type schemes.

A careful analysis of the costs and benefits of each of these ideas is required. This should be carried out by the Department of Finance, the Department of Public Expenditure and Reform and the Department of Environment, Community and Local Government.

### ***Pension Funds***

A further idea for addressing the extreme weakness of domestic demand and strengthening recovery is to explore whether the very significant amount of Irish resources in pension funds (noted in Section 3.3.1) could be used to fund more investment in Irish infrastructural and other strategic projects.

Any consideration of policy intervention which alters the pattern of investment needs to engage with two concerns: first, that the first duty of investors is to protect the value of the assets under their control and to seek the maximum return for this degree of risk; and second, that the actions of those managing investment, by definition of being freely undertaken, do generally achieve these goals. In the light of the experience of the past decade, there can be no general presumption that financial market outcomes are necessarily in the long-term interests of those who have made deposits/investments; or that they are conducive to good overall economic performance at international level.

This is not to say that it is easy to identify policy actions that can ensure that Ireland's strong rate of savings and high level of financial assets are put to the service of Irish investment. But it certainly suggests that—conceptually and practically—there is every reason to explore the possibility of such actions.

There are reasons to explore possibilities in this direction, not only in the interest of investment but also of Irish pension-policy holders. Irish pension funds are quite unusual in the degree to which they are exposed to equities and, as a result, to the

kind of finance sector risks that have materialised in recent years (Cotter *et al.*, 2011). The reasons for this need to be examined. Investment in infrastructure projects are typically seen as less risky or volatile than equities, but more risky than bonds. They may thus provide a means of balancing the risk portfolio of major pension-funds. Indeed, there is a growing interest among pension funds internationally in finding infrastructural projects, both economic and social, with the potential to provide stable returns over the long-term. (Inderst, 2009).

Ireland has made significant investments in infrastructure and continues to do so. However, there are projects that are not being pursued because of the unavailability of finance. Given the young age profile, and the need to further enhance the care and health infrastructure and infrastructural needs in relation to renewable energy and energy saving, there will be a need for further infrastructural investment. While there is a strong rationale for this, it will be of great importance to learn from the experience of the UK Private Finance Initiative, since economic and accounting analysis has questioned the value yielded to society and the level of returns to private investors. The experience of other countries who have developed effective public-private partnership models should also be examined.

This section suggests that there may be some infrastructural investment opportunities and that pensions-funds in general are interested in this type of investment. It is also worth noting that as the cost of Government borrowing has increased this also makes alternative funding potentially more attractive. Discussion with the pension-fund industry is now required to explore these issues further and to identify any policy actions. Issues for consideration would include how pension-funds assess risks and set benchmarks for measuring the investment performance of investment assets; current rates of return being achieved by Irish pension-funds; and the potential that exists to attract pension-fund investment into Irish infrastructures.

### ***High-profile 'Local' Projects***

There is a need to consider how high-profile projects, in a local region could attract investment from within those communities. The Medium-Term Exchequer Framework highlights that funding will continue, though the scale will be less than in recent years, for major tourist projects such the Book of Kells Visitor Centre in Trinity College, the Viking Triangle in Waterford, The Great Western Greenway in Mayo, King John's Castle and the Limerick Riverside, and Killarney House and Derrynane House in Kerry. When it comes to future commitments, it states that priority will be given to relatively low-cost projects to enhance or renew existing attractions and provide new ones. In particular, there will be a greater focus on activities such as recreational walking and cycling. These are the types of projects

that have been used in other countries, as we discuss further in Section 5.4, to generate direct-employment on a temporary basis in communities experiencing particular need. These projects should also improve the productive capacity of the economy in the medium- to long-term.

There is also a need to consider in more general terms how government might support local initiatives. There are a number of local-led initiatives, such as the Local Heroes project in Drogheda<sup>13</sup>, which are finding ways to increase demand for local products and services and creating employment. Given the fiscal constraints, government may have a limited role in the traditional sense of provision grants in these types of projects. However, further discussion with local groups may highlight new ways in which the public sector can engage with them, for example by helping to address constraints or accessing and using data. In the face of a crisis of this severity, the public system needs to be as imaginative as the many local and civil-society groups that are seeking ways to promote economic activity and meet unmet needs. Indeed, our work suggests that many parts of the Irish public system have demonstrated similar problem-solving capabilities as social organisations and enterprises (NESDO, 2009).

### ***Housing and Housing Policy***

A review of housing and housing policy could ensure that, post-crisis, Ireland develops a sustainable and socially balanced housing system. In 2004, the Council identified issues and anxieties that existed in relation to housing—including market instability, inequality and the sustainability of housing patterns; analysed the drivers of demand and supply; and assessed future policy challenges (NESC, 2004a). While the context has changed in terms of the collapse in house prices, the need for this type of analysis remains essential to the social and economic future of Irish society. In addition, a shift away from owner-occupied-led demand, as noted above, would have important policy implications—in areas such as tax on property and rent; planning and sustainable housing patterns; and standards and regulation of rented accommodation.

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<sup>13</sup> See [www.droghedachamber.com](http://www.droghedachamber.com)





# Chapter 4

## Credit and Finance

## 4.1 Introduction

Ireland's economic downturn has been characterised initially by a slowdown in credit growth, and since 2009 the outstanding level of credit to the private-sector has fallen. To a considerable degree, the fall in credit is an inevitable part of Ireland's economic adjustment; indeed, reduction in outstanding debt is a central feature of the economic adjustment in the world economy. The question arises as to whether the fall in credit is having an unnecessarily negative influence on the economy. The fall in credit is a real concern if it restricts the ability of businesses to undertake viable business proposals. It is also a concern if it has the effect of excessively limiting the ability of solvent households to avail of credit. This chapter considers evidence on the access of enterprise to credit in the downturn and also discusses evidence on the longer-run role of the banking system in supporting economic development. We also discuss international experience on the role of credit and policy responses at national and European levels.

Our approach contains a number of elements. We attempt to provide a balanced account of the continuing debate about whether the problems in relation to financing of small and medium-sized enterprises (SMEs) are predominantly supply-side or demand-side. But we also attempt to look beyond this debate, since its focus on arm's-length transactions does not get to the heart of the matter. Certainly, the evidence surfaced on the debate about demand and supply has revealed the need to look in more depth at the interface between supply and demand—the relationship between lending and investment institutions and Irish SMEs. Indeed, across the liberal world we confront the need to find new relationships between finance and the real economy. In the Irish context, we find some evidence that, at a practical level, approaches to SME finance and development are emerging that involve new relationships between SMEs, banks and third parties, such as Enterprise Ireland and the Enterprise Boards.

## 4.2 Evidence on Finance for Enterprise

### 4.2.1 Institutional Context: The Credit Review Office

Perceptions that the banks are unwilling to extend credit have been apparent for some time. In the December 2009 budget, the Minister for Finance announced that a review process would be setup for SMEs, sole traders and farm enterprises that have been refused credit from banks participating in the NAMA scheme. The new

Credit Review Office (CRO) would examine credit policy to assist the Minister in deciding what further actions may be necessary to increase the flow of credit.

The CRO accepts applications from SMEs, sole traders and farm enterprises that have had their application for credit (for sums from €1000 up to €500,000) refused or reduced, or have had credit facilities withdrawn, and feel that the bank's decision is unjustified. The CRO will, on application from the borrower, carry out an independent review of the bank's decision, which it may dispute. The CRO has no regulatory or mandatory powers over the opinions it gives on applications. However, to date the banks have complied 100 per cent with the recommendations of the CRO. The outcomes of the appeals are collated into a regular report for the Minister for Finance to inform the government on how the credit system is operating in the participating banks.

The CRO has been operating since April 2010 in reviewing the credit decisions of the two main Irish banks, Allied Irish Banks and Bank of Ireland. Only a small number of potential borrowers have requested it to review credit decisions by banks. Up to November 2011, it has upheld 36 decisions to refuse credit and disputed 41. It has begun to provide a quantitative illustration of the implications of its review decisions by indicating that its overturning of bank decisions meant that €3.49m of credit was provided for in the period up to November 2011 and 417 full-time jobs and 21 part-time jobs were protected (CRO, 2011a).

#### **4.2.2 Evidence on the Supply and Demand for Finance**

##### ***Demand for Credit***

A CSO survey on finance for SMEs found that the share of enterprises applying for finance fell from 37 per cent in 2007 to 31 per cent in 2010 (CSO, 2011b). A series of Mazars surveys found a larger fall in the demand for credit in recent years. The first Mazars survey (Mazars, 2009), found 52 per cent of SMEs had sought credit in the twelve months to June 2009, while this had fallen to 36 per cent in the most recent survey, which covered the six months to October 2011 (Mazars, 2011). The periods covered in the two surveys, are different (twelve months versus six months), but there would appear to have been a substantial real fall in the demand for credit. There are a number of differences between the Mazars and the CSO surveys that can explain the differences in results. First, the years covered by the respective surveys are different. Second, there is a difference in the composition of the sample of SMEs covered. The CSO results are based on a sample of enterprises that had between 10 and 250 people employed in 2005 and still employed 10 people in September 2010. The Mazars surveys are based on separate samples in

each survey period and microenterprises (those employing less than ten people) are included.

In the Mazars surveys, those who had not sought bank credit were asked why this was the case. The most common reason for not seeking credit was that credit was not needed (80 per cent). Enterprises were also asked about their expected demand for credit in the period ahead. The results point to a continuing fall in demand for credit, with 24 per cent expecting to seek credit in the six-month period to March 2012.

### ***Supply of Credit***

The evidence on access to finance by enterprises is discussed in the recent NESC Secretariat paper on the economy (NESC, 2011b). The discussion here will be brief, focusing on the most recently published evidence.

The CSO (2011b) survey found that there was a large fall in the share of bank loan applications that were successful between 2007 and 2010. In 2007, 95 per cent of bank loan applications were successful, while this had fallen to 55 per cent by 2010. If partially successful applications are also taken into account, 98 per cent of bank loan applications were either fully or partially successful in 2007 (i.e., only 2 per cent of applications were fully rejected), while in 2010, 74 per cent of bank loan applications were fully or partially successful (i.e., 26 per cent of loans were rejected).

More recent information on enterprises experience in seeking credit is available from the Mazars (2011) survey. It shows that in the period April to September 2011, 70 per cent of enterprises were either fully or partly successful in obtaining bank credit; i.e., 30 per cent of applications were declined. This is a somewhat higher rate of decline than shown by the CSO survey for 2010. The Mazars survey found that the highest rate of decline of credit requests was experienced by microenterprises for whom the decline rate was 44 per cent. These microenterprises, are not included in the CSO survey, as noted above<sup>14</sup>.

Eurostat data shows that in 2007 the share of bank loan applications by SMEs in Ireland rejected (i.e., neither fully nor partially successful) was the second lowest in the EU (of twenty countries for which data is available). In the period from 2007 to

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<sup>14</sup> These decline rates quoted in the text exclude pending applications; i.e., applications that have been submitted but a decision has not yet been made. If pending applications are included in the calculations, then at the time of survey 23 per cent of all applications had been declined.

2010, the increase in the share of unsuccessful loan applications in Ireland was the second highest in the EU, with only Bulgaria having a larger share. By 2010, Ireland's ranking for loan rejection rates was the second highest in the EU. Further international comparisons are drawn by Lawless and McCann (2011). They point out that the increase in loan rejection rates for Ireland over this period was even more pronounced than the experience in Eastern European countries over the period 2005 to 2009. They also note that the rejection rates for Irish SMEs are higher than rejection rates for high-risk UK companies.

A survey by the ECB and the European Commission (ECB, 2011) confirms that credit continued to be relatively less accessible for Irish SMEs in 2011. During the six month period to September 2011, this survey found that 23 per cent of loan applications from Irish SMEs were rejected outright compared to an average for the euro area of 10 per cent. The rejection rate for Irish SMEs was the highest out of 11 euro area countries. The survey also found that just 27 per cent of Irish SMEs obtained all of the finance that they were seeking compared to a euro area average of 63 per cent. This was the lowest figure of 11 euro area countries.

The impact and significance of credit decisions depends not just on the rates of success or rejection but also on the quality of applications that are rejected. It is of less concern if banks are rejecting applications from weak companies than if there is a high rate of credit refusal to companies generally. Lawless and McCann (2011) used the CSO survey on access to finance, in conjunction with other CSO enterprise surveys, to examine the performance of successful and unsuccessful credit applications. The performance measures considered were labour productivity, labour productivity as a percentage of the frontier (most productive) firm in the sector, sales and sales growth. They found no evidence that there was a statistically significant difference in performance across these four indicators between enterprises that were successful and those that were not successful in obtaining credit. There was some difference in terms of sales growth, companies that had been successful in obtaining credit in 2010 had higher sales growth in 2007/2008 compared to those who had not been successful in obtaining their desired finance but the difference 'is a long way from being statistically significant' (Lawless and McCann, 2011:11) The impact of exporting was also examined. They found that exporters were just as likely as non-exporters to be rejected. The results quoted held whether success was defined in terms of being fully successful only or including both fully and partially successful applications.

The impact of performance on companies' success in obtaining finance was also examined in the Mazars (2011) study, with performance measured by changes in turnover and profit. The Mazars study found that companies which had experienced an increase in turnover had a lower decline rate (21 per cent) in their credit

applications than companies that had a decrease in turnover (27 per cent). They also found that companies that made a profit had a lower decline rate (20 per cent) than those that broke even (26 per cent) or made a loss (24 per cent).

Lawless and McCann also examined the ability of Irish SMEs to access credit relative to *comparable* firms in other euro area countries. This meant looking at the rates of rejection of loan applications by Irish SMEs, while controlling for a range of observable characteristics that are likely to affect the ability to obtain credit. The control variables used in their analysis included factors such as turnover, employment, sector, profit, capital and credit history. In matching Irish firms to comparable firms in other euro area countries, they estimated that there was a large effect not explained by the characteristics of the applying firm. 'This effect, explained solely by the fact that the firm is Irish, is interpreted as evidence of significant credit rationing on behalf of the Irish banking sector relative to other European countries' (Lawless & McCann, 2011: 21-22). They found that an Irish firm was 11–14 per cent more likely to be refused credit than a matched firm from Portugal, Italy, Greece or Spain and 25–29 per cent more likely to be refused credit than a matched firm from another euro area economy.

A caveat in regard to the findings of Lawless and McCann (2011) is that the research used a relatively small sample of Irish SMEs and, consequently, they do not regard their findings as conclusive. However, it represents the most comprehensive, independent piece of analysis that has been conducted to date; it is indicative that the availability of credit is a real problem for Irish SMEs at present.

