Labour's New Deal:
Key Proposals for Economic Recovery

INTRODUCTION

Fianna Fáil has brought the Irish economy into recession and has no strategy to get us out of it. Although the recession has been made worse by the international credit crunch, it has its origins firmly in the house-price bubble which Fianna Fáil stoked, mishandled and refused to dampen. Now that the construction sector has dramatically slowed, tax take has fallen and the live register is climbing, the Government is fixated on the problems in the public finances. They have no strategy for managing the problems in the real economy. Instead, they are adopting a scorched earth approach to public spending, which will leave those least able to cope to carry the burden of their economic failures.

As the economic news has worsened, a conservative consensus has developed, that the root of the problem, and the cure, lies in cutting public expenditure. This is simply not the case. The Irish Government needs to have an economic strategy that is focused on the whole economy, on generating jobs, securing people's incomes, and maintaining strong businesses, and not focused simply on the public finances.

The Irish economy must ultimately be weaned off its dependence on construction and return to a pattern of export-led growth, focused on high value-added sectors particularly internationally traded services. In the short-term, however, it is necessary to mitigate the worst effects of the construction downturn. It is also important to take targeted measures to prevent the emergence of structural problems, which are themselves caused by the recession, and which have the potential to delay recovery further.

As the fallout continues from the turmoil in international credit markets, the Government must develop a strategy for economic growth and development in an era of much tighter credit conditions. It must also review and strengthen Ireland's system of regulation for financial services and be a leader in demanding greater international regulation of the financial services sector. It is time for a return to an economics that that promotes economic development as a means to social progress.

WHAT IS HAPPENING IN THE IRISH ECONOMY?

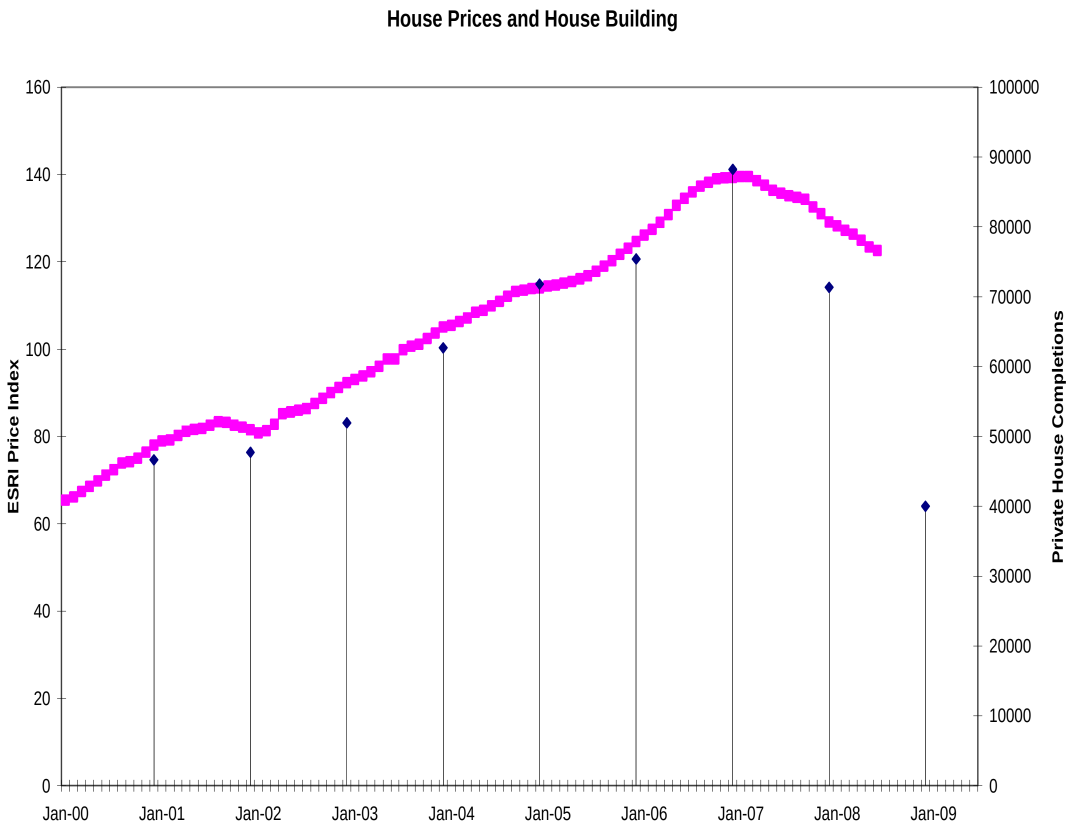
The Irish economy is in recession. GDP growth in the first two quarters of 2008 has been negative – in other words the output of the Irish economy is shrinking, and unemployment is rising as a result. Why is this happening?

It started in the construction sector…

The main factor precipitating the recession is the collapse in house-building, and the problems besetting the broader construction/property sector. While the 'Celtic Tiger' economy was export-led between 1993 and 2001, from 2001 onwards growth was driven by domestic demand, and particularly by house building. Chart1 below shows the trend in house building and house prices in Ireland since 2000. The total number of house completions rose from approximately 47,000 in 2000, to approximately 90,000 in 2006. This rate of activity was unsustainable. Since then housing starts have collapsed, and most commentators expect that house completions in 2008 will be approximately 40000, with a similar number in 2009.