In its various reports, the Credit Review Office has disputed what it sees as the conventional wisdom that 'banks aren't lending'. It has pointed out that some decline in lending activity has to be expected in a more prudent and healthy banking system. The most recent report of the CRO notes that the message from the two main banks' head offices to SMEs and farms are that 'they are open for lending to viable businesses'. However the report also states that this message is not always evident on the frontline:

The two banks however need to ensure that tenor of their corporate messaging is matched by their frontline staff interfacing with customers, where the message is far from clear that there is a desire to do business – indeed sometimes quite the reverse (CRO, 2011a: 3).

Earlier reports of the CRO recognised that the banks needed time to address capital and skills deficits. In the most recent report, the CRO refers to the return to growth in the economy and encourages 'the banks to be more proactive in ensuring that viable businesses are able to access credit they need to recover and grow' (CRO, 2011c: 3). The CRO identifies the two main issues as follows:

- i. the strict imposition of tight credit policies by Head Offices;
- ii. the lack of solution-finding and deal-making skills in frontline staff (CRO,2011d:3).

The CRO comments on bank lending policies as follows:

My opinion is that banks have returned to having traditional prudent cashflow lending at the centre of their lending policies. These policies are being somewhat rigidly applied, with an observed lack of solution-finding or deal-making appetite being evident for SME and farm borrowers, when they interface with the frontline lenders in the banks. This use of rigid credit-score-based lending policies has the potential to result in some viable businesses being unable to access the credit they need (CRO, 2011a:3).

Earlier reports of the CRO have commented on the difficulties that some businesses have in producing the kind of information that banks now expect in any credit review. The CRO has noted that its reviewers have witnessed many cases in which financial accounts have only been produced for a tax computation and cashflow forecasts have only been produced at the bank's request. In this light, the CRO has recommended that business organisations and accountancy bodies should work with SMEs to hone their business planning and financial skills and that the State should support upskilling of management capabilities. The CRO has assisted AIB and Bank of Ireland in developing a standard lending application for SMEs and is seeking to have this extended to other banks. The standardisation of the information required for bank loans should be of help to customers seeking loans and their advisors.

The fourth quarterly report of the CRO highlighted the lack of solvency of small businesses as a reason why banks were not lending. It was noted that examinership was not a viable option for small businesses due to its high cost. Hence, 'there needs to be a process where businesses that can demonstrate future viability through a recovery plan to be "right sized" by e.g. (a) Debt/Equity swaps or (b) debt write-off and restructure' (CRO, 2011c). The CRO proposed that banks should use some of their capital to 'save' good SMEs. It was argued that this would require some government initiative to underwrite this lending as some of this lending would be beyond prudent cashflow lending criteria. This would involve a separate initiative to the loan guarantee that is due to come into operation in 2012.



### 4.2.3 Credit Assessment Capabilities

The apparent lack of a relationship between enterprise performance and credit decisions, identified by Lawless and McCann (2011), raises the question of the ability of the banks to effectively undertake credit assessment. A review of SME lending strategies by the Central Bank found that ‘the banks have a significant retraining challenge to ensure their staff possess the requisite credit skills to execute their SME plans’ (Central Bank, 2011:54). The recent OECD *Economic Survey: Ireland* referred to the banks’ lack of experience of SME-lending based on cash flows rather than collateral and noted that the situation was further complicated by the fact that SMEs were under financial pressure and the lack of local market knowledge by the banks (OECD, 2011a).

The first report of the Credit Review Office (CRO, 2010) also noted evidence of a ‘lack of experience’ among some frontline banking staff in relation to dealing with SMEs and helping them with their loan applications. A later report (CRO, 2011b) commented that satisfactory progress is being made by the banks in relation to their commitment to run training programmes for frontline lenders and support staff—with plans by the banks to train staff lending to the SME sector. Both banks have recruited specialists in lending for the agricultural sector. In addition, the CRO commented on the beginnings of systematic collaboration between the banks and Enterprise Ireland (EI), with the cross-secondment of staff from EI into the banks and vice versa, to develop the sectoral understanding of banking staff.

As in other spheres—such as training and further education for the unemployed and early school leavers—we should not be reassured merely by the existence of training programmes. It is the quality of such programmes and the use made of the acquired skills, that counts. The most recent report of the CRO commends the banks’ upskilling of staff but raises significant concerns in regard to how the banks make use of the skills of their staff:

I would urge them to give their staff the confidence and support they need to develop their banking skills beyond the theory of lending. The ‘art’ of banking is in working with borrowers to seek solutions and an acceptable deal for everyone in terms of risk and pricing. Banks appear to be abandoning these traditional skills (CRO, 2011a:3).

In addition, the CRO comments that from the feedback received it appears that:

a more traditional branch manager centric approach to SME/farm lending, with an appropriately overviewed level of lending discretion devolved to the frontline, is what the market wants. This model could be considered appropriate for the challenges the economy faces today,

having served AIB, Bank of Ireland and the other banks well in the past; and it should be remembered that it was not these smaller level SME/farm lending decisions that caused the banking crisis (CRO, 2011a:3).

These observations by the CRO point to the desirability of further significant reform in the banking system.

#### **4.2.4 Other Forms of Finance**

SMEs are less likely to seek forms of finance other than bank loans. The CSO (CSO, 2011b) survey found that while 31 per cent of SMEs sought loan finance in 2010, just 4 per cent sought equity finance in the same year. The percentage seeking equity finance in 2010 was marginally higher than in 2007, when 3 per cent sought equity. The percentage of SMEs that sought finance other than loans or equity in 2010 was 20 per cent. The CSO survey also shows that the success rate of those seeking non-bank sources of finance has fallen by less than that experienced by those seeking bank loans. The success rate for equity finance fell marginally from 66 per cent in 2007 to 65 per cent in 2010. For sources of finance other than loans or equity, the success rate fell from 92 per cent in 2007 to 80 per cent in 2010.

The Mazars survey (Mazars, 2011) found that just 11 per cent of enterprises sought non-bank finance in the period April 2011 to September 2011. Of those seeking non-bank finance, 62 per cent were either fully or partially successful; this was lower than the success rate for bank loans in the Mazars survey.

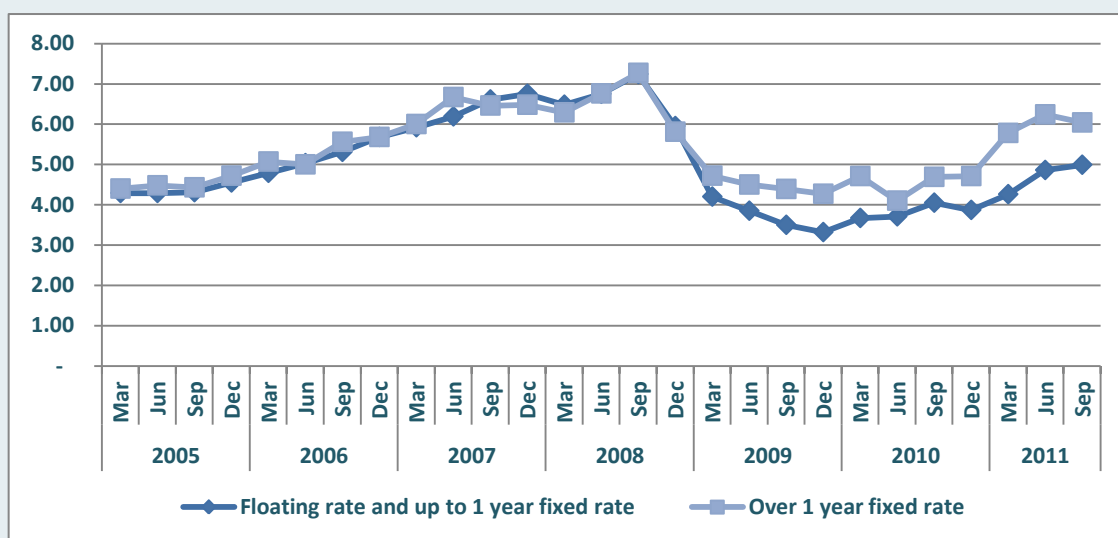
Compared to other EU countries, Eurostat data shows that Ireland ranked eleventh out of twenty EU countries in terms of the percentage of SMEs that sought equity in 2010 (3.6 per cent). The countries with the highest percentage of companies seeking equity were Greece (32.2 per cent), Luxembourg (11.9 per cent) and Belgium (8.7 per cent). The countries with the lowest share of SMEs seeking equity were the UK (1.4 per cent), Italy (1.1 per cent) and Germany (0.7 per cent).

In regard to finance other than loans or equity, Eurostat data show that the share of SMEs seeking this type of finance in Ireland at 17.3 per cent was among the lowest (sixteenth out of twenty) in the EU. There could be scope to further develop the use of other types of finance by Irish companies. In particular, there could be potential for greater use of bond financing by the middle to larger companies.

#### 4.2.5 Costs and Conditions of Credit

In addition to the availability of credit, the prices and the terms and conditions on which it is available are also issues for business. Interest rates reached a peak in September 2008 and then fell sharply. Since the start of 2010, interest rates have risen. Interest rates vary by size of loan, the risk involved and between outstanding amounts and new business loans. The Central Bank publishes average interest rates for key loan categories. For new business loans on amounts up to €1 million on variable interest rates (and rates fixed for up to one year), the interest rate fell by more than half from September 2008 to December 2009. Since then, there was an increase of 1.7 percentage points. This brings interest rates back to the level of 2007.

Figure 4.1 Interest Rates on Business Loans up to €1 Million

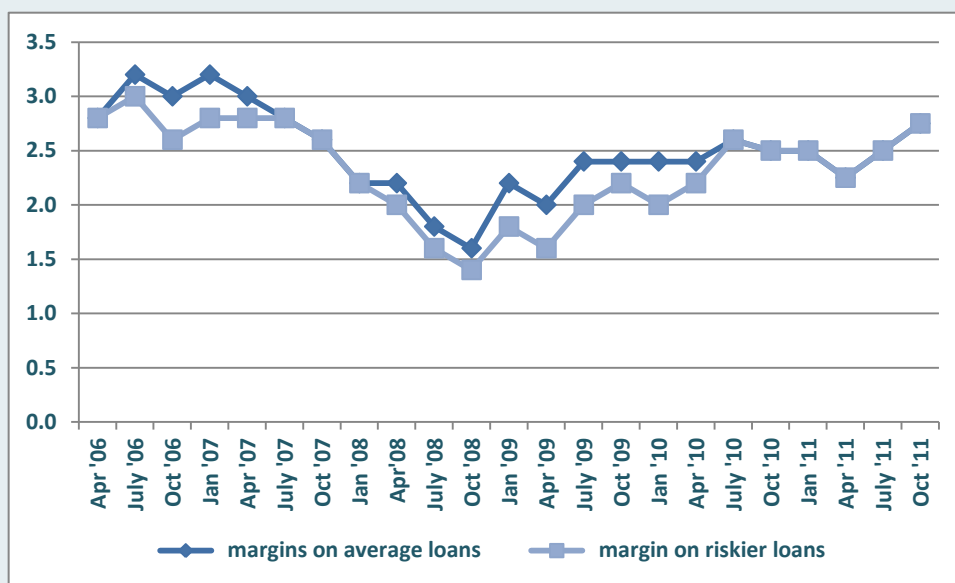


Source Central Bank of Ireland, Euro Area Bank Lending Survey, October 2011

Retail interest rates depend on banks' cost of funds and their margins. The CRO (2011) notes that the cost of funds for each bank depends on its funding structure and varies for each bank. Information on changes in margins on loans, and other matters, as perceived by banks, is available from the Euro Area Bank Lending Survey

(Central Bank, 2011). In this survey banks are asked to rank their perception of the change in the variable concerned on a five-point scale. A ranking of three indicates that there has been no perceived change in the variable concerned, for example, loan margins, compared to the previous quarter. A ranking below three indicates a widening of margins or a tightening of terms and conditions. A ranking above three indicates a narrowing of margins or an easing of terms and conditions. The survey shows that, since 2007 there has been a widening of perceived margins and this has continued up to the third quarter of 2011 (see Figure 4.2).

**Figure 4.2 Changes in Loan Margins as Perceived by Banks<sup>15</sup>**



Source Central Bank of Ireland, Euro Area Bank Lending Survey, October 2011

<sup>15</sup> Ranking of three means no change. Ranking below three means perceived widening of margins.

Terms and conditions are monitored in this survey in relation to the following variables: non-interest rate charges, size of loan, collateral requirements, covenants and maturity. A tightening in terms and conditions of lending is also evident in the survey results. For all of these variables there was a tightening of conditions (i.e., ranking below three) from the final quarter of 2007. For three variables (collateral requirements, loan covenants and maturity), this has continued up to the final quarter of 2011. For the other two variables (non-interest rates charges and size of loan), there was a stabilisation in conditions during 2010.<sup>16</sup>

#### **4.2.6 The Role of Finance in Ireland's Economic Development**

Beyond the current economic crisis, there are questions concerning the contribution of the financial system to Ireland's economic development in the long run (Ó Riain & O'Sullivan, 2011). Ó Riain notes that in the decade to 2007, the vast bulk of the increase in bank lending went to construction, real estate development and mortgage finance (Ó Riain, 2009). By contrast, there was relatively limited bank lending to expanding export sectors; for example, lending to computer services firms remained a tiny percentage of total lending (0.05 per cent in 2007). Honohan pointed out that most of the debt of the non-financial corporate sector in Ireland in 2005 was borne by a small number of international firms who sourced their debt abroad. 'The role of Irish finance in long term growth appears muted when placed in international comparison' (Honohan, 2006:60). He emphasised the role of global financial integration in filling the gap: 'Quietly the rest of the world has taken up the slack in facilitating the financing of the larger companies operating in Ireland and also in easing financing surges in credit demand' (*ibid.*). Ó Riain highlights the significance of Enterprise Ireland in financing high-tech investment and stimulating the emergence of a venture capital in Ireland. This is further discussed below.

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<sup>16</sup> Non-interest rate charges had a ranking of three from the final quarter of 2010 up to the third quarter of 2011, while size of loan had a ranking of three in every quarter except one quarter from the second quarter of 2010 to the third quarter of 2011.

## 4.3 International Experience

### 4.3.1 Credit and Economic Recovery

The role of credit in economic recoveries has been extensively studied. A number of papers have found evidence of ‘creditless recoveries’; i.e., economic recoveries in which the real rate of bank credit growth is zero or negative in the initial years. An IMF staff paper estimated that around one in five economic recoveries is creditless (Abiad *et al.*, 2011). However, that paper also found that such recoveries are considerably weaker than normal recoveries.

Other research has questioned the evidence on creditless recoveries. Biggs *et al.*, 2010 have argued that the evidence on creditless recoveries is based on an inappropriate comparison between GDP—a flow variable—and the stock of credit. To the extent that spending is financed by credit, they argue that demand (and hence GDP) in a period should be related to the net expansion of credit in that period; i.e. the flow of credit or the change in the stock of credit. When one looks at the *change* in GDP it would be expected to be related to the *change in the flow of credit* and not change in the stock of credit.<sup>17</sup> They re-examine empirical data on creditless recoveries and show that during these episodes there is a relationship between GDP and the *flow* of credit rather than the stock of credit.

Where total credit is contracting, it is still possible for *changes* in the flow of credit to move in a positive direction. The logic of this argument is that a slowdown in the pace at which credit is contracting may be sufficient to boost demand growth. ‘A credit-led rebound in domestic demand can occur even while credit growth is negative’ (Biggs *et al.*, 2010).

Biggs *et al.* provide empirical evidence for their argument from recent US experience as well as the Great Depression. The level of credit in the US fell in the final quarter of 2008 and continued to fall in the first three quarters of 2009. However, as the pace of decline in credit contraction moderated, there was a rebound in the economy. Likewise, during the Great Depression, credit fell in 1934

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<sup>17</sup> In mathematical terms, this means relating the change in GDP to the second derivative of the stock of credit. For example, if the stock of credit increases from €100 billion in one year to €110 billion in the next year, the flow of credit is €10 billion. If the credit stock increases to €120 billion in the following year, the flow of credit is again €10 billion. In this case the flow of credit in each year is €10 billion. There is no change in the flow of credit between the two years so in this case credit would not make a contribution to the growth of demand of GDP.

and 1935 but the pace of decline slowed and there was a recovery in private-sector demand. Both of these episodes illustrate that a slowdown rather than reversal in the rate of private-sector de-leveraging can be sufficient to achieve a recovery in demand.

#### **4.3.2 Access to Credit for SMEs in OECD Countries**

An OECD report found that access to financing continues to be one of the significant challenges for SMEs, especially innovative ones, and that this had been strongly exacerbated by the financial and economic crisis (OECD, 2009). This OECD report identified anti-crisis responses to the problems of SMEs and classified them into three groups:

- i. Measures supporting sales and preventing depletion of SMEs' working capital; relevant instruments include export credit and insurance, tax reductions and deferrals and better payment discipline by governments;
- ii. Measures to enhance SMEs' access to finance through bank recapitalisation, expansion of existing loan and credit guarantee systems;
- iii. Actions aimed at helping SMEs maintain their investment capacity through measures such as investment grants, accelerated depreciation and R&D financing.

The report found that the most widely used policy measure to increase access to finance was the extension of loans and loan guarantees. There is wide variation in the design of these measures.

In addition to the anti-crisis measures, this OECD report proposed a number of recommendations for consideration to address long-standing concerns in the SME financial environment. The list of recommendations is both valuable in itself and a striking confirmation of how far financial services have fallen behind other services in the sophistication of its engagement with actors in the real economy:

- Encourage banking competition across economies;
- Monitor SME lending and establish a code of conduct for SME lending by banks (Ireland has such a code);

- Automated lending systems are widely used for SME lending. Banks could consider providing discretion in decision-making so that ‘adequate room be left for the specificities of the client’;
- Systems are needed to evaluate credit risk of SMEs on a company basis rather than a sectoral basis;
- Microfinance (finance for enterprises with less than ten employees) schemes could be developed in countries without such schemes;
- Develop the managerial competence of SMEs including in the field of finance;.
- SMEs should be involved in design of policies and programmes.

To appreciate the full significance of this, we need to recall that the SMEs that have, almost incredibly, been facing a banking system **without these characteristics** have, at the same time, been involved in sub-supply networks with large firms, and relationships with environmental and food safety regulators, which involves deep, context-specific, monitoring and sharing of fine-grained information on every aspect of their operations. This highlights the extent and nature of the transformation that needs to happen if finance—not only in Ireland, but across the liberal world—is to find a new, and more productive, relationship with the real economy, as we discuss briefly below.

In addition, it is of interest to note what the OECD has to say on one aspect of finance that has been innovative in a socially useful way and that has continued to see financial services as a combination of finance and **services**—i.e., venture capital. The OECD report found a relative shortage of measures in OECD countries to encourage venture capital, and considered that there was scope for additional incentives to promote venture capital or ‘business angels’. Suggested measures include increasing guarantees for risk capital, more co-investment by public bodies, and tax credits for venture-capital investments.



## 4.4 National Policy Responses

### 4.4.1 Improving Access to Finance

Irish public policy has long played a role in the financing of enterprises through EI, County Enterprise Boards and other agencies. With the economic crisis the State has made major interventions to rescue and restructure the banking system. In addition, there have been a number of targeted interventions to secure the availability of finance for enterprise. As noted above, the CRO was established to review credit decisions by banks (Bank of Ireland and AIB at present) with regard to SME and farm lending. Under the recapitalisation legislation, Bank of Ireland and AIB were required to sanction €3 billion each in new or restructured lending per year for two years, starting from April 2010. The target was exceeded for the first year.

A higher target of €3.5 billion has been set for 2012. Two new initiatives to assist firms in accessing credit are due to come into place early in 2012. First, a temporary, partial, credit-guarantee scheme will be introduced. A credit-guarantee scheme is essentially a form of insurance of the potential losses that a bank incurs when providing a loan. The scheme will target commercially viable companies with the capacity to repay loans, but who have difficulties accessing credit due to either of the following: (i) insufficient collateral or (ii) the lender has insufficient skills or experience to properly assess the proposition due to a lack of knowledge of new sectors, markets or technologies. Second, the government has announced its intention to establish a microfinance start-up fund to provide loans on a commercial basis to start-up businesses and microenterprises. The exchequer is to allocate €10 million to the fund and it is intended to obtain additional private funding.

In 2009, EI established a small team, the Department of Banking Relationships, that works with the Irish banks to improve their capacity to work with SMEs. The focus is on the three major banks (Bank of Ireland, AIB and Ulster Bank), but a number of foreign banks in Ireland are also involved. This was initially triggered by difficulties encountered by EI clients in securing credit following the financial crisis, but also seeks to address long-term structural dimensions of the relationship between the banking system and enterprises. EI is seeking to encourage banks to develop deeper expertise in key growth sectors of the economy, such as software and life sciences. In addition, EI is working actively to further develop the SME capabilities of the Irish banking system, and argues that it needs to adapt to meet the needs of a modern, internationally trading, small open economy. It envisages a banking system that:

- Assesses loan applications with informed assessment of company business plans and cash-flow projections;
- Provides supportive services (advisors, workshops, etc.) to help SMEs assess their finance and credit options;
- Has deep sectoral expertise, particularly in relation to new growth sectors (e.g., software, ICT, life sciences, cleantech);
- Provides internationalisation teams capable of linking Irish SMEs with international finance providers abroad; and to have a range of risk-sharing facilities for export growth activities, comparable to what is available to competitors abroad.

On the demand side, the CRO has been critical of the quality of business planning in evidence from a significant number of SMEs. It comments:

It is essential that any business that is fighting for survival prepares a recovery plan—supported by cashflow forecasts to establish future viability. There is a role for banks, small business organisations, trade bodies and accountants to facilitate and support SMES in producing such plans in an affordable and timely way. There may be a role for Government to lead and co-ordinate a programme to facilitate recovery plans being prepared for SMEs, in a way that ensures it does not become a fee fest on hard pressed SMEs (CRO, 2011c:3),

and

... It is essential that the State supports the public and private sector to upskill management capabilities especially to smaller enterprise promoters to ensure they understand and can deal with their obligations as Directors and business decision makers (CRO, 2011c:3).

There is evidence emerging, too, that Enterprise Ireland is beginning to recast its model of developmental support for SMEs. Partly in order to cast a 'wider footprint', EI is now distinguishing the type of service required of SMEs, according to their state of readiness for export growth. EI allocates its generalist Development Advisors and expert Sectoral Specialists to work intensively in one-to-one relationships with those client companies that are in a state of readiness to commence or grow their exports. These advisors support the SME on all aspects of its growth plan, from detailed business planning, through finance planning and loan applications (including engaging with banks on the client's behalf), and onwards to

implementation. For other clients who are less ready for such supports, EI is beginning to work towards providing a range of preparatory supports: opportunities for leadership and management training and development, networking opportunities with other similar SMEs, working with business development mentors, diagnostic exercises, and briefing sessions on export growth opportunities. Once SMEs have developed their awareness and skills to the point of being ready and prepared to enter the detailed planning phase, they move on to the one-to-one support offered by the specialised advisors.

#### **4.4.2 Venture Capital**

Venture capital is medium- to long-term finance provided in return for an equity stake in potentially high-growth unquoted companies (IVCA, 2011). Enterprise Ireland has played a significant role in stimulating venture capital (Ó Riain, 2009). It is estimated by Ó Riain that the agency provided over 40 per cent (€115 million) of total venture capital (€274 million) in Ireland over the period 2000 to 2005. In addition to the direct provision of venture capital, EI has also encouraged the development of private-sector venture capital by establishing funds with private partners in which both EI and private partners contribute funds. By the end of 2010, total investment in funds set under EI's Seed & Venture Capital Programme 2007–2012 reached €618 million.

Innovation Fund Ireland is a recent initiative to encourage venture capital investment in innovative companies. It was one of the proposals in the government's *Building Ireland's Smart Economy* document published in 2010. It is designed both to increase the number and scale of innovative businesses in Ireland and to attract international venture-capital fund managers to Ireland. It was launched in the New York Stock Exchange in July 2010. Up to €250 million of public money will be available to the Fund and it is intended to attract additional private investment. The exchequer is providing €125 million to be managed by EI. A first call to fund managers to make investment proposals to EI for this component of the fund was issued in September 2010. Fund managers that receive money from this fund must commit to investing an equivalent amount in Irish companies or companies with substantial Irish operations. A second invitation to fund managers in relation to the remaining EI-managed component of the fund will be issued in the first quarter of 2012. In addition, the National Pensions Reserve Fund may make commercial investments through the fund of up to €125 million. The first NPRF investments under Innovation Fund Ireland were announced in October 2010.

Entrepreneurs in high-growth sectors in Ireland at present have considerable opportunities to seek seed and venture capital (Reddan, 2011). Accessing this type of funding requires entrepreneurs to give up equity shares in their enterprises.

#### **4.4.3 New ERA and the Strategic Investment Fund**

In September 2011, the government announced the establishment of New ERA and the Strategic Investment Fund. New ERA will reform the management of the State's shareholding in major commercial State companies: ESB, Bord Gáis, EirGrid, Bord na Móna and Coillte. Its responsibilities include reviewing capital-investment plans of these companies and identifying synergies between these plans. It will support the work of the Minister for Public Expenditure and Reform, who has responsibility for the disposal of State assets.

New ERA will also undertake the development of a new Strategic Investment Fund, which will be a forerunner of a Strategic Investment Bank. The Strategic Investment Fund will comprise a series of funds that will make commercial investments in the Irish economy. It will invest money from the NPRF—this will require legislative change—and will also seek matching investment from private investors. The areas for investment include infrastructure, venture capital and provision of long-term capital for SMEs. The first of these sub-funds was announced in November 2011. This consists of an infrastructure fund that will invest in 'new and existing infrastructure assets'. Investment in existing infrastructure assets implies that existing State assets will be sold to this fund. The NPRF is to invest €250 million in this fund while the fund will seek up to €1 billion from institutional investors. The fund is to be managed by a private fund manager.

#### **4.4.4 ICC Bank<sup>18</sup>**

The commitment in the Programme for Government to establish a Strategic Investment Bank calls to mind Ireland's earlier experience of the Industrial Credit Company (ICC). ICC was established by the State in 1933. The public was invited to buy shares in ICC but there was limited public interest. Consequently, the State held over 98 per cent of the shares. The initial mandate was to provide long term

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<sup>18</sup> This subsection is based on a review by Casey, (2000).

capital to industry through loans and share capital investment and by the underwriting of public share flotations. In its early years it had very limited capital and its main activity was in sponsoring share issues. Its activity in this area was associated with almost a doubling of the number and value of quoted shares on the Irish Stock Exchange (ISE) in the period 1934 to 1938. Notable companies that were first brought to the stock exchange by ICC include Newbridge Cutlery, Cement Limited, the Irish Sugar Company and Roadstone. In 1970, Cement Limited and Roadstone were merged to form CRH. In the first four decades of ICC's existence, it sponsored more than half of the flotations on the ISE.

Under the first programme of economic expansion, ICC was allocated an increase in its capital while at this time the Minister for Finance indicated that he was not seeking a dividend for ten years. Hence, in the 1960s for the first time, ICC had considerable financial resources available to it and its lending increased more than threefold over the decade. A report by the National Industrial and Economic Council (NIEC) highlighted the need for capital investment in the distributive sector. ICC took on this challenge and became a significant lender to the wholesale and retail trades. This represented ICC's first lending outside industry.<sup>19</sup> In 1968, ICC first began accepting deposits. Substantial deposits were obtained mainly from the corporate sector initially.

In 1973, ICC negotiated the first of many loans with the European Investment Bank (EIB). Loans from the EIB in conjunction with exchange-rate guarantees provided by the State enabled ICC to provide long-term loans at fixed interest rates to SMEs. Another development in the 1970s was the acquisition of properties for leasing to industrial and commercial customers.

Venture capital became a more significant element of ICC's activities during the 1980s. In 1987, venture capital was established as a separate division within the bank. In 1994, ICC launched its first venture-capital fund in which there was participation by external institutional investors. This followed discussions in 1993 and 1994, between the government, the Irish Association of Pension Funds and the Irish Association of Investment Managers on investing institutional funds in Irish companies. One quarter of the 1994 fund was invested in software and IT. Subsequently, a software-venture fund was established by ICC in association with Enterprise Ireland.

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<sup>19</sup> Industry was interpreted by ICC to mean manufacturing and the film industry. ICC provided long-term capital to Ardmore Studios.

ICC was profitable throughout its existence. Its assets grew from a modest IR£688,000 at the end of 1934, to over IR£2.4 billion at the end of 1999. It was sold to Bank of Scotland (Ireland) in 2001. Bank of Scotland (Ireland) ceased trading as a bank in Ireland in 2010. Its assets and liabilities were merged into Bank of Scotland. Certus was established to manage its existing loan book, but is not engaged in new business activity. The sale of ICC in 2001 represented a significant contraction of the institutional support for development of sustainable business in Ireland. The subsequent closure of Bank of Scotland (Ireland) represented a significant exit from the Irish business banking market.

## 4.5 European Union Programmes and Policy Responses

In considering business development and finance for SMEs, it is important to take note of EU programmes and new responses since the onset of the crisis in 2007. Indeed, several of the national policy responses, described above, have been supported by EU initiatives.

European industrial and enterprise policy is set out in Europe 2020 and associated Commission policy statements. The role of SMEs is viewed as critical to the economic development of member states, a point that is emphasised in the Commission's detailed industrial policy statement of June 2010 (European Commission, 2010b). Within this there has long been a particular focus on access to finance. Since the onset of the crisis the problem has taken on an acute dimension.<sup>20</sup> Thus, the policy approach to improving framework conditions for businesses includes both short-term, temporary measures and longer-term developmental measures to improve the levels of investment and access to finance for European businesses.