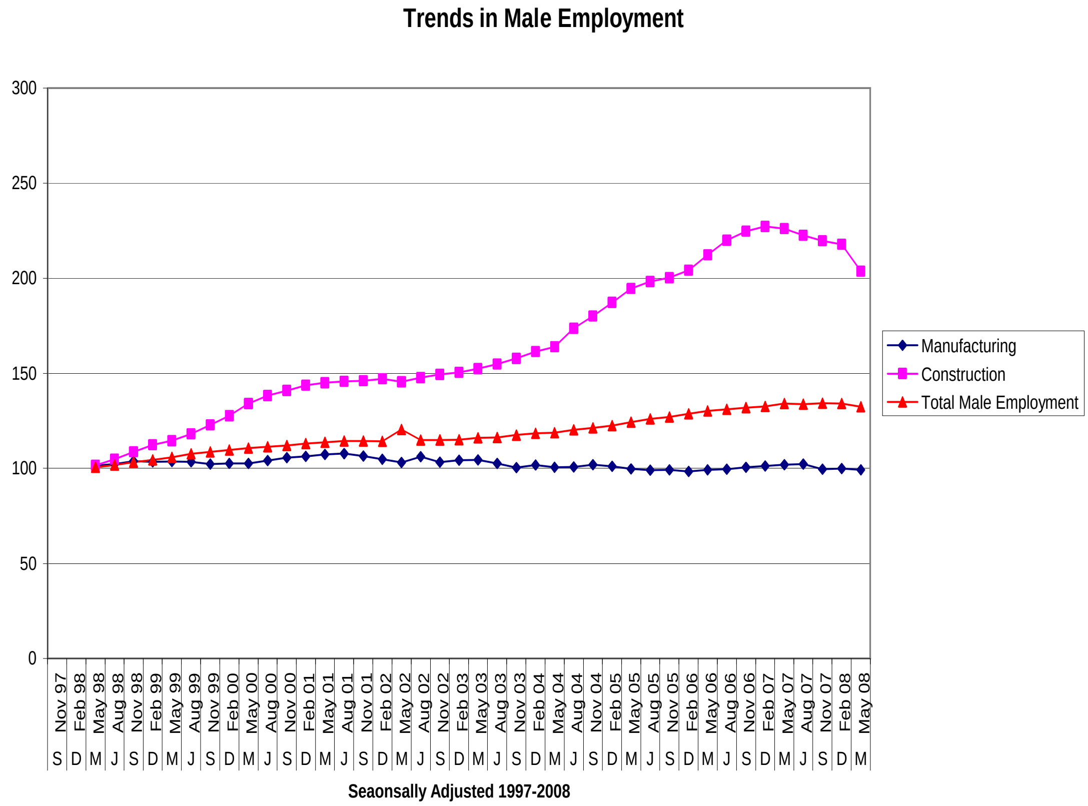
Chart 1 also shows the relationship between house prices and building activity. Prices more than doubled between 2000 and 2007, but peaked between October 2006 and February 2007, and then started to fall, precipitating the collapse in house sales and construction of new homes. This housing crash was essentially a domestic phenomenon. House prices were allowed to rise without check, despite repeated calls for the Government to intervene to contain the rate of increase. No effective action was taken to quell speculation in development land, or to curtail irresponsible lending by financial institutions that fuelled speculation in housing, and the Government remained addicted to property-based tax incentives.

Chart 1: House Prices and House Building



Equally, the economy was allowed to become over-reliant on the house building sector in respect of employment and tax revenues to a dangerous degree. Chart 2, for example, shows the extent to which construction had become a major driver of new employment creation for men. When the house price bubble burst, the result was a collapse in house building activity which has reduced economic activity by approximately 4- 5 per cent of GNP, and had a major direct impact on the live register.