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<sup>20</sup> See, for example, OECD (2012) *Scoreboard on SMEs and Entrepreneurship*, which shows that in most OECD countries, business loans and SME loans declined markedly during the recession and, while they recovered somewhat in 2010, they did not reach their 2007 levels. It cites the Eurostat survey of 25,000 enterprises in Europe that shows that the share of successful loan applications by SMEs between 2007 and 2010 fell particularly sharply in Ireland (from 97 per cent to 53 per cent), Denmark (from 92 per cent to 60 per cent), Greece (from 88 per cent to 60 per cent) and Spain (from 87 per cent to 59 per cent).

The Small Business Act (SBA) (2008) sets out the policy framework for SMEs in Europe and its member states.<sup>21</sup> The emphasis of the SBA is on developing SMEs by alleviating the administrative burden, facilitating access to finance and supporting SMEs in accessing new markets. The Commission's recent review of the SBA (European Commission, 2011a) identified a number of ways in which public policy (at EU and member state levels) can better respond to the challenges facing SMEs in the current economic climate. It emphasises the need for further policy action in a number of areas, including access to finance through measures such as loan-guarantee schemes, improving access to venture-capital markets, and allowing banks (irrespective of size) to easily implement EIB loans and EU financial instruments.

Under both the Lisbon Strategy and the Europe 2020 Strategy, the EU has created a number of programmes to assist SME development. In addition, several programmes were adapted and new ones created in response to the crisis. Among the programmes that aim to increase access to finance for SMEs are:

- The Competitiveness and Innovation Framework Programme (CIP), with a budget of €3.621 billion, including over €1 billion to facilitate access to loans and equity finance for SMEs where market gaps have been identified;
- The High Growth and Innovative SME Facility (GIF) supports venture-capital funds;
- The SME Guarantee Facility (SMEG), created in 2007, provides loan guarantees to encourage banks to make more debt finance available to SMEs, including microcredit and mezzanine finance, by reducing the banks' exposure to risk.

Improving access to finance for SMEs is a major function of the (EIB). In September 2008, at the onset of the crisis, the European Council requested the EIB to increase its supports to European SMEs, and the investment levels for SMEs have increased by 50 per cent. Among its long-standing and crisis response instruments are:

- The European Investment Fund (EIF), is a major vehicle for venture-capital funding of European SMEs, providing both equity and loan facilities;

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<sup>21</sup> In Ireland, the SBA provides the policy context for government initiatives such as the Small Business Forum.

- The 'Loans for SMEs' facility allows the EIB support lending to financial institutions (intermediary banks) for onward lending to SMEs. The EIB has more than 170 intermediaries across the European Union, including the main banks in Ireland.<sup>22</sup>
- The Risk Sharing Finance Facility (RSFF), launched in 2007, provides loan finance to private and public entities to support additional investment in research, development and innovation in the order of €10 billion for the period 2007–2013;
- The EIB and the European Commission launched a new loan-guarantee facility for innovative SMEs in December 2011. It is designed to encourage lending to SMEs undertaking research, development or innovation. It will be managed by the EIF which will enter individual agreements with banks. In exchange for a fee, the EIF will provide a partial guarantee against losses on loans to SMEs. It is intended that this initiative will reach up to 500 enterprises in the EU.
- Joint European Resources for Micro to Medium Enterprises (JEREMIE) offers member states the opportunity to use part of their EU Structural Funds to finance SMEs by means of equity, loans or guarantees;
- Joint Action to Support Microfinance Institutions (JASMINE) is a pilot initiative launched in 2008 in response to the European Commission call (November 2007) for the establishment of a European initiative for the development of microcredit in support of growth and employment.

In its proposals for the new European financial framework for 2014–2020 (European Commission, 2011b), the Commission proposes a dedicated "Competitiveness and SMEs Programme" with a budget of €2.4 bn, which will focus on measures to promote more dynamic and internationally-competitive SMEs. This programme will place a heavy emphasis on access to finance for SMEs, and will include the use of innovative financial instruments (including an equity facility to provide venture capital for SMEs and a loan facility providing direct or other risk-sharing arrangements with financial intermediaries to cover loans for SMEs). Meanwhile, the Commission proposes that research and innovation support for SMEs will be

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<sup>22</sup> In 2010, Bank of Ireland and AIB each drew down EIB loans of €100m, while Ulster Bank drew down €100 million on an all-island basis.



included in the Common Strategic Framework for Research and Innovation, known as Horizon 2020.

The implementation of European-level strategies and financing resources is ultimately dependent on the capacity of 'partner institutions' within member states. In Ireland, the partner institutions include the main functioning banks and, in terms of direct supports to companies, agencies such as Enterprise Ireland, the City and County Enterprise Boards and Science Foundation Ireland. While Ireland would seem to be an active participant in EU programmes designed to improve the provision of financial services to SMEs, we are not in a position to judge the effectiveness of this activity. In the Irish case, any weak link seems more likely to be the banks than the state development agencies. Since the banks are a key intermediary in the transmission of EU funding, and since they are, by all accounts, including their own, relearning how to do financial services for SMEs, it is important that not only the financial regulator and the CRO, but also the development agencies and business associations, monitor their progress closely and work with them.

#### 4.6 Conclusions: From Crazy Credit, to No Credit to Financial Services?

Following Ireland's credit boom and severe banking crisis, it is to be expected that the economy would experience a fall in the stock of credit. International experience shows that it is possible for an economy to recover in these circumstances, but these 'creditless recoveries' are considerably weaker than normal economic recoveries. There is also evidence from the literature that, even when the outstanding stock of credit is contracting, there is a relationship between changes in the flow of credit and growth in the economy. This implies that a slower rate of credit contraction can make a positive contribution to demand in the economy.

There is evidence that the provision of credit is a concern for the Irish economy. There has been a reduction in the number of banks in the Irish market and a consequent reduction in competition. The contraction in credit in the Irish economy over the period 2007 to 2010 was the most severe in the EU. Survey evidence indicates that Irish SMEs in 2010 had a higher rate of rejection of credit applications than comparable SMEs in other euro area countries. A survey by the ECB and the European Commission showed that in 2011 Irish SMEs had the highest rate of rejection of loan applications of eleven euro area countries (ECB, 2011). The Euro Area Bank Lending Survey (Central Bank, 2011) indicates a tightening of

lending terms and conditions since 2007. The November 2011 report of the CRO commends banks for the upskilling of staff that they are undertaking but urges them to give staff the confidence and support to use their banking skills effectively. The report refers to an 'observed lack of solution finding or deal making appetite being evident for SME and farm borrowers' (CRO, 2011d:3). There are also weaknesses in the capabilities of SMEs to present credible lending propositions.

There is a gap between Ireland's requirements as a small internationally trading economy and its current banking system. There is insufficient capabilities in banks to effectively assess enterprises in new technology sectors. The international downsizing of Ireland's banks is an unhelpful trend from the perspective of having banks with the resources to support exporters to diverse international markets.

There has been a public policy response to the credit issue. A temporary credit-guarantee scheme and a new microfinance fund are to be introduced in 2012. A strategic investment fund has been established comprising a number of sub-funds. The first of these has been announced and will invest in infrastructure. This is to be a forerunner of a strategic investment bank.

While positive steps have been taken, further action is needed to ensure that Ireland develops a banking system that supports its potential as a small internationally trading economy. The Council views the proposal in the Programme for Government to establish a strategic investment bank as a key step to support business investment. A vice president of the EIB, Plutarchos Sakellaris, has recently indicated that a state development bank could be a solution for Ireland and that the EIB was willing, if requested, to provide advice on setting up such a bank (as reported by Ilhe, 2011).

Beyond arm's-length supply and demand relations, the August 2011 NESC Secretariat Paper, *Ireland's Economic Recovery*, proposed an institutional response, such as an independent investment taskforce with involvement from business people. Such a taskforce could monitor the emerging policy initiatives and ensure that the issue of credit is effectively addressed.

Not only in Ireland, but across the liberal world, what we are faced with is the task of finding a new relationship between finance and the real economy. Banking and finance need to return to smoothing frictions in the real economy, after several decades in which the major focus was on smoothing frictions in financial markets, when it wasn't something worse.

In this regard, interesting relationships are evident in the face of severe and prolonged crisis. One example concerns supply-chain finance and invoice factoring. Banks are being drawn into roles between sub-suppliers and large firms, such as

BMW or Volkswagen. On delivery of components, the sub-suppliers present the contracting firm with an invoice. They are directed to a bank, such as Citibank, which provides them with a loan on the strength of their invoice—and, ultimately, their status in the supply chain of a prestigious firm. They gain credit. The large contracting firm gains time (and therefore credit) before it pays the invoice.

But, viewed this way, the engagement of EI with the Irish banks is an equally, perhaps more, interesting example of the possibility of new relations between finance and the real economy. In addition, the evolving work of the CRO is fascinating and, perhaps, indicative. It was set up as a complaint-and-review entity. However, its work would seem to be drawing it into a more diagnostic role. Beyond simply upholding or disputing credit refusals, it has drawn attention to weaknesses within SMEs and the need for further public policy initiatives if the gap between bank willingness to lend and SME projections is to be bridged. We see this as moving the debate regarding credit beyond the orthodox and somewhat fruitless duality of supply-side versus demand-side factors. The emerging synthesis recognises that there is considerable evidence of a skills and capabilities deficit within both banks and SMEs.

The developmental role played by agencies such as Enterprise Ireland is undoubtedly instrumental in supporting many SMEs to access finance, but there is growing evidence that the quality of sectoral knowledge and deep understanding of business development plans in such agencies can also impact on the lending behaviour of banks. The evolving model of support for SMEs is opening up new possibilities for the role of enterprise-support agencies in mediating and enhancing the relationship between the lending institution and the borrower. In other words, the agencies can be a critical partner in Ireland's version of the international process of turning finance back into financial services that serve the real economy.

Furthermore, once we see the issue as a return to financial services, there are intriguing and fertile parallels between what is happening in the welfare state and the wider public system, and what needs to happen in finance. Under the reforms to build the National Employment and Entitlements Service, a large part of the Irish welfare system is beginning to be recast from a system of payments to a system of labour-market services—combining income transfers and tailored services (see Section 5.2 below). In like manner, the financial system must be moved from a system of pure loans (or, indeed, denial of loans) to become once again a system of financial services—combining transfers of credit and tailored, expert services.

It follows that in approaching this task, the actors need to bring to it what has been learned about services, more generally, in the past two decades. We can summarise this as follows:

- Products and associated services are much more closely bound together;
- Services are less uniform and are increasingly tailored to the particular needs and context of the client;
- This tailoring involves the relevant actors in a process in which they have limited ability to define *ex ante* what the service will be or which roles each will play;
- In this process they make themselves mutually vulnerable in ways that cannot always be insured against in standard contingent or risk-related contracts and, consequently, they are drawn into processes of mutual monitoring.

What is taken for granted in so many other services—and, indeed, in the ‘services’ that modern regulatory and local authorities provide—must now be re-woven into financial services so that Ireland’s domestic and international businesses can access the credit and tailored financial services that they require.



# Chapter 5

## Employment, Welfare and Activation Policy

## 5.1 The Context

The short- and medium-term prospects facing a large number of those currently seeking employment in the Irish economy are bleak. In the year now ending, total employment is estimated to have fallen by 1.8 per cent; it is to continue marginally contracting in 2012, while the **cumulative** net job growth over the three years, 2013–2015 is expected to be of the order of 65,000 (by contrast, net employment growth averaged 84,000 *a year* between 2005 and 2007). The unemployment rate may have peaked in 2011 at 14.5 per cent, but an anticipated decline to 11.6 per cent by 2015 is based largely on the assumptions that more jobseekers will emigrate or otherwise withdraw from the Irish workforce (Department of Finance, 2011).

It is the considered view of ‘the Troika’ and of the OECD that, without significant improvement in employment services and substantial reform in social-welfare, the already high **long-term** unemployment (7.7 per cent, or 164,000 people, in the second quarter of 2011 (CSO, 2011c) will inexorably translate into rising structural unemployment. This would mean that large numbers of those now unemployed will not be offered work even after economic recovery. Specific actions to counter this scenario are required under the terms of the EU/IMF Programme of Financial Support, which Ireland has signed. Much of what is being required of the Irish policy system ‘from outside’, as it were, is not, in fact, an imposition but was already largely anticipated in indigenous analyses of the limited effectiveness of employment services and social-welfare support for people of working age during the boom years (NESC, 2005a, Department of Social and Family Affairs, 2006, Department of Social Protection, 2010).

The message is still not being clearly communicated that poor net employment forecasts are not grounds for abandoning the reinvigoration of employment

services and reform of social-welfare. NESC's August 2011 report *Supports and Services for Unemployed Jobseekers* sought to communicate why:

- There continues to be significant churn in the Irish labour-market with replacement jobs continuing to appear across a wide range of occupations; it is extremely important that people who are unemployed have a fair chance of accessing these vacancies;
- There is evidence that the level of job creation, particularly on the part of small businesses serving the domestic market, is responsive to the availability and quality of jobseekers (that 'supply creates its own demand' to a certain extent);
- In a period of recession, employment services and the social-welfare code have a larger role to play in helping people identify and successfully complete further education, training or work-experience programmes that maintain their status as credible candidates for employment (NESC, 2011 (b): 60–66).

## 5.2 The Establishment of NEES and SOLAS

Major institutional, legislative and programme changes are underway in how employment services are provided and social-welfare is administered to people of working age. When implemented, these changes will address most of the major issues that have been identified in external and domestic policy reviews.<sup>23</sup> It is not the omission of important issues, therefore, so much as the capacity to implement what is already in focus—fully, successfully and within a relatively short time frame—that will determine whether a significant number of the currently unemployed become lost to the mainstream workforce or not.

### 5.2.1 The National Employment and Entitlements Service (NEES)

The Department of Social Protection now has a clear remit to help working-age recipients of long-term social-welfare 'progress' and is being provided with the necessary systems and tools for doing so. Its new National Employment and

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<sup>23</sup> Their breadth and potential may be significantly underestimated in the October 2011 OECD *Economic Survey: Ireland* (e.g., the somewhat dated observations on Ireland's NEAP, p. 100).



Entitlements Service (NEES) is intended to ensure more regular and ongoing engagement with people on the Live Register (in effect, a wholly revamped NEAP), the better targeting of activation places and opportunities, and the greater incentivising of claimants to avail of these opportunities. Such steps are being prompted by Ireland's own experience of what has not worked and by international evidence of what does work (the latter insisted on strongly by the Troika lending to Ireland). They will be reiterated in the government's restatement of labour-market activation in the New Year ('Pathways to Work') because of their integral role in stemming the rise in long-term unemployment and the onset of structural unemployment.

Where NEES plans to arrive has been transparently and well outlined<sup>24</sup>; its capacity to get there is the core issue. A major change programme is underway. It is important should this develop quickly while, at the same time, not sacrificing the quality of the foundations being put in place to a political demand for short-term results.

The core operational capacity that NEES needs is the ability to intensify engagement with recipients of social-welfare as durations in receipt of payment lengthen in a way that develops their capacity to eventually be self-reliant.<sup>25</sup> This makes demands on data systems, profiling procedures, staff numbers, staff competence, inter-agency/cross-departmental protocols, the quality of the programmes and services to which claimants are referred and required to use, the appropriateness and effectiveness of sanctions, and the adequacy and flexibility of income support as personal progression plans unfold (and this list is not complete).

The Council's report of August 2011 (NESC, 2011a), *Supports and Services for Unemployed Jobseekers*, drew attention to several particular issues:

- The challenge of integrating staff from different public-sector bodies and motivating them to collectively deliver a new service (*ibid.*: 78);
- The importance of not limiting entitlement and access to NEES services only to unemployed jobseekers in receipt of social-welfare (*ibid.*: 78);

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<sup>24</sup> A progress update on the Project Plan for the Development and Implementation of the National Employment and Entitlements Service was provided by the Assistant Secretary responsible (John McKeon) at NESC's conference on 15 September 2011 (McKeon, 2011).

<sup>25</sup> Or, in words taken from the DSP's website, it is 'to ensure that the payment of income supports to people who do not have a job is directly linked to the equally, if not more important, task of supporting such people in their pursuit of employment and related opportunities and improving their life chances'.

- The quality of the ‘intelligence’ informing the advice and direction NEES provides its clients (*ibid.*: 79);
- The importance of NEES being able to work with a broad range of other actors and promote higher standards on behalf of its clients (*ibid.*: 79);
- The need to translate a commitment to customer-service into proactive and systematic methods for listening and responding to clients (*ibid.*: 81);
- The need to match expectations of what NEES is to achieve with an appropriate level of resources for the Service (*ibid.*: 81);
- The need for a shared understanding of and commitment to what ‘conditionality’ entails (*ibid.*: 178); and
- The need to explore whether and how the C&V sector and the private-sector could bring ‘additionality’ and not just ‘contestability’ to the area of employment services and activation (*ibid.*: 179).

This a demanding but feasible agenda of reform and institution building. It is vital that its purpose and ambition is clearly articulated, rather than that each small reform be seen as merely a search for efficiency or an instance of austerity. The employment services for which NEES has assumed responsibility will need to develop strong links with employers and acquire intimate knowledge of local labour-markets. These were some aspects of best practice when employment services were the responsibility of FÁS that will need to be retained and developed inside the new organisation, most of whose personnel are coming from backgrounds in social-welfare administration and among whom, therefore, specialist labour-market expertise may initially be thinly spread.

### **5.2.2 The Further Education and Training Authority (SOLAS)**

As well as NEES succeeding in what it is setting out to do, the corresponding and complementary success of SOLAS will be essential if outcomes for NEES’s clients are to improve in many instances. This is because many of the personal progression plans that NEES draws up will entail referral to a vocational training or education programme under the aegis of SOLAS; unless places are available on programmes, and those programmes deliver, many NEES clients will remain out of work and disappointed.

Progressing the activation agenda espoused by NEES necessitates the provision of relevant further education and training programmes that are capable of reskilling and upskilling unemployed jobseekers in accordance with both individual's needs and the needs of the labour-market (NESC, 2011a; (OECD, 2011b). The mutual obligations principle that is central to the effective operation of activation reaffirms the need for the state to ensure that the further education and training programmes that jobseekers may be mandated to participate in, have the capacity to enhance an individual's prospects of progressing to future employment, education or training.

A new agency, SOLAS, under the aegis of the Department of Education and Skills (DES), is to be the new further education and training authority with responsibility for co-ordinating and funding the provision of integrated further education and training services and programmes to unemployed jobseekers and all other learners. This potentially provides NEES with a hugely important new partner in designing and implementing effective activation policies. The government has indicated that one of the advantages of establishing SOLAS as an integrated further education and training authority is that it will facilitate further education playing a significant role in the activation of the unemployed through its systematic inclusion in the National Employment Action Plan (NEAP) referral process, which is to be implemented by NEES.<sup>26</sup> It is essential that proper structures are put in place to ensure close co-operation between SOLAS and the VECs under Department of Education and Skills and NEES under the Department of Social Protection. This is necessary to ensure that education, training and activation policy are implemented coherently so that those seeking employment are given every opportunity to do so, and that all training and further education courses are linked to both the needs of the unemployed and business. The key principle governing the relationship between activation and FET provision should be that the transition is both seamless and focused on the needs of clients and current and future employers (Kelly *et al.*, 2011).

Once established, SOLAS will be responsible for a large and diverse sector, both in terms of the scope of its further education and training services and the range of potential client groupings. As part of this process, FÁS is to be disbanded and the VECs, which themselves are to be restructured and modernised,<sup>27</sup> are to be

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<sup>26</sup> Draft Memorandum for the Government; Establishment of a new further education and training authority called SOLAS 21/06/2011.

<sup>27</sup> In May 2011, the Minister for Education and Skills announced that the number of VECs was to be reduced from 33 to 15. See also General Scheme of Education and Training Boards Bill 2011.

ultimately responsible for the delivery of both further education and training services to the public. It is estimated that the combined budget (pay and non-pay) for FÁS and the VECs in 2011 will be approximately €920m, which is very considerable given the broader context of fiscal retrenchment.<sup>28</sup>

These developments reflect the fact that a strong emphasis on training and education as the primary route back to work has been the core element of the state's response to the unemployment crisis since 2008. Significantly, the current crisis has also created a more urgent, and indeed challenging, context for delivering the National Skills Strategy (NSS) (Expert Group on Future Skills Needs, 2010). Despite the dramatically changed economic, fiscal and labour context, NESC (NESC, 2011a) emphasised that the core reasons advanced before the recession for a major increase in skills across the workforce remain valid (NESC, 2011a). The rapid rise in unemployment since 2008 and the emergence of more constrained and complex labour-market has actually reaffirmed the salience of the broader objective of this strategy, namely to upgrade skills across the entire workforce; of people in employment and of the unemployed; of people with post-Leaving Cert. qualifications and of early school leavers; of the workforce employed in multinationals and of those working in microenterprises and the self-employed. The fact that the most significant challenge regarding the implementation of the Skills Strategy in the period to 2020 is upskilling those at Level 1–3 on the National Qualifications Framework to Level 4 and 5, highlights the pivotal role that SOLAS and the FET sector have to play in achieving our medium-term aspirations of a more competitive, innovation-driven, knowledge-based and inclusive economy (Expert Group on Future Skills Needs, 2010).

Comparative research indicates that although vocational education and training can play a central role in preparing young people for work, developing the skills of adults and responding to the labour-market needs of the economy, it has been rather neglected and marginalised in policy discussions (OECD, 2011a). The establishment of SOLAS and the associated institutional and policy changes represents a real opportunity to fully harness the potential of the FET sector in both addressing the current unemployment crisis and in supporting the continued upgrading of the labour force.

It is important that FET programmes equip individuals with the right mix of skills, combining core transversal competences (which support occupational mobility) and

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<sup>28</sup> In addition, the DES estimated that it will provide approximately €14.5m to Skillnets through the National Training Fund.

lifelong learning with job/occupational-specific skills (that meet employers immediate needs) (OECD, 2011a). Within SOLAS, there is to be an increased emphasis on the provision of generic transferable skills<sup>29</sup> and a greater focus on training and education programmes that prepare individuals for occupations in growth areas such as services, ICT, medical devices, food and biopharma.<sup>30</sup> These changes reflect the need for SOLAS to provide further education and training that is relevant to the skill requirements of sectors that the Expert Group on Future Skills Needs has identified as particularly important as current or prospective sources of employment in the Irish economy. This may also serve to address skills shortages and deficits that continue to exist alongside the rapid rise in unemployment. Strengthening the relationship between skill supply and labour-market demand also requires the development of a more intensive, constant and sophisticated dialogue between education and training providers and the world of work (Campbell *et al.*, 2010, Expert Group on Future Skills Needs, 2010, NESC, 2011a).

It is increasingly evident that attempting to accurately predict future labour-market demand for specific jobs or occupations, and then seeking to centrally plan skills supply to meet this demand, is not only problematic but probably undesirable (Campbell *et al.*, 2010). Rather, what is needed is an agile system that responds to market signals and in which labour-market intelligence informs the decisions of consumers, providers and funders (*ibid.*: 31). The key, therefore, is excellent information drawn from a variety of sources—expert groups, academic research and engagement with employers—an enhanced capacity to analyse and interpret the information and increased accessibility to it (*ibid.*: 30). For the FET sector, developing this type of authoritative labour-market intelligence will enhance its capacity to assess existing skill needs, more effectively direct upskilling efforts and provide a longer-term perspective so that we can not only anticipate future requirements but also actively shape them.

The use of labour-market intelligence could be augmented by a greater focus on the potential of social innovation to provide novel solutions to complex social problems and needs. For example, demographic trends mean that a growing number of older people will require more care, medical support and therapies in their homes or in senior citizen residences. It is estimated that within the EU by 2020 the largest number of job vacancies, both new and replacement jobs, will come from this sector (*ibid.*: 13). In Ireland, these same pressures, when combined with the need to

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<sup>29</sup> These include people-related skills, thinking and problem-solving skills and digital literacy.

<sup>30</sup> This in turn will mean less skill provision for jobs in the traditional construction and manufacturing sectors, which was one of the core strengths of FÁS.

both improve the quality of care and develop a more sustainable financing model, suggests that there is merit in exploring how social innovation in eldercare could generate a more effective, efficient, sustainable and just solution, and for which the value created accrues primarily to society as a whole not just private individuals (Phillis Jr. *et al.*, 2008). However, harnessing the full employment potential of growing sectors such as eldercare requires us to raise our ambition for the sector; it is important to consider not only the number of potential jobs but also the quality of jobs created and the extent to which it is possible to identify viable career trajectories in this area. Public and private providers need to be encouraged and supported to raise their demand for, and utilisation of, higher skills. This, in turn, will require the FET sector to display its capacity to respond flexibly in supplying individuals with the appropriate mix of competences and skills.

Given the scale of the unemployment crisis and the extremely tight fiscal constraints, it is essential that all publicly funded further education and training programmes provide value for money and are as effective as possible. Recent research by the ESRI highlights the extent to which some programmes are more effective than others in enhancing the employment prospects of unemployed participants (Kelly *et al.*, 2011). It is argued that only a minority of participants took part in more effective training programmes and that over two-thirds of all training days delivered during a particular eighteen-month period were in less effective training programmes (McGuinness *et al.*, 2011).

Addressing the twin challenges—delivering better outcomes for clients while simultaneously securing better value for money for the state—highlights the importance of putting the issue of ‘quality’ at the very centre of the redesign and reconfiguration of the FET sector. It is suggested, therefore, that in establishing SOLAS there is an urgent need to focus on the following issues:

- i. Adopting standards and systems of accountability that ensure quality and continuous improvement in further education and training provision;
- ii. Fostering a more sophisticated outcomes-focused performance dialogue across SOLAS broader network of public, private and non-for-profit service providers. This would centre on the extent to which specific policies and programmes are genuinely supporting an individual’s progression to employment, further education or training opportunities;
- iii. Embedding within the sector a more robust and systematic process of policy evaluation. This would assist in identifying and allocating scarce resources to those FET programmes that are most effective in generating positive outcomes for clients;

- iv. Improving the FET sector's capacity to collate, analyse and use data on labour-market outcomes in manner that enhances organisational performance;
- v. Ensuring that the FET sector provides individuals with the right mix of skills and competencies for the labour-market, in particular generic transferable skills along with the occupationally specific skills;
- vi. Constructing effective mechanisms for engaging employers and unions in further education and training policy and provision;
- vii. Improving the sector's capacity to anticipate and shape future skills needs through the better use of quality labour-market intelligence.
- viii. SOLAS should experiment with new forms of devolution that combine local autonomy, and outcome monitoring with a new type of external reporting.

Indeed, there is evidence that the relevant departments see the challenge of SOLAS in these terms. At the same time, we should be clear that no large Irish public service organisation has a system of quality assurance and continuous improvement of the kind sketched above. Consequently, in approaching this vital but challenging task it will be necessary to draw on the best of international and national experience in creating institutional regimes capable of delivering tailored services and continuous improvement (NESC, 2002).

### 5.3 Social Welfare

Prompted by the severity of the unemployment crisis, the new profile of those who are unemployed at the current time and its analysis of responses to the crisis to date, NESC's August 2011 report, *Supports and Services for Unemployed Jobseekers*, introduced further elements to previous analyses of the weaknesses in Ireland's social-welfare code. Earlier analyses underlined the undue passivity in the administration of social-welfare payments to people of working age, the need to integrate lengthening durations in receipt of payments with the growing use of services, and the greater effectiveness of quality services rather than higher payments in tackling poverty and social exclusion. NESC Report No. 123 adds:

- That how those made unemployed by the current recession are supported has become a new litmus test of how economic and social policy align with each other and across the lifecycle;<sup>31</sup>
- The importance of distinguishing between short- and long-term unemployment regimes;
- The importance of protecting the positive labour-market functions of short-term unemployment benefit;
- The evidence that on becoming unemployed in Ireland people receive low levels of support, by international standards, but high levels if they remain unemployed; and
- The evidence that recession produces circumstances in which political and popular demands to police the Live Register more vigorously increase at the very time when the objective grounds for intensifying efforts are smaller.

The August report went on to make several specific observations about the difficult decisions to be made by the government and Department of Social Protection. In particular:

- In seeking savings from the social-welfare budget, there should be no assumption that concentrating on the Live Register (LR) will produce a ‘double dividend’, i.e., immediate savings *and* more people in work;
- Further general reductions in Jobseeker’s Benefit and Jobseeker’s Assistance are likely to have little or no impact in getting more people back to work because the large majority currently on the LR already have a major financial incentive to do so;<sup>32</sup>

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<sup>31</sup> The context of recession makes clear that Ireland cannot aspire to high standards in how its children, people with disabilities and older people are supported if it does not first ensure the members of its workforce are supported to high standards.