Chart 2: Employment in Construction



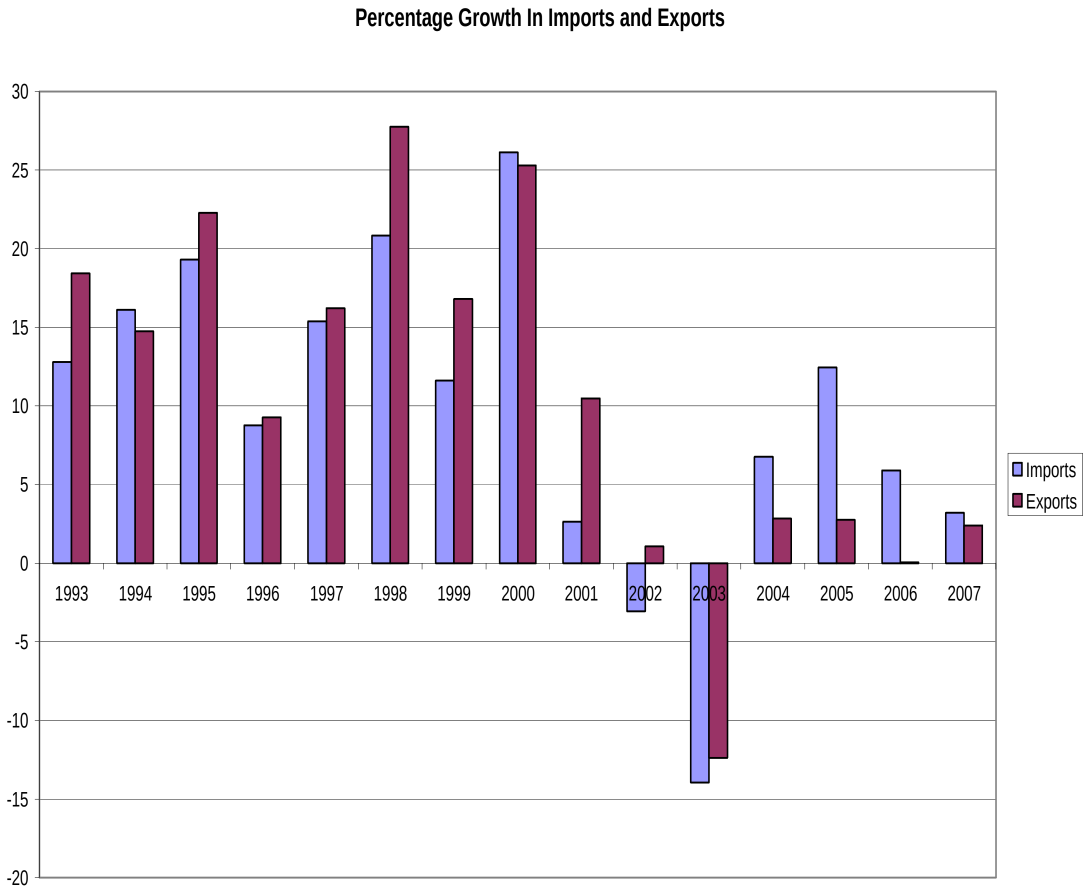
The credit crunch ...

While the housing crash was largely a domestic phenomenon, which pre-dated the international credit-crunch, the problems in the housing sector have been worsened by the international financial turmoil, which has increased the cost and limited the availability of credit, particularly for construction. This has deepened the difficulties faced by the construction sector on which the Irish economy has come to depend. There has also been a general re-pricing of credit, which has put pressure on Irish businesses particularly small and medium-sized enterprise. So, the domestic recession has coincided with difficulties in the world economy, which have hit an export sector already confronting significant competitiveness problems. In the longer term, the collapse of international investment banks, and the broader problems in international credit markets could result in a major reduction in the availability of credit in general, and for house construction in particular.

Competitiveness...

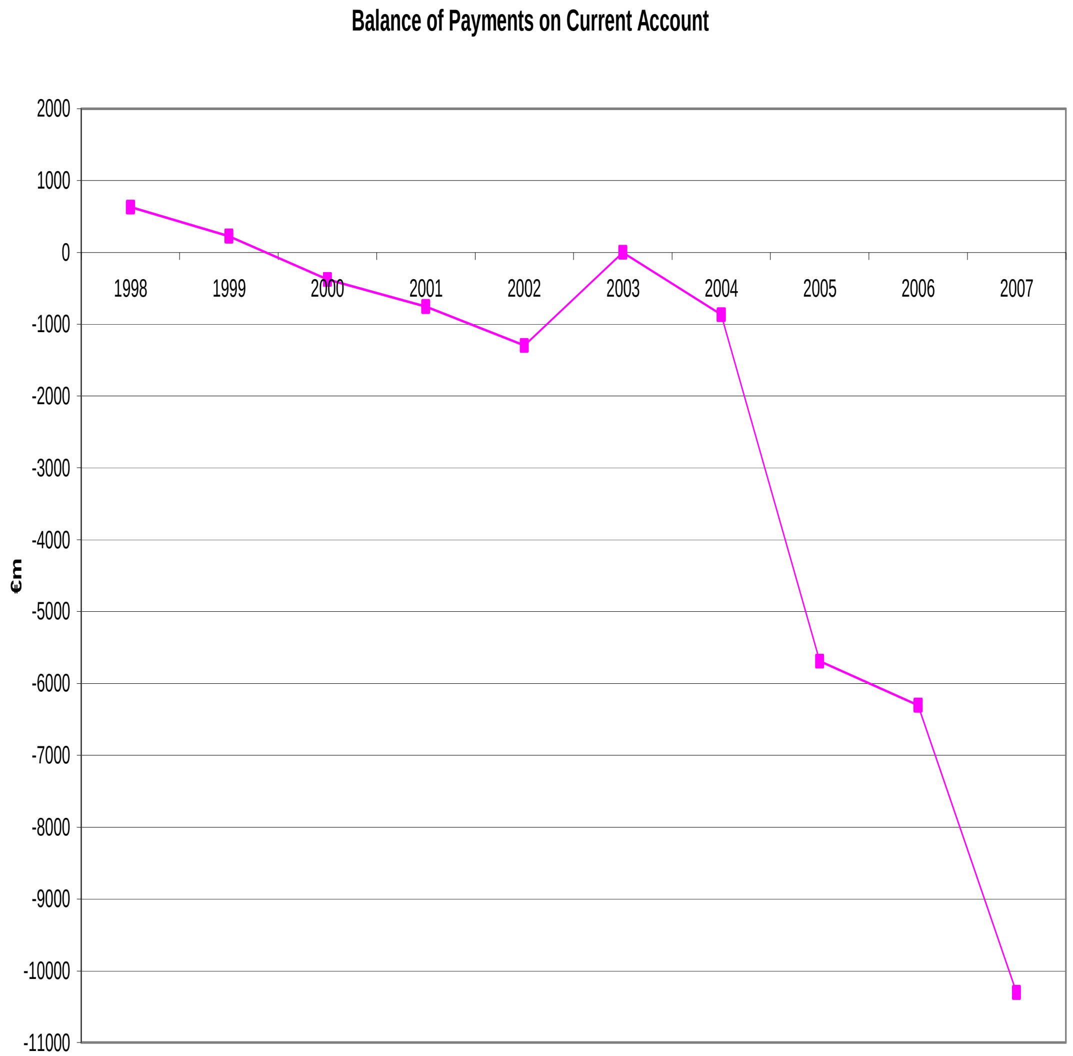
These developments have occurred at a time when Ireland was already confronting significant competitiveness problems. While the Celtic Tiger boom was originally export-led, for some years growth had been driven by domestic demand i.e. consumption and investment spending. This pattern was reflected in Ireland's worsening balance of payments, as imports grew and export growth faltered.