<sup>32</sup> The August report uses data from the July 2010 Live Register. Updating for the LR in August 2011 shows substantially the same picture: almost 50 per cent were getting less than €188 per week (the maximum personal rate). This was because 19 per cent received no payment at all, 15 per cent a payment for part of the week only and 16 per cent were reckoned to have household means that reduced their payment below €188. Another 25 per cent received the maximum personal rate only. Callan *et al.* (2011) use a microsimulation



- Replacement rates of 70 per cent or higher (traditionally interpreted as evidence of a disincentive to work) apply, at the most, to about 20 per cent on the LR. These are claimants who also receive Rent Supplement and/or increases in recognition of a family they are supporting (Increases for Qualified Adults, Increases for Qualified Children);
- Less than 5 per cent on the LR receive both RS and are in receipt of an Increase for Qualified Adults (IQA) and Increases for Qualified Children (IQCs). The degree of attention paid to this ‘perfect storm’ where replacement rates are concerned is not based on labour supply concerns but has other roots;
- Ireland’s unusual pattern whereby replacement rates can be measured as rising the longer unemployment lasts<sup>33</sup> is due to the fact that eligibility for secondary benefits is based to a significant extent on receipt of a long-duration welfare payment. In other countries, replacement rates fall as unemployment durations lengthen, largely because people transfer from higher-rate insurance-based payments to lower-rate social assistance payments;
- A new strategy for secondary benefits is needed. Having the Rental Accommodation Scheme substitute more promptly for Rent Supplement (and administering the latter on lines similar to the Local Authorities’ differential rents scheme) will significantly reduce disincentives. The assumption by Local Authorities of responsibility for meeting the needs of long-term Rent Supplement recipients cannot happen too soon; (Department of Environment, Community and Local Government, 2011);
- Eligibility for the medical card, too, needs to be placed on a basis that ensures it operates much less as a work disincentive. On low earnings, people in employment in Ireland are liable to incur medical expenses for their families that are high by international standards (including Northern Irish) whereas their medical security is much greater if they remain on social-welfare. Minimally, the extension of entitlement to free GP consultations to more of those on low earnings would help ensure ‘work pays’ for more people;

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approach that reinforces this basic message: actual replacement rates are lower than data based on standard OECD methodology suggest. They add the important finding that marginal effective tax rates have increased significantly for most workers.

<sup>33</sup> ‘One of [Ireland’s] welfare system’s main shortcomings [are its] time-invariant replacement rates. The authorities should reduce benefit rates with unemployment duration’ (OECD, 2011a: 100).

- As periods in receipt of social-welfare lengthen, it is not additional cash income but the increased usage of services that fosters the capacity to regain more self-reliance, which should characterise Ireland's social-welfare system;
- The need to substantially update how the social-welfare code facilitates part-time and temporary employment has become urgent at the present time. It is not unusual that claimants on the LR find opportunities to work hours that are occasional, part-time or full-time for short periods or purely on Sundays. It is important that claimants should be better off from doing so, while their welfare payment can also be reduced.<sup>34</sup> It is also important, however, that partial and limited earning opportunities are facilitated in a way that is equitable to all jobseekers and without expanding a casual workforce that has little interest in working full-time;<sup>35</sup>
- 'Activation' is **not** primarily about ensuring less people draw Jobseeker's Assistance. It is, fundamentally, about requiring claimants to take steps that the labour-market authorities are confident will improve claimants' progression prospects as a condition of their continuing to receive payment;<sup>36</sup>
- Activation 'saves' money only over time. Immediately, **additional** public spending results (the claimant 'consumes' some services while continuing to receive their payment); public savings eventually result (on transfers and services) in so far as the service consumed **proves effective** in helping the claimant get into a job;
- Sanctions, by their very nature, are targeted and conditional and are much more effective than general welfare cuts in securing a return to work where there is resistance to doing so;

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<sup>34</sup> Anecdotal evidence suggests that this dilemma can face unemployed construction workers if approached by their former employers to work on small projects.

<sup>35</sup> Rules governing when a LR claimant is considered 'available for work' and, therefore, unemployed, need revision; for example, having one hour of work per day Monday to Friday disqualifies a person from receipt of any payment but a person full-time employed on two of the five days and without any work on the other three qualifies. Budget 2012 announced two significant measures beginning reform in this area.

<sup>36</sup> A working definition was suggested by the 15 September NESC conference: 'The manner in which benefit recipients of working age are offered, and required to use, services in conjunction with income support so as to move closer to or into employment'.

- Further general reductions in welfare payments to people of working age should only be implemented if the combination of deflation and falling net earnings make them necessary to prevent replacement rates rising.

## 5.4 Designing New Labour Market Interventions for New Times

A significant group among those now unemployed had difficulty in finding and retaining employment even during the boom years. They are particularly at risk of becoming structurally unemployed if they 'lose out' in the greater competition for vacancies and demand for employment services that the recession has produced. 'Profiling' and targeting are two core strategies for ensuring they continue to receive support, while they also stand to benefit from the overall reform and improvement that the crisis has spurred in the state's supports and services to unemployed people generally.

A major new feature of the current unemployment crisis, however, is the large number of jobseekers who *have* extensive work experience and good skills. They present no particular difficulty to employment services other than that they do not have jobs. They have sufficient educational attainment to ensure their ability to learn and adapt, recent work experience and a developed work ethic. In short, they are eminently employable. Their availability for, and commitment to, work cannot be doubted and little is gained by devoting scarce public resources to monitoring and testing their job-search and availability for work. They have skills and competencies that need to be exercised if they are not to deteriorate and, in many instances, public resources will bring a better return if used to help them exercise the skills they have rather than to acquire new ones.

It is of huge importance to bring imagination and energy to creating more opportunities for unemployed people to exercise the skills they have, in a voluntary capacity and without withdrawing their social-welfare entitlements, so as to allow them to contribute to society and society to benefit from their skills. Working voluntarily, or for approximately the equivalent of their social-welfare entitlement, should not block them from job-search or diminish their employability in any way.

Diversity should characterise different projects' answers as to how participants are guaranteed at least the equivalent of their Live Register payment. For example, sponsors of projects who, presumably, stand to benefit directly from their completion could be expected to cover expenses and/or pay a supplement; the

maximum hours participants work could be based on dividing the amount of their weekly social payments by an agreed going rate for the work in question;<sup>37</sup> sponsors could commit to ensuring that an accredited training award would result from satisfactory participation in the project as a major ‘benefit in kind’; etc.

Actual programmes and projects are best developed through intense collaboration between the actors who have a role in making them happen. Schemes designed and announced at the national level frequently fail to deliver on expectations because operational difficulties were not sufficiently identified, while schemes advanced by single organisations may not address the concerns of all core constituencies and easily reflect partial interpretations of the unemployment crisis. NESCC does not consider itself to be the body or the place to adjudicate the competing merits of individual schemes, much less to advance schemes or projects of its own. Even three years into this unemployment crisis, however, fora or clearing houses are still lacking where the many actors who are in positions to identify, manage and deliver valuable projects and ensure that people on the LR are employed on them in a satisfactory way, have not been established. This is addressed in Section 5.4.3 below.

Two principal types of measures should be pursued by regional or local fora, and facilitated and supported by national authorities and national policy:

- i. Work experience programmes, i.e., internships and work-placement programmes. These open up existing workplaces and projects to utilise the skills, time and talents of unemployed people, on terms and conditions that ensure they are not cheaper labour than employers can otherwise source, and that they are accorded equal respect to existing workers;
- ii. Direct-employment projects. These either provide services genuinely valued by their users or enhance existing infrastructures, i.e., the projects must produce valued end-products, a condition essential to protecting the status of those temporarily employed on them.

Both sets of measures should be **temporary** and phased out as the labour-market recovers.

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<sup>37</sup> As advocated by Social Justice Ireland in its Part-Time Job Opportunities Programme (Social Justice Ireland, 2011).

### 5.4.1 Direct-Employment

It is important to distinguish between two separate roles for direct-employment programmes in active labour-market policy.

First, they are an integral 'last resort' component in activation strategies. The option for a body such as NEES of being able to send a client to undertake specified work for a period of time is important in two sets of circumstances: (i) to counter demoralisation and the loss of basic work habits in clients who have co-operated with all that was asked of them but remain without job offers, and (ii) to improve co-operation and raise the level of service usage on the part of clients who have demonstrated an unwillingness to engage. The stock of places on direct-employment programmes needed for these purposes will be small relative to the actual numbers unemployed. The participation of any given individual will be time-limited but the programme places themselves need to be established ongoing features of the labour-market policy landscape. In most countries that have such programmes, the local authorities play a major role in ensuring their provision.

Second, direct-employment programmes may be introduced as specific, counter-cyclical stimulus measures. As such, these programmes are temporary and the projects/tasks around which they are organised need also to have a once-off and unique aspect in order not to undermine existing jobs or create dependency on the part of participants. It is important that the programmes should be positive for the participants' future employment prospects (not lead to any 'scarring' or confer any stigma, etc.) and that they should create something of genuine value for the community/society. Again, it is clear from experience in other countries that regional and local authorities have a major role to play in identifying projects and tasks that communities and regions need doing, and which would generate significant temporary employment as a result. Community infrastructure projects that focus on the heritage and the environment (including National Bike Paths), for example, have figured prominently in Australia's response to the emergence of high unemployment in some of its regions (in its 'Jobs Fund', 2009–2011). As already suggested, projects that have strong local appeal and are considered to guarantee significant benefits that can be captured locally (e.g., enhancement of tourist attractions; national or regional cycle lanes; removal of major environmental 'sores'; routes to school obviating the need for car use; after-hours childcare facilities in school grounds; etc.) may lend themselves to some form of local participation in their investment.

There are several respects in which the Community Employment programme, the largest single measure adopted in response to the last unemployment crisis, is *not* a template for how further direct-employment opportunities should now be provided. Participation on CE proved long-term for many of its participants. What

training was provided was weakly linked to market needs. Only small numbers progressed to FET or employment, and relatively few openings were available each year to new entrants. Its dual role in providing services as well as temporary direct-employment made it difficult to evaluate (i.e., did the value of these services to local communities compensate or not for its weakness in helping participants progress?).<sup>38</sup> A stronger role for local authorities and a greater input from NEES working with other organisations should be features in how further opportunities for direct-employment are brought on stream.

#### **5.4.2 Work Experience**

The provision of work experience is important in at least three contexts.

First, it is integral to quality vocational education and training programmes, where it strengthens links between providers and employers, and reinforces the motivation of students/trainees. Alternating periods in real work settings with class room education/training already characterises the most successful programmes and institutions delivering FET in Ireland (e.g., apprenticeships, the Shannon College of Hotel Management, etc.). However, work experience could become a much stronger component in PLCs and FET programmes that are targeting the emerging newer sectors of the economy (such as those identified by the EGFSN).

Second, it is integral to quality activation strategies where the opportunity and requirement to report for work to a specific employer can function, variously, as a test of an individual's availability for employment and as a welcome and recuperative break from the tedium of unemployment and unsuccessful job-search.

Third, it is integral to strategies for coping with youth unemployment and to escaping a situation where no job offers are made to the inexperienced but no experience can be gained without employment. In this context, 'internships' are a form of work experience particularly suited to unemployed graduates. While there are aspects of the National Internship Programme (Job-Bridge) that can be commended, the organisation and roll-out of the Programme were initially weak in several respects and efforts are being increased to ensure the quality of the Programme. There may even be a case for giving temporary recruitment agencies some role in applying their expertise to improve the quality of what employers offer on the programme and increase uptake on the part of young people. Ireland

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<sup>38</sup> See for example, Forfás, 2010 and Halpin & Hill, 2007. For a fuller discussion, see NES, 2011a: 166-168.

appears to lack a ‘culture’ of internships. However, this should only redouble efforts to communicate their potential for keeping the emigration of young people to a minimum and retaining the economy’s capacity to respond swiftly once demand conditions improve. At the same time, complementary steps should be taken to ensure that as many as possible of those who do emigrate maintain contact with Ireland’s employment services and are aware that Ireland retains an interest in the skills they are acquiring in working overseas (including whatever foreign language they may be using).

### 5.4.3 Towards a Second Labour-Market Activation Fund

Job-Bridge has been one of several new measures adopted since the crisis began. Other programmes aim to give people on the Live Register the opportunity for further education or training (e.g., Springboard), work experience (e.g., Work Placement Programme) or temporary direct-employment (e.g., Tús).

Rather than advocating one or more specific new interventions of its own, NESC recommended that the processes for identifying, adopting and driving such interventions be urgently revisited (NESC, 2011a: 196). The interval within which the labour-market authorities must act if they are to tangibly improve the situations of significant numbers of those now unemployed is short. In more normal times, the process of consultation, design, piloting, evaluation and mainstreaming a new labour-market intervention might take two years or longer. Every six months at present, however, sees significant cohorts of the employed leave the country, withdraw from the workforce or drift into long-term unemployment. There is a tension between wanting swift and effective labour-market interventions, on the one hand, and interventions to be evidence-based and guided by outcomes that often are only verifiable well after programme completion, on the other.

In this context, the evaluation of the Labour-Market Activation Fund (published November 2011) is an opportunity not to be lost (PA Consulting, 2011). It embodies significant learning from 55 projects in which 12,630 unemployed people participated, with a budget of €29m. The learning has, in some instances, been negative (notably where providers were not required to track participants’ outcomes after project completion, as discussed above) but, overall, can be considered to significantly reinforce ‘a new model of labour-market activation’ (*op. cit.*) for Ireland (Kelly *et al.*, 2011). The positive learning has featured:

- The successful engagement of unemployed jobseekers requires that they be fully and clearly informed of programmes, have a single, accessible contact point, and have any and all significant barriers to their participation addressed (e.g., childcare);

- The successful design and delivery of programmes requires close and on-going collaboration between a diverse set of actors—principally, education and training providers, employer bodies, local economic development actors, and employment service providers capable of targeting sectoral or local labour-markets (be they public, not-for-profit or private-sector);
- The focus on tailoring pathways to employability and employment for participants, the context of the National Skills Strategy and National Framework of Qualifications, and the weight given demonstrable outcomes in determining ‘success’ clarifies and strengthens the platform for collaboration among diverse providers; and
- A competitive tendering process, on the basis of clear criteria and on the part of an accessible and flexible commissioning body (in this case the Skills Unit in the Department of Education and Skills), stimulates innovation on the part of public, private and not-for-profit providers to clear criteria.

The ambition now should be to build rapidly on the LMAF evaluation, so as to extend the opportunity to participate under a reconstituted Fund to multiples of the 12,630 unemployed jobseekers who participated in 2010 and 2011. NESC supports the recommendation to reconstitute the Fund and believes it should be provided with a significantly larger budget. Regional and local actors should be encouraged to debate, discuss and apply the lessons of the LMAF report to their regional and local circumstances and to stimulate consortia of local actors to advance applications of the required quality and on the required scale to the new Fund.

The ability of regional and local actors to act constructively together is widely acknowledged as vital to regional and local development and to the realisation of the National Spatial Strategy, and much is happening (e.g., Forfás, 2011). Local and regional constellations of actors, who will have diverse loci of leadership and methods of working, will also be instrumental in extending opportunities for reskilling, work experience and direct-employment to larger numbers of those now unemployed.