Chart 3: Percentage Growth In Imports and Exports



Disimprovements in the cost base were making Ireland less attractive as a business location. Strong figures for services growth seemed to indicate that Ireland was beginning to achieve a move-up the value chain, but the downturn in the world economy, at the same time as competitiveness disimproved and the Euro appreciation has made trading conditions more difficult.

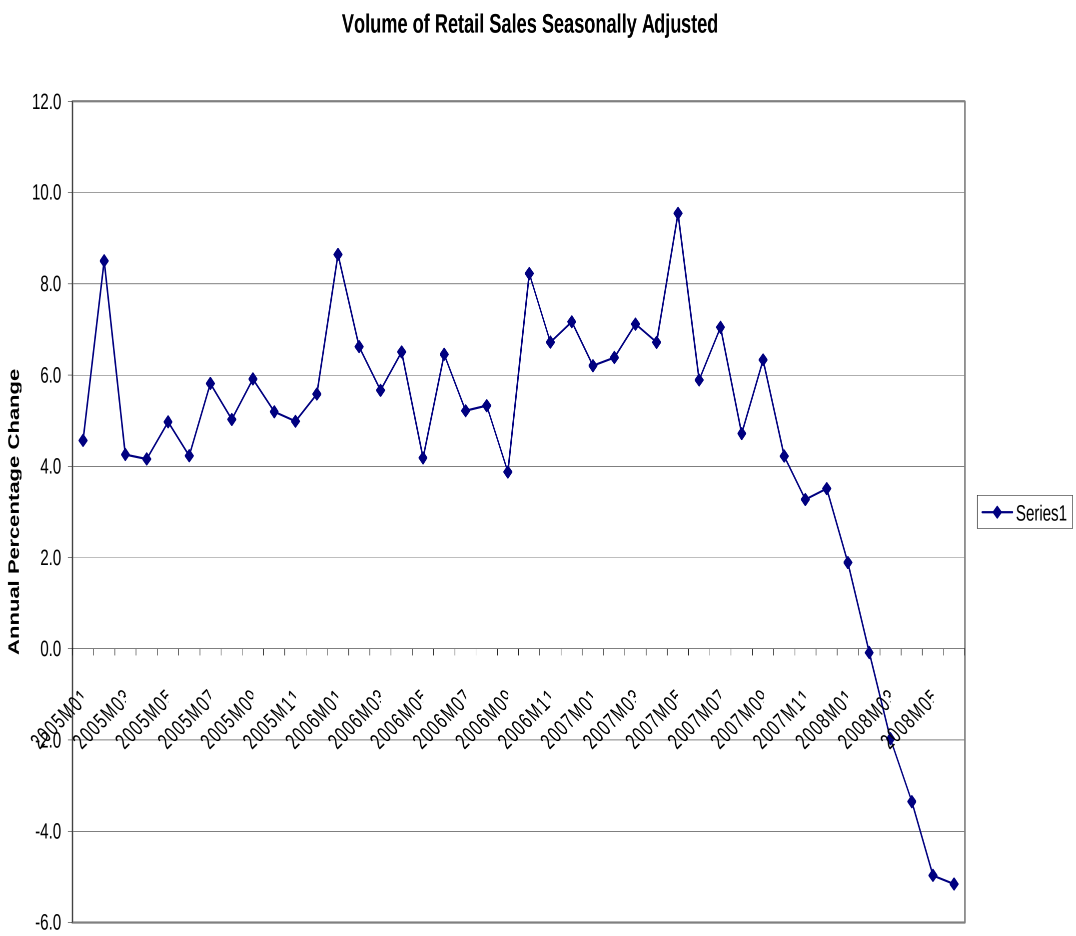
Chart 4: Deterioration in Irish Balance of Payments



The recession spreads out …

As the position in the construction sector has worsened, the recession has spread out into other sectors. Deteriorating competitiveness and poor international trading conditions have contributed to a string of redundancies in manufacturing. The marking down of growth forecasts for 2008, however, also strongly reflects the stagnation in consumption. There has been a dramatic drop in retail sales, and a collapse in consumer confidence. The ESRI consumer confidence index has fallen to historically low levels. While there was some improvements in retail sales figures in the late summer, this was driven by car sales, arising from the change in tax arrangements, with underlying activity in other sectors still performing poorly.

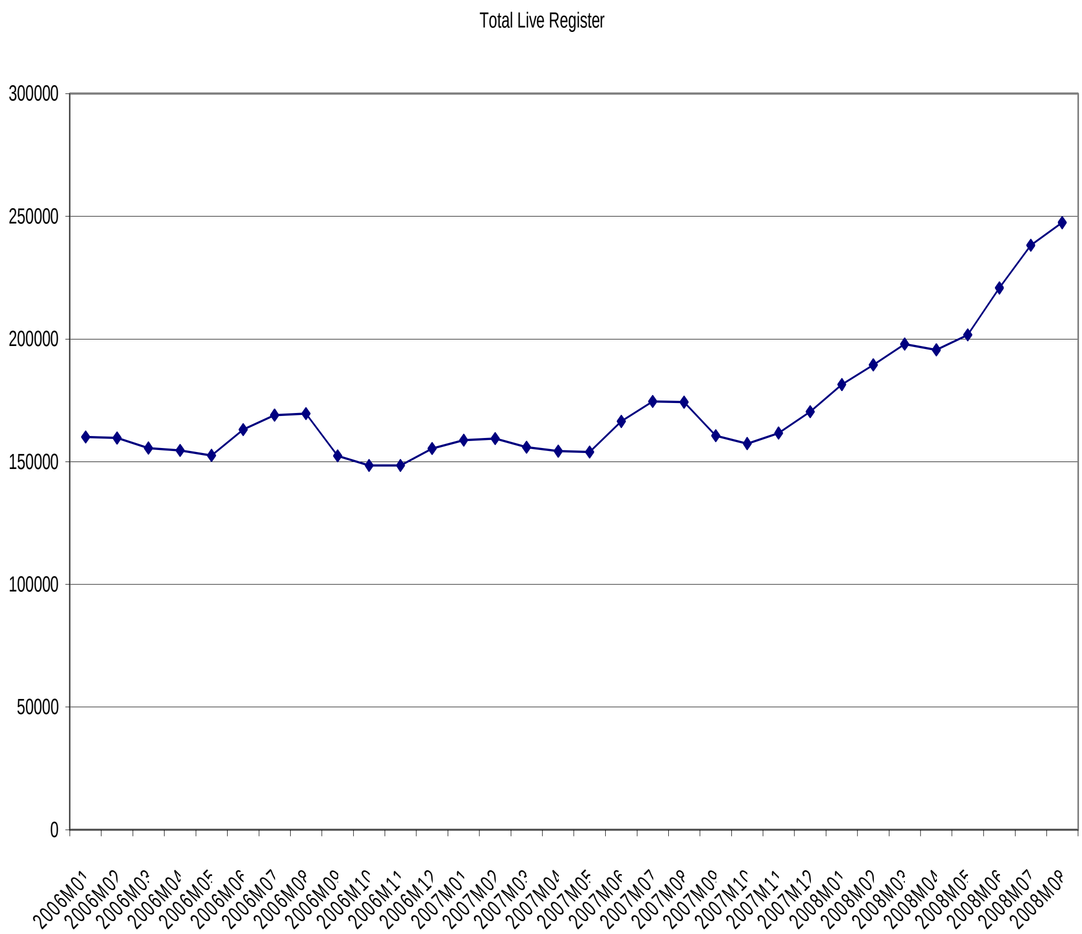
Chart 5: The Fall in Retail Sales



Unemployment rising….

The downturn has been reflected in the steepest rise in the live register on record. Redundancies in manufacturing and labour shedding in the construction sector have had an impact, but the rise in the live register shows a broader down-turn. An additional 73000 people joined the live register in the year to August 2008.

Chart 6: The Live Register



The Public Finances

The public finances have been in the eye of the economic storm. The exchequer had been allowed to become dangerously reliant on taxes from the property boom, which have now evaporated. Tentative estimates from the Department of Finance show that for 2006, total tax take from the Construction sector came to some €9.5 billion, or 17.5% of total taxation. This does not include Capital Gains tax from development land, or development levies received by local authorities. Much of that revenue has evaporated. In the first eights months of 2008, for example, stamp duties alone are €1 billion down on the same period in 2007.