# Chapter 6

## Taxation

## 6.1 The Principles Guiding Tax and Tax Reform

The principles that should guide tax policy and tax reform have been articulated in a range of policy reports over the past two decades, including the first Commission on Taxation, *A Strategy for Development 1986-1990* (NESC, 1986); the 2009 Commission on Taxation; *Tax and Growth* (OECD, 2008); *Tax Reform Policy and Growth* (OECD, 2010); and, the *OECD Economic Survey: Ireland* (OECD, 2011a). Among these principles are the following:

- Taxes that have smaller negative impact on the economic decisions of individuals and firms are less negative for economic growth;
- Within the main tax categories—consumption, property, personal income and corporate income—a broader base is more conducive to economic growth;
- Targeted tax reliefs should be subject to cost-benefit criteria, including externalities where relevant;<sup>39</sup>
- The distributional impact of such reforms should be analysed carefully, especially since application of these principles tends to reduce progressivity;
- Framing the debate around tax reform is critical.

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<sup>39</sup> An externality is a cost or benefit not included in the market price and experienced by a third party. A negative externality might refer to pollution caused in the production of a good when the producer does not bear the cost of the damage. A positive externality might refer to investment in R&D where newly developed technology can, in turn, be used by other industry firms.

The main import of these principles for Ireland are as follows:

- The need to rebuild a sustainable tax base;
- The need to introduce an appropriate range of property and capital taxes in order to minimise taxes that impact on economic activity but also achieve equity;
- The need to view tax and benefits in an integrated way;
- The need to create a more effective system of local finance;
- The need to reflect environmental concerns, especially global warming, more fully in the tax system.

## 6.2 Broad Tax Policies Supporting Growth and Jobs in Ireland

The OECD argues that international evidence suggests that taxation policies that support a low and stable corporation tax, aim to minimise tax on labour (focusing instead on raising revenue through indirect taxes), and seek to broaden the tax base, have the least impact on economic growth.

Levels of income tax can be discussed on a number of dimensions; these include the overall tax burden, as well as the tax burden on various income groups. The trend, across OECD countries, including Ireland, over the past twenty-five years has been one that has seen some marked decreases in the top rates of personal income tax. At the same time, average income tax for the single production worker at average earnings had been subject to only small reductions. Contrary to most other OECD countries in this respect, Ireland had the most significant drop in income tax for this group. Between 1985 and 2004, the average income tax for the single production worker at average earnings reduced by almost 20 percentage points, leaving Ireland's tax take for this group in the lower third of OECD countries (OECD, 2010: 33-34). Since the onset of the crisis, it has been recognised that the policy of narrowing the Irish tax base—which occurred over the previous decade and a half

and brought many of those on lower incomes out of the tax net—was not sustainable.<sup>40</sup> In the Budget 2011, a number of measures were introduced that served to broaden Ireland's tax base; although tax rates remained unchanged, tax credits and the entry levels to both the standard and marginal tax bands were reduced, and the introduction of the universal social charge and increased PRSI charges meant, in effect, that taxpayers were paying more taxes. A range of tax reliefs were also abolished.

In Ireland's case, starting with a narrow tax base, a policy of broadening the tax base while maintaining already low rates, would seem to be supportive of growth and employment. The Programme for Government states an intention to maintain current rates of income tax together with bands and credits. This commitment to keeping taxes on employment to a minimum is restated in the *Medium-Term Fiscal Statement* (Department of Finance, 2011).

There is, however, a critical need to further alter the tax mix and broaden the base. The OECD *Economic Survey of Ireland 2011* says that government should further reduce tax expenditures and proceed with the planned property taxes. This echoes the recommendations of the 2009 report of the Commission on Taxation, which also states that domestic water charges should be introduced. A carbon tax, signalled in the report, was introduced in Budget 2010. Tax and tax expenditures supportive of environmental goals are a good example of externality correcting measures. The 2011 *Medium-Term Fiscal Statement* notes a continuing need to consider the use of indirect taxes.

### 6.3 Tax Measures that Might Support Growth and Jobs

Some specific measures have already been introduced with a view to supporting growth and employment creation. The OECD *Economic Survey of Ireland 2011* notes that some of these should be continued, extended, redesigned or reviewed.

Under the 2011 Jobs Initiative (announced in May 2011), employers' PRSI was reduced from 8.5 per cent to 4.25 per cent on weekly wages up to €356 euro (5.5 per cent above the NMW). The OECD views this measure as both supporting the

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<sup>40</sup> A point also highlighted in the National Recovery Plan.

employment of the low-skilled and supporting cost competitiveness in the hotel and restaurant sector. It is considered to be more broad-based than previous job subsidies and, while it may involve higher deadweight loss than previous less broadly based jobs schemes such as those under the Employer Job Incentive Scheme, it is easier to monitor and administer. The OECD proposes that the duration of the cut in employers' PRSI for low-wage worker should be extended beyond the proposed withdrawal time of end-2013. In addition, some tweaking of the design should be considered to taper the application of the lower rate, thus smoothing the discontinuity of moving from 4.25 per cent up to €356 to 10.5 per cent thereafter (OECD, 2011a: 104). Compensating budget measures would be needed to support this.

Reductions in VAT rates for some labour-intensive industries were implemented in tourism-related services (for example, restaurants, hotels and entertainment activities), in addition to hairdressing and publications. The rate was reduced from 13.5 per cent to 9 per cent. The OECD suggests an independent review of the effectiveness of this measure in respect of job creation should be undertaken.

Research and development may have a high social value considerably in excess of its private value and is sensitive to subsidy in the long term (Myles, 2007). Evidence-based measures to support R&D should receive continued support, (OECD, 2011a: 118).



# Chapter 7

## Enterprise Policy



## 7.1 Introduction

Companies are grappling with extremely challenging market conditions. The question addressed in this chapter is how enterprise policy and enterprise supports can respond to the changing circumstances and pressures facing enterprises and entrepreneurs.

The imperative in both the near and medium term must be to protect and create employment in the Irish economy. This section argues that there are a number of actions that could be of assistance in the near term, in particular in relation to access to credit and investment, business rates, pre-competitive public procurement and public-sector 'data' innovation. In addition, it argues that in the medium to long term there is a need to develop a better understanding of the underlying strengths and weaknesses of the Irish economic model.

The chapter is structured as follows. Section 7.2 considers how companies, enterprise agencies and parts of the wider public sector have responded to the economic crisis. Section 7.3 identifies a number of areas in which constraints exist on growth and employment creation. Section 7.4 discusses the role of the state in supporting economic growth. Section 7.5 suggests a programme of work that would review Irish enterprise policy.

## 7.2 Responding to the Crisis

In its recent meetings, the Council considered evidence that highlighted the way in which companies have approached the challenge of sustaining their businesses during the recession.<sup>41</sup> The evidence described companies actively and continuously examining possibilities for growth. It showed that when faced with problems, companies engage in open-ended exploratory processes to find solutions. The approach to this is measured and systematic. Companies use tools from advanced algorithms, which track performance of services, to off-the-shelf balanced scorecards. Continuous and rigorous benchmarking accompanies exploratory search; the process is open-ended but is not haphazard.

A wide array of state supports and actors can be part of this problem-solving process. The cases highlight that the acid test of state support is increasingly linked to the extent to which it can be a partner to this measured search process. The input of the state is not limited to its impact, via grants and other incentives, on the rate of return for a given activity. Instead, the state in various guises is seen as a potential contributor to the process of reimagining possibilities. The cases highlighted that not all parts of the enterprise support system are engaging in this way with companies. Indeed, difficulty in supporting firms' open-ended search to create new economic possibilities seems more pronounced in the wider public sector.

The companies interviewed argued that there was more that enterprise agencies and the wider public sector could do to support Irish business. A common theme was that the additional support needed was not—and, indeed, recognising the current fiscal position—could not be—more grants. Instead, companies focused on support in terms of facilitating, brokering and enabling a greater opening up of opportunities, domestically and internationally. This can be described as a networked approach focused on continuous development, or in short, networked developmentalism.

The companies interviewed by the Secretariat spoke of the need to create more open-ended exchanges in which they could explore possibilities. One company specifically mentioned the need to find ways to explore and imagine and the need for 'iterative dialogue'.

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<sup>41</sup> The NES Secretariat provided the Council with a briefing paper entitled *Enterprise, Enterprise Policy and Open Possibilities*, which reported case studies carried out by the Secretariat.

Usually when you're in a collaborative dialogue with someone, you don't know what the other guy can do and they don't know what you can do, and part of it is about throwing things out and exploring, and imagining what you could do with this or that. It's an iterative dialogue that's needed.

An example from within Enterprise Ireland (EI) helps to make this concrete. The EI procurement team organised an event where engineers/managers from a number of local authorities came together and discussed their needs (in this instance, in relation to flood prevention and water management). The procurement team invited a number of technology companies who were clients of EI to present possible solutions. The local authority managers were then given an opportunity to question the ideas put forward, but they did so as a group. This allowed those managers to have a higher degree of confidence and increased their willingness to try new solutions. The companies used these feedback and discussion sessions to improve their designs and solutions. They subsequently tendered for business with local authorities. This has been a very successful initiative and has resulted in a number of companies agreeing contracts with local authorities.

In conclusion, these experiences suggest a number of arguments about our understanding of enterprise policy and the role of state agencies, namely that:

- Enterprise policy needs to support cost competitiveness and inward investment, but a total focus only on these issues underestimates the ways in which Irish companies are competitive—for example, through the provision of personalised products and services aligned with customers' needs through continuous data monitoring and analysis;
- The project of creating sustainable economic growth depends on the ongoing efforts of companies and other stakeholders to find new opportunities;
- The new opportunities and economic possibilities are not known by the companies or institutions but are 'worked out' on an ongoing basis;
- The state through various bodies and agencies, in particular IDA and EI, can play an important role as a collaborator in such open-ended exploration of economic possibilities.

This set of arguments has implications, in both the near and medium-to long-term, for enterprise policy. In the near term, it suggests that addressing constraints—such as access to credit and investment funding; business rates; and an underdeveloped pre-competitive public procurement system—can have an

immediate impact on growth and employment. In the medium term, it is also worth exploring if improved institutional means of identifying and understanding such constraints can be developed.

In the medium to long term it also suggests that a process of review—which examines the characteristics of the Irish economic model—would complement the ongoing joint exploration of open-ended possibilities that is taking place between the companies and agencies.

### 7.3 Dealing With Immediate Constraints

This section notes four constraints on growth and employment:

- Credit and investment;
- Business rates;
- Pre-competitive public procurement;
- Public-sector ‘data’ innovation.

The section concludes by noting the need to consider how such constraints might be identified and solved.

The first constraint is the issue of credit and finance, which has been discussed in Chapter 4. There it was argued that alongside a contraction in the demand for credit, there is also evidence of a continuing supply-side constraint. The weakness in demand provides a reminder of the need to continue to focus on identifying opportunities for growth. This is, in part, addressed in Chapter 3. In addition, dealing with the supply-side constraint can have a positive impact on growth. In particular, addressing the perceived failure of Irish enterprise to invest, especially between 2000 and 2008, in productive (rather than speculative) assets must be an important consideration (White, 2010).

The second constraint is the level of business rates charged by local authorities. This is a complex question, which will take time to resolve. The creation of a more stable and community-wide system of funding for local government would allow a reduction in the burden of municipal services. However, the question of transferring the tax burden from business to households needs to be considered in

the context of wider reforms of local authorities. Consequently, changes in this area would require further analysis. The starting point for this analysis is the work carried out in 2010 by the Local Government Efficiency Review Group. The Review Group examined how the base for rates might be broadened by including state properties, reviewing some exceptions in the catering and accommodation area and including offshore structures such as wind farms. It was projected that this would increase revenue by €77–87m although €50m of this relates to state properties and €10m to third-level and professional education institutions. However, it did not examine the question of reducing business rates.

Third, pre-competitive public procurement is a constraint, particularly for SMEs producing high-technology goods or services. Many policy reports highlight the potential to use public procurement more effectively in the Irish economy (for example, the *Report of the Innovation Taskforce*). One of the key problems is how to find ways to facilitate small companies to capitalise and benefit from public contracts. The problem in many cases is that SMEs will not be able to compete for large public contracts. For example, a new ICT company will not have the track record or the resources to compete against a larger or longer-established firm.

The use of pre-competitive tendering processes is a standard practice in many European countries. It creates a process of engagement, usually a funded competition, in which firms are invited to work on aspects of particular problems facing a public-sector body. The results of this process are used to design the final tender. The initial engagement will have enabled smaller companies, and often groups working collaboratively, to develop a good understanding of what is required. The process also provides the public organisation with a sense of what the people in the smaller companies can do. The result in many European countries is much more success for smaller local enterprises in tendering for public-sector contracts. It also means that public organisations improve their ability to design tenders and specify their needs. This process is potentially relevant to design of new products and services—for example, the design of activation and support services for unemployed people. In that sense, it links to the major public-reform projects discussed in Section 5.4.

Fourth, the public sector in the broadest sense is gatekeeper to information and data in several domains—health, education, traffic flow, energy usage, cartography, food safety. In some areas the value of this data is being realised and used, for example Dublin City Council’s work with IBM on the Smarter Cities project. However, little systematic thought has been given to how such data might be used as a basis for economic, social and environmental gain. There is considerable potential to use this data to provide personalised services in the public service, for example in the provision of activation services. This issue has been underlined in the

recently published Public Service Reform Plan (November 2011), which has promised a renewed emphasis on the use of innovative technologies to support enhanced customer-service channels, to improve information sharing and to reduce transaction costs. In the case studies, carried out by the Secretariat, capturing these types of possibilities depended on networks capable of searching widely for possible solutions. Keenan, for example, has an International Scientific Advisory Board to assess international research across many fields—animal nutrition, agricultural economics, engineering and ICT. This has supported its development from machine manufacture to the broader provision of a (personalised) animal nutrition service.

Finally, the specific examples discussed in this section suggest a general conclusion. That there is a need to find effective institutional means of identifying and helping to address the developmental constraints that face enterprises. The cases noted above illustrate that companies at times encounter a public sector that is not responsive enough. In some cases there may be legitimate reasons for the perceived delay, but in others the delay may reflect the fact that those receiving requests from commercial companies are unfamiliar with them or the business ideas/models being proposed.

This could range from the very specific, a single company making a request to a Local Authority to test a new technology, to general issues such as the impact on business of changes to regulations, standards or planning procedures.

It would be useful to examine how enterprise agency staff could have a more proactive role in scanning for and dealing with such constraints. In doing so, agency staff could liaise with companies, company networks and other interests, and act as interlocutors for the wider public sector. This should extend to scanning for vulnerable employments and working proactively with the public sector to develop possible solutions.

## 7.4 Extending Enterprise Policy

In this discussion of possible initiatives in enterprise policy that might assist firms in driving the Irish recovery, we have taken a practical approach. We have described some ways in which firms are responding to the crisis and noted the nature of their engagement with the development agencies, such as EI and IDA Ireland. The strengths in these responses, and some gaps in the engagement with agencies, have led us to suggest ways in which public policy could do more to address constraints on business development.