The overall impact of the downturn has been dramatic and is now affecting almost all tax headings. Ulster Bank are forecasting that revenues in 2008 will be €5.5 billion below the target set on budget day. As a result it will be impossible for Ireland to stay within the 3% of GDP limit set in the Stability and Growth Pact in 2008 or 2009

WHEN AND HOW WILL THE ECONOMY RECOVER?

Assessments of the timing of a recovery in the Irish economy vary, largely depending on the view taken as to when the property market will normalise and when an up-turn can be expected in the international economy. While there had been optimism about the prospects for 2009, more recently expectations have shifted, and a more prolonged downturn is now likely.

The prospect of a longer slow-down raises a number of questions about how and when growth will resume in Ireland. The 'short down-turn' thesis was prefaced on the idea that the correction in the property market would run its course, and that stronger international growth would feed through to the rest of the Irish economy. The prospect of a longer recession increases the risk that structural problems or imbalances will emerge and deepen in a way that will either delay recovery, or damage Ireland's longer-term growth potential. These risks include the following:

Hysteresis / Structural Unemployment

As the live register grows, there is a clear potential for the emergence of a new problem of 'hysteresis' or structural unemployment. The downturn in the construction sector in particular, raises the prospect of large numbers of men, with few qualifications, or highly sector-specific skills, spending long- periods out of work. Equally, it may be difficult for those loosing jobs in manufacturing to find jobs that fit their skills. This problem will get worse, the longer the person is out of work. So, the longer the recession continues, the more difficult it will be for these workers to find new jobs, and the more serious their de-skilling will become. This risk may be particularly grave in some areas of the country, including many of the counties along the western seaboard, which have particularly heavy reliance on construction employment among male workers

The Property Market

To date, many economists have been assuming that the correction in the house-building sector would work itself through, and that activity would resume at a level close to what is regarded as long-run demand – some 40,000-50,000 homes per year. Achieving the transition to this new equilibrium, however, could be problematic. There is believed to be a considerable over-hang of unsold homes, and as prices continue to fall the level of activity in the property sector has slowed to a trickle. It may take some time for would-be home buyers to believe that house-prices have stopped falling. This could be further delayed as a longer recession undermines confidence, and as mounting job losses dampen the demand-side of the housing market. A stagnant property market will in turn act as a drag on confidence which delaying a revival in construction activity to normal levels. Government intervention to prop up property developers, dressed up as ‘assisting first time buyers’ will delay normalisation of the property market and act as a further drag on economic growth

The Public Finances and the Real Economy

While there has been plenty of focus on the impact of slower growth on the public finances, little attention has been paid to the opposite chain of causation i.e. the impact of the public finances on the real economy. Although the experience of the 1980s can provide some guidance in this regard, there are limits to the lessons that can be applied from that period, crucially because membership of EMU has fundamentally altered the relationship. Hence, stabilisation of the public finances now, will not have an impact on the economy through lower interest rates, as it would have done in the late 1980s.

In general, it can be taken that cutting current spending or raising taxes will reduce economic activity in the short-term, while cutting investment spending will curtail activity in the short and longer-term. What the full impact of such measures will be, however, will depend on the particular actions taken and the sector where they first impact. A key issue in respect of the public finances is to maintain confidence in the Irish economy among consumers and investors by demonstrating that the Government has a medium-term strategy for dealing with the public finance crisis, rather than excessive focus on any one year.

THE LEADERSHIP VACUUM

Since 1997, fiscal policy in Ireland has been heavily influenced by the electoral cycle, with significant spending splurges in advance of the last two general elections. This has been part of a broader picture of large and unfocused expansions in public spending. Despite arguments put forward by Labour, or by the NESC, there was little strategic focus to public expenditure management. While elaborate documents were produced to support the National Development Plan, this too had a scatter-gun approach, particularly in its implementation. There has also been undeniable evidence of a casual approach to value-for-money, and some appalling examples of wasteful spending. In general terms, the Government was able to browse on, to a greater or lesser degree, increasing public spending in a broad and unfocused fashion.

The recession has brought a reversal in engines, but not in habits. The series of cuts announced in June again show no strategic focus to spending decisions. The Government will cut that which they can easily cut. As with 2002, there has been a targeting of social spending and agencies, but no attempt to adjust spending patterns to meet the emerging needs of either economy or society. Having avoided the crisis for several months, the spending cuts are essentially of a scorched earth variety. Nor have any positive measures been taken to prevent the emergence of structural problems or to correct imbalances. There has been no action to normalise the property market, nor any sign that labour market policy will be geared up to deal with the new realities.

The Government remains wedded to the conservative consensus that its only role is to deal with the public finances. Changing the date of the 2009 budget will have no effect on the real economy. What is required is a comprehensive recovery strategy that goes beyond the public finances, to deal with emerging structural problems in the economy.

LABOUR'S STRATEGY FOR STABILISATION AND GROWTH

The Irish economy must be weened off its dependence on construction and returned to a pattern of export-led growth in high value-added activtities. In the short-term, however, there is a need to mitigate the effects of the construction downturn, and prevent the emergence of structural problems which will lengthen and deepen the recession.