We are interested in exploring these constraints. Work by Hausmann *et al.* in their analysis of economic development and industrial policy, provide an analysis which is helpful in this regard (Hausmann *et al.*, 2008). They argue that neither economists and public officials on the one side, nor private actors on the other, necessarily know where the relevant market failures or distortions are. Consequently, they suggest that a key feature of the development policy process is identification of the distortions or, more precisely, organisation of 'searches' to identify and respond to them. In their view, solutions to distortions require complex bundles of measures of various kinds and, therefore, the space that needs to be searched to assemble such bundled solutions is very large. Most of the distortions, that inhibit enterprise and development, cannot be addressed through appropriate cash subsidies or money transfers. Instead, they reflect missing markets or public inputs (e.g. infrastructure, industry-specific skills, regulation, property rights, and social norms).

Industrial policy, in this view, is necessary to assist firms in their search and discovery processes for new lines of comparative advantage. This approach puts the emphasis on getting the strategic collaboration with the private-sector which directs policy to work right. This process of engagement is seen as necessary element in identifying and addressing market failures and constraints on growth.

The evidence, provided by the case studies reviewed by the Secretariat, is consistent with this view. The cases suggest that the standard way of thinking about market failure may not, in fact, fully capture what should be done in enterprise policy, innovation policy, training, local development and other areas. To be sure, traditional industrial policy might compensate for financial market failures by providing grants or a favourable tax rate, which tip the rate of return on certain projects in Ireland positive and thereby ensure that business formation, investment and employment occur. Innovation policy might compensate for externalities in R&D and ensure that research occurs which maximising actors would not undertake. Publicly subsidised training might address the problem that individual employers will tend to under provide training because they fear that workers will move to other enterprises. What characterises this understanding of these policies is that the set of possible actions (investments, research projects, training courses), is more-or-less known to the actors, or at least exist to be found in a process of rational search. What the public policy interventions does is alter the return on actualising these possibilities in Ireland. But there is reason to believe that there can be more going on in each of these policy areas when they work effectively. Enterprise agencies not only tip the rate of return on known projects, but work with firms to find new projects and resources and to combine them in ways that help them address old and new constraints. Innovation policy does not only fund known research projects, but often brings together a range of stakeholders to collectively assess research capability, explore research possibilities and undertake joint

projects. Not only enterprise agencies, such as IDA and EI, play a role in supporting new business possibilities, but also entities such as Dublin City Council in its work with IBM on the Smarter Cities Initiative. Likewise, an effective public training agency would not simply reduce the net internalised cost of known training courses, but would work with a range of firms and providers to work out what training should be undertaken and what works for which employees, firms and sectors.

If we accept the contingent and evolutionary nature of economic possibilities and the role of institutions in business and technological development, this has implications for how we think about the possibility of growth, employment, skill development, business start-ups and social and environmental enterprise in the wider economy. We need to pay greater heed to the way business, technology, organisation and value creation has changed in the past two decades, and to the developmental challenges facing the economy and society.

## 7.5 Next Steps

A view of the economy that resonates with the dynamic networks capable of searching locally and globally—which come through in the case studies (noted above), and, which reflects the developmental-type work taking place between companies (foreign and Irish-owned) and parts of the public sector—could help inform policy. This is a long-term project but there is work that can take place now which will help in time to inform this overall view.

One aspect of this project is getting a sense of the balance (or imbalance) that exists in the Irish economy. Foreign-owned companies and foreign investment are a crucially important part of the Irish economy. The economy continues to be reliant, particularly in the current phase of export-led recovery, on exports from within the foreign-owned sector. It may well be the case that the foreign-owned sector—with higher propensity to export, spend on research and development, and higher productivity—masks a weak and underdeveloped indigenous sector. However, this view is hard to reconcile with evidence from individual companies and from the enterprise agencies. Along with the cases discussed above, there are various pieces of evidence that suggest a more careful analysis is required. For example, in 2010:

- Enterprise Ireland client companies achieved €14bn export sales, which included €1.95bn of new export sales;
- Irish companies operating in the US employed 80,000 people compared to 110,000 employed by US companies in Ireland (IBEC, 2011);



- Food exports increased by over 11 per cent in value terms; and,
- In volume terms the increase in Irish service exports in 2010 was 9.9 per cent which was the largest increase in services exports in the EU (15) (NESC, 2011b).

A straight comparison between foreign- and Irish- owned—on issues such as export propensity, spend on innovation, or productivity—tends to portray Irish-owned industry unfairly. A comparison of Irish companies with similar companies would be preferable. The aim of this type of analysis would not be to gloss over the gaps between foreign-owned and indigenous companies. It would instead help to pinpoint more accurately the challenges facing Irish companies in particular sectors relative to similar companies in other countries.

In addition, the crisis has brought to the fore the need to value hugely, and insist more strongly on indigenous industrial development. In growing exports, it has been well noted that Ireland's exports remain geographically and sectorally concentrated, and that Irish-owned companies account for only 10 per cent of their total value.<sup>42</sup> But there is also a strong awareness that the sectors which can be considered as having a significant export potential has widened well beyond those associated with inward investment by multinational companies, which remain hugely important, but are now joined by indigenous companies in food, services, tourism, education, life sciences, software, renewable energy and the creative industries. To a significant extent, what is an exporting sector and what is not, and what exporting success requires, have to be periodically reconceptualised in order to keep pace with the rapidly changing global and technological context and Ireland's wholly different relative standing within it. Considerable work has already been done in such documents as the *Strategy and Action Plan for Irish Trade, Tourism and Investment to 2015* and *Food Harvest*. These provide a comprehensive inter-departmental statement of what public policy must do on multiple fronts to adjust and attune the economy's ability to grow jobs, and quality jobs, from participation in the world economy. The current recession and hugely changed outlook for global supply chains and the international financial system only serve to reinforce how important it is that the strategies of bodies with responsibility for Ireland's natural resources (e.g., Tourism Ireland, Bord Bia, the Marine Institute, Coillte, Sustainable Energy Authority and Education Ireland<sup>43</sup>) unfold successfully

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<sup>42</sup> When the share of exports is adjusted for the level of expenditure in the Irish economy the share of exports by indigenous companies rises to 28 per cent (NESC, 2011a:16).

<sup>43</sup> The economic activities these bodies foster not only source a large proportion of their inputs from elsewhere in the economy but generate jobs in areas and communities where alternatives are often very limited.

and are given heightened urgency at the present time. In seeking to foster greater exporting activity on the part of indigenous companies, their traditional reliance on the huge British market needs, certainly, to be protected but, to an even greater extent, the supports that enable them to position themselves more firmly in the emerging markets of the global economy 'where we do not have the historical links, shared language, similar economic structures and favourable geographic positioning that have served us so well in the past in markets such as the US' (Department of Enterprise, 2010:23) need to be strengthened. In addition to growing exports from existing indigenous enterprises, the policies that support the gestation of wholly new Irish companies have grown in importance at the present time; there are new cohorts of Irish entrepreneurs capable of understanding and, if properly backed, seizing new business opportunities in cloud computing, clean technologies, 'silver technologies' (products and services that improve well-being of older people) and other areas.

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# Chapter 8

## Conclusion

This report constitutes an initial exploration of policy actions that might strengthen recovery and enhance employment. It is motivated by the Council's anxiety about the depth and duration of the crisis and, particularly, the current high level of unemployment and the prospect of a prolonged limitation of opportunities for employment and earnings. It has gathered ideas that have been in the public domain and sought to generate some new ones. In this concluding chapter we consider the kind of policy work that might be necessary to take these ideas further and locate this work within the Council's wider analysis of Ireland's five-part crisis and understanding of the characteristics of an effective Irish response.

In broad terms, the ideas and policy possibilities identified in this report fall into three categories, each of which involves a different process of policy analysis, development and execution.

First, there are a set of measures that are likely to have a positive impact—such as adapting the welfare and tax systems to better favour employment and business activity without eroding social protection and allocation of increased resources to existing retrofit programmes—which the core policy system can assess and design in more detail, perhaps assisted by further economic analysis. Although these measures may involve difficult political decisions, and can only be introduced gradually, they are relatively straightforward in two senses: there is limited doubt that they will have some positive impact on business activity and employment, and they rely largely on the executive power of central government.

Second, there is a set a set of possible actions—such as measures to increase credit and finance to SMEs, further public-works programmes and 'iconic' projects, actions to involve pension funds in Irish investment, new financing models for retrofit programmes, green-economy investments and others—where the exact nature of the problem, and certainly the shape of possible new policy action, cannot be determined by desk analysis, but requires the state to create mechanisms that engage the relevant private, civic and public actors in a process of search and joint problem solving. This is so for two related reasons: first, national policy makers are critical in creating the framework for policy development, but cannot know specific

problems in enough detail to design tailored solutions; second, the deep expertise that is essential is largely held in Ireland's vibrant ecosystem of firms, associations and public bodies.

Two policy areas illustrate this finding. The clearest case may be the supply of credit and finance to companies; and here, in fact, interesting developments are in train. One set of actions (the creation of the Credit Review Office) and research (by the Central Bank) have definitely thrown some light on the issue, but still reach somewhat different conclusions. On the narrow question, we believe that there is, on balance, evidence of a supply constraint, but this conclusion provides little guide to possible actions. To assess the scope and nature of further policy action we need to turn to parallel actions initiated in the past year, involving Enterprise Ireland, the banks, the CRO and possibly other actors. It is only such actions that can get to the bottom of the credit and finance constraint. Indeed, it may be necessary to explore existing and possible patterns of supply-chain finance; this would require the engagement of leading companies, such as Glanbia and Intel, along with the agencies, banks and financial authorities. Indeed, the work of Enterprise Ireland and the CRO in response to the credit difficulties experienced by firms illustrates something that may be of wider significance. While it is often correctly observed that measures adopted in response to crisis can lead policy in the wrong direction, or create programmes that mistakenly become permanent, the opposite can also be the case. Initiatives and processes started in the face of severe difficulties can disclose policy and institutional possibilities that should be generalised. The crisis has prompted EI to a deeper engagement with the financial system; the crisis has highlighted the important role of the wider public system—including local authorities, licensing authorities and many others—in assisting enterprise to identify and exploit business opportunities. The pressure on the enterprise agencies to engage in new ways with the financial and wider public system may be a harbinger of a more networked model of enterprise policy.

A second important illustration of the need for immediate creation of a new process of search and joint problem solving arises when we consider the possibility of further direct job creation through public-works projects and other actions. In Chapter 5 we repeated our suggestion that a board or entity be created to quickly identify and assess ideas for projects that would both create valuable infrastructure and increase employment. Likewise, the prospect of a long-term increase in employment opportunities in care services and a range of environmental activities suggests that more supportive frameworks for, and engagement with, the social enterprises may need to be developed.

Third, our discussion suggests that there is a set of policy actions that are definitely relevant in enhancing recovery, supporting employment, assisting structural

adjustment and ensuring social cohesion: welfare reform and activation, reform of further education and training, actions on social and care services, educational reform and enterprise policy. But, equally definitely, these policies share a common feature: they require an enhanced ability of the public system to record, compare, assess outcomes, benchmark performance, tailor services to diverse and changing needs and review policy and service systems (NESC, 2010b). Nobody, in Ireland or elsewhere, has a complete picture or blueprint of what institutional arrangements will support this. But there is plenty of evidence and examples to guide the way—in the business disciplines developed over the past two decades; in the public-reforms that have yielded striking results in Finnish education, US child protection and Scottish social services; in wide areas of EU regulation; and, it is important to note, in the work of Ireland’s Environmental Protection Agency, Food Safety Authority, the IDA and other public bodies. Indeed, the critical role of tailored services, and the move to a ‘new centre in public administration’ that supports this, has been a central theme in NESC’s work in the past decade.<sup>44</sup> The crisis has underlined the degree to which the structural adjustment of the **economy**, the future of Irish **society** and the maximal use of a sustainable environment all depend on urgent generalisation of a similar set of capabilities and institutions. It is vital that this become a central focus of policy analysis, development and public-sector reform.

This classification of the policy possibilities and challenges into three groups is not the same as the conventional distinction between short-term, medium-term and long-term. That distinction underestimates the degree to which almost policy is shaped in practical action. All the problems discussed in this report—domestic demand, credit to SMEs, unemployment, activation, training, education and enterprise competitiveness—are present now, and urgent. Our discussion has revealed several ways in which an immediate response to the crisis, which may have initially been seen as temporary expedient, can in fact open up new policy possibilities that will need to be generalised in more ‘normal’ times. But to see this we need to be attentive to, and reflect on, both the changes in current practice and the emergent shape of the future economy, society and public system.

Although this report focuses on a specific set of urgent and troubling problems and possible measures, we see this as reflecting our earlier observations on the

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<sup>44</sup> The 2002 and 2005 *Strategy* reports (NESC, 2002), (NESC, 2005b), *The Developmental Welfare State* (NESC, 2005a); *Migration Policy* (NESC, 2004b); *Ireland’s Five-Part Crisis* (NESC, 2009b); *Next Steps in Addressing Ireland’s Five Part Crisis* (NESC, 2009a); *The Euro: An Irish Perspective* (NESC, 2010b); *Re-finding Success in Europe* (NESC, 2010a); and the forthcoming *Quality and Standards in Human Services in Ireland: Overview of Concepts and Practice* and associated sectoral studies.

characteristics of an effective Irish response to the crisis. In our report on Ireland's five-part crisis in March 2009, we argued that an effective Irish response must:

- Address all five dimensions of the crisis: banking and credit, fiscal, economic, social and reputational;
- Be based on social solidarity, seen as sharing the burden of adjustment fairly and yielding a fair economy and society in years to come;
- Involve a consistent combination of macroeconomic, distributional and structural measures;
- Be framed around a positive perspective on the future of Irish society;
- Combine high-level coherence with maximum engagement and local problem solving;
- Take short-term measures that move us in the correct long-term direction; and
- Have a sequence and timing that enhances these characteristics (NESC, 2009b: 37).

The report on the five-part crisis, in October 2009 NESC highlighted the difficulty of achieving an integrated, nationally supported and widely understood response: a convincing approach to any one dimension of the crisis is, in part, dependent on a widely-understood approach to the overall crisis; but equally, a widely understood approach to the overall crisis requires a clear and purposeful approach to each of the five elements, taken one by one (NESC, 2009a: vii). In Chapter 2 of this report we identified a spectrum of views on the nature of the crisis at European and global level, which clearly remains a cause of great anxiety. The policy possibilities identified in this report do not amount to a new or alternative approach to the overall crisis but they do suggest that the policy system and economic and social organisations must relentlessly seek practical measures to address all the parts of the crisis, particularly the challenge of unemployment.





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