The decisions made by Government in the next twelve to eighteen months will have a crucial impact on how and when Ireland recovers from the recession. Failure to address key imbalances and emerging structural problems will elongate the recession, and damage Ireland's longer term growth prospects. Instead of the present panic measures, what is required is a programme of targeted measures.

1. <u>Stimulate and Re-Direct the Construction Sector</u>

   As the correction in the property market continues, there is a strong possibility that house building activity will fall substantially below the 40,000-50,000 level that is widely regarded as a normal or sustainable level for Ireland. This means that the number of people employed in construction would fall below what is sustainable in the medium-term. At the same time, construction workers will remain idle while the property market adjusts. This scenario can be limited through Government intervention. A major school building programme, for example, would give employment to people loosing their jobs in construction, provide much needed school accommodation for the 40,000 children currently in pre-fabs, and allow the state to avail of softer tender prices and better value for money. Similarly, pushing ahead with social housing construction serves both a social and an economic need.

   A similar win-win could be achieved through a national insulation scheme. Ireland is currently paying hundreds of millions to purchase carbon credits, at a time when energy prices have spiralled. Concerted action to retrain construction workers in the relevant skills, coupled with modest tax incentives, low interest loans or grants to incentives insulation in homes, would generate much needed activity and employment, while lowering carbon emissions. The scale of this task is considerable and would require development over a number of years. There is an urgent need, therefore, to move from pilot schemes to rolling out a major programme to address insulation requirements on a phased basis.

2. Active Labour Market Policies.

   Job losses in construction and manufacturing mean that there is a serious risk of the emergence of a new group of long-term unemployed, who have either poor qualifications and/or highly sector-specific skills. The longer a person remains out of work, the harder it becomes to find a job. As job losses mount, it is essential that measures are put in place to avoid the emergence of a new group of long-term unemployed. This requires a substantial programme of investment in skills and qualifications. Re-training options at a range of levels should be put in place, with the Institutes of Technology having a key role to play.

   This requires a real and substantial shift in thinking on behalf of the relevant agencies, who have been adopting themselves to addressing the needs of a tight labour market. There is also a requirement for co-ordination across a number of agencies, which will only be achieved through strong political leadership. Specific measures should include increasing the number of places available on the Vocational Training Opportunities Scheme (currently capped at 5000), and the use of vacant places in universities and colleges. There is also scope to encourage people loosing jobs in construction to establish their own business, including the harnessing of social finance to this end.

   At the same time, it is important to review the operation of the social welfare system to prevent the re-emergence of poverty traps in the light of changing labour market conditions.

3. Normalisation of the Property Market

   The Irish economy must be weened off its dependence on house building and return to a pattern of export-led growth. At the same time, it is important that the property market and house building sectors normalise, in order to meet the housing needs.

   Housing is a basic human need, and should not be a vehicle for speculation. Short-term measures to support property developers, dressed up as ‘support for first time buyers’, will only delay a return to normal market conditions, and have the potential to bring about further problems of family indebtedness and negative equity. It is important that the present correction in the market should lead to improved affordability of housing for families who have unmet housing needs.

   While it is too soon to predict what impact recent events on international credit markets will have in Ireland, there already evidence of a tightening of credit availability for house purchase. This could worsen over the coming months, and will be particularly acutely felt by those on modest incomes. Labour's proposed 'Begin to Buy' scheme is a modern and rational scheme of shared ownership which is designed to provide the housing needs of families on low and modest incomes. Had it been introduced when first proposed, it would have helped to dampen the housing bubble. It is also important that Government commitments to social housing are met, and do not become the victim of the scorched earth approach to the public finances.

4. <u>Restore Confidence through a coherent medium-term fiscal framework</u>

To restore confidence, and to demonstrate its commitment to fiscal stability, the Government should bring forward a medium-term budgetary strategy outlining a pathway to return the public finances to order within three or four years.

This should involve a statement of medium term fiscal targets which fit within the Stability and Growth Pact (SGP) criteria. The emphasis should be on returning the public finances to a sustainable path over a number of years, rather than fixating on the 3 per cent of GDP reference value. The Stability and Growth Pact, as revised in 2005, makes explicit allowance for an 'exceptional and temporary' excess of the deficit over the 3% reference value. Ireland's present circumstances clearly fit within the category of 'exception and temporary' circumstances envisaged in the revised stability and growth pact, while our low debt/GDP ratio strengthens the case for interpreting the present difficulties in this way.

The Government should also adopt an explicit medium-term debt/income ceiling i.e. a debt/income level that it believes it would be undesirable to breech. This should be situated within a longer-term assessment of the impact of demographic change on the exchequer, so that the medium-term target is related to longer-term objectives for the National Debt net of the National Pension Reserve Fund (NPRF). Having a debt-income target would make it clear that the Government regards a breach of the 3% reference limit as temporary and provide a clear rationale and set of expectations for future fiscal policy.

Ireland's debt/GDP ratio is still among the lowest in the Euro-zone, particularly when account is taken of the NPRF, making it possible to sustain comparatively high levels of investment, provided that projects are properly evaluated. In the meantime, the notion that the Government would borrow at higher interest rates to invest in falling financial market is senseless. More importantly, the

Government should use the resources in the fund to finance productive investment in the Irish economy – something which it has not managed to achieve to date.

5. Targeting Investment Through A New NDP

It is vital that Ireland continue investment in future jobs and incomes, both to enhance long-term competitiveness and to maintain activity in the short-term. There is scope to re-prioritise capital projects within the NDP, focusing on projects with a high economic and social return, and on projects, such as school buildings and social housing, where advantage can be taken of softer tender prices in construction. The present NDP was written as an election manifesto and lacks strategic focus. A more focused and coherent approach is required. It is vital that Government policy maintains a strong focus on competitiveness, including investment in productive infrastructure. Revision of the NDP must include a real commitment to balanced regional development, particularly given the heavy reliance in recent years on construction to support employment in the BMW region. In terms of both national and regional development, the on-going problems in broadband must be an urgent priority.

6. Ring-fence Investment in Education

Although most of the money spent by the Department of Education is not categorised as 'capital' spending, education is the most important investment we make in our people and in our future. It is vital to the long-term success of the Irish economy, and to a thriving society. Yet, there are glaring weaknesses in the Irish educational system, particularly, but not exclusively, at primary and pre-school level. Rather than targeting education for expenditure cuts, now is the time to ring-fence education spending, and to target improvements particularly at pre-school and primary levels. We must afford educational expenditure priority as though it were a capital item.

7. Encourage High-Tech Start-Ups

In recent years, substantial resources have been invested in research and innovation programmes, intended to enhance Ireland's scientific infrastructure, and to increase our capacity as a knowledge economy. Labour has been arguing for some time, however, that stronger policies were required to ensure that this activity is translated into high-tech start-ups and high quality jobs. The present downturn makes this shift in policy thinking more, rather than less, pressing. Now is the time to encourage research, innovation and enterprise, with a particular emphasis on the need to ensure that adequate venture capital is available for high-tech start-ups

8. Improve value-for-money in public spending.

   There is a clear requirement to improve value-for-money in Government spending. The review of administrative budgets promised in Budget 2008 should be published. Targets for curtailment in the short-term should include Government PR, advertising, and routine consultancies. Front line services must be prioritised for resources. In the longer term, significant enhancement in value for money is possible through structural changes as outlined in Labour's 2007 Manifesto. In the past, cuts in Government spending have been targeted at social programmes, often in areas where there are no strong vested interests. These have often resulted in false economies, such as where in-home services for elderly people have been cut, leading to greater demands on acute hospital beds, or where social housing programmes have been cut leading to greater demands on funds for emergency accommodation. These false economies should be avoided.

9. Review of Central Bank and Regulator Performance

   Notwithstanding the problems on international credit markets, the collapse in the house building sector poses serious questions for the Central Bank and the Financial Regulator. While the focus of regulation was on protecting the financial system, the behaviour of the banks supported and perpetuated and unsustainable house price bubble. By aggressively promoting mortgage lending, including abandonment of the traditional credit rules, the banks promoted a rise in house prices, the subsequent collapse of which has had severe consequences for the Irish economy. Had a more regulated approach been taken to mortgage lending, these excesses, and the cost of adjustment, would have been greatly reduced.

   The Government should therefore commission a look-back review of the performance of the Central Bank and the Financial regulator, to examine how they exercised their regulatory functions over the past five years, and whether existing legislation is adequate to ensure that this kind of speculative bubble is avoided in future. Such a review should be time limited and under-taken by an international authority on financial regulation

10. <u>Support Stronger International Financial Regulation</u>

As the events of recent weeks make plan, the model of unregulated finance has failed. The Labour Party has been active with its sister parties in Europe in promoting better regulation of the international financial services sector. In May of this year, a group of Senior PES members wrote to the EU presidency calling for a European Crisis committee to review the financial crisis, and the PES is currently advancing proposals through the European parliament. The 'Rasmussen Report' includes the following measures:

- Mandatory capital requirements for all financial institutions;
- Aligning reward packages with longer term outcomes, to reflect losses as well as profits;
- Full transparency of high level executives and senior managers' remuneration systems;
- Disclosure of leverage/debt exposure, source and amount of funds raised, and identification of shareholders (above a certain level) for all investment products (and therefore including hedge funds and private equity) to investors and public authorities;
- Extending the Directive obliging employees to be informed and consulted during takeovers to include leveraged buy-outs;
- Measures to "avoid unreasonable asset stripping in target companies";
- Action to avoid excessive debt caused by leveraged buy-outs, so that "the level of leverage is sustainable both for the private equity fund/firm and for the target company";
- Employees or staff representatives of pension funds be informed on how their pensions are invested and the associated risks.

CONCLUSION

The Irish economy is not about statistics, it is about people. Today, thousands of Irish families are suffering anxiety and hardship because of the mishandling of the economy. The conservative consensus is ignoring their needs.

Ireland needs a New Deal – a new determination by Government to address the real problems in the real economy.