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**SYMPOSIUM  
ON  
ECONOMIC MANAGEMENT IN IRELAND POST-EMU**

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**Economic Management in Ireland Post-EMU:  
Ireland's Potential within EMU**

BRIAN GEOGHEGAN  
*Irish Business and Employers Confederation (IBEC)*

**1. INTRODUCTION**

A tendency to seriousness is not usually a characteristic associated with the Irish but our national image may be in the process of being redefined as we treat the management of success with almost as much caution and worry as we did the management of the crises of the past. The economy has outperformed all the prognostications – the *Economic and Social Research Institute* (ESRI), damned at the time for being over optimistic in its medium-term review, was, as it turned out, far too cautious; the emigration problem has been reversed; standards of living are close to EU average; employment is booming; public finance surpluses are forecast for a number of years and business confidence remains high even if we are at the cusp of this extraordinary period. As we assess the implications of the new monetary and exchange rate straightjacket for our booming economy, it is right that serious reflection be given to the appropriate policy mix for economic management.

The new paradigm is not just an economist's construct. Business already grapples with the immediate practical consequences of EMU and plans to deal positively with the strategic challenges and opportunities. This is an important year in shaping thoughts and policies for the future – we at IBEC are consulting our members widely on the future of social partnership (as presumably are the other partners), *National Economic and Social Council* (NESC) is already deeply involved in the strategic analysis, *Forfas* is updating its own "Shaping our Future" study, the ESRI is heavily involved in assisting the process of preparing a new *National Development Plan*. All of this serious analysis and preparation should hopefully result in general acceptance of the need for longer-term perspectives in managing the economy within EMU.

In the preparatory phase over the last number of years the Maastricht criteria have determined the framework of policy. Business was relatively comfortable in the certainties which adherence to the criteria seemed to bring with it –the relatively strong fiscal discipline and the consistently good behaviour of inflation added to business confidence. The private entrepreneurial sector in Ireland in a very real sense came to a new maturity in the years leading up to EMU. To some extent what is needed within EMU is more of the same – but the rules have changed and it may take some time for that reality to be felt generally in the economy. The efforts of economists, which more recently focused on the problems of Ireland joining EMU, must now be directed at solutions and new thinking for optimising Ireland's performance in the euro-bloc.

There are some new certainties, good and bad, there are also new uncertainties, some economic, some political; new emphasis on structural change is needed, new strategies are called for and as the theme of this seminar implies, a new focus is required in leading the economy through this unknown territory. It is not an option to concede intellectual leadership of our economic and social prosperity fully to Europe. Business confidence in Ireland is strong and its continued strength will depend on the ability of policymakers to push the competitiveness drive ever deeper.

## **2. IN BUT OUT OF PHASE?**

We do need to distinguish between the set of problems/issues arising because we have entered EMU out of phase with the rest of Euroland – from those longer term and arguably more important challenges in the ongoing management of the economy in this new environment. It is interesting that many external commentators saw our boom as a major risk factor for Ireland and even for stability within the system in the first year of EMU and prescribed radical remedies to be delivered in the 1999 budget. There are indeed serious pressure points in the economy and I shall return to these but the external analyses tends to be based on the automatic prescriptions for large economies and miss some of the essential characteristics of our somewhat unique “quasi regional” European case. I shall mention three features :

- Firstly consensus within the social partnership, particularly in relation to pay and tax does make a difference – on the assumption of course that this consensus sticks. I recognise that there are some worrying signs that expectations in the non-traded public sector are running well ahead of the present agreement and threatening the possibilities for a successor. There is much more drift in the system (certainly in the public sector but also in the private sector) than under earlier agreements but if the consensus were to break down or even be stretched much further the strategy of tax giveaway could indeed be inappropriate.
- Secondly, the Irish economy has both the potential to grow much faster than many other EU member states and the need to do so to bring living standards

here really up to European levels. While the present boom is unsustainable there is no strong probability that it will be followed by bust; rather the growth path can plausibly fall back to sustainable (but high by European standards) levels over the next year or so. (On the assumption, of course, that unreal expectations do not feed the pressure points in the labour and housing markets beyond breaking point.)

- Thirdly, the Irish economy continues to benefit from a dual identity. On the one hand a hugely successful modern, mainly foreign-owned, high technology export sector dependent for growth on broad world demand (and not therefore supersensitive to fluctuation in, say, the UK market). On the other an indigenous sector, while still dominated by food related industry, but increasingly populated by new or restructured industrial or service exporters; much more exposed to the UK market. Provided competitiveness dependent on domestic factors is not allowed to deteriorate, the dual nature of the economy tends to cushion us somewhat from bouts of weak demand in the economies of our nearest neighbours. The risks of sectoral over-concentration in high technology companies in Ireland are referred to frequently but the fact is that the demand for their output e.g. information technology and pharmaceuticals, is very broadly based in world-wide markets and we are keen to harness the increasing opportunities, such as e-commerce, that high technology brings.

There are other factors in a small open economy which will tend to mitigate some of the possible adverse effects of entering EMU at an unsustainable rate of growth. In the absence of severe shocks such as a sudden sharp weakening of sterling, the short-term strategy to manage the boom must include preservation of the pay agreement and diversion of more resources towards investment rather than consumption. Longer-term strategies are also needed.

### **3. CERTAINTY AND UNCERTAINTY**

The sets of certainties and uncertainties facing business have shifted as a result of our entry to EMU. Not all of these changes are attributable to the single currency itself but must come into play as strategies are being reassessed. Macroeconomic management must mirror the adjustments required of individual businesses. Certainty around the strategies required to achieve participation in EMU are replaced by new ones:—

- The euro guarantees sharper competition within the single market, price transparency will change behaviour and create new opportunities and threats and these realities will not be eased by the cushion of devaluations;
- Enlargement of the EU to the East seems now a certainty requiring new investment strategies at firm and at national level in respect of foreign direct investment;

- Lower EU funds and a fairly early move towards being a net EU contributor is a certainty adding importance to the management of boom surpluses and offering opportunities for private sector investment to fill some of the gap;
- Lower interest rates seem to be a reasonable certainty for the foreseeable future giving rise to significant adjustment in the financial sector and providing a welcome stimulus to ongoing fulfilment of infrastructure needs;
- It may be argued that we have had the certainty of fiscal discipline *a la* Maastricht for some time but the *Stability and Growth Pact* brings a sharper certainty with its inbuilt penalty clause;
- Business also now regards tighter labour supply conditions as a certainty over the next number of years implying pressure on training costs and on the need for greater productivity.

New uncertainties abound. The sterling uncertainty in the new situation dominates and while present wisdom tends to underplay the likelihood of sudden sharp weakness (or strengthening) of sterling, the memory of 1992-93 is fresh. Much has been written about the need to build in automatic or semi-automatic adjustment mechanisms in the wage agreements to deal with such a potential problem. NESO will no doubt address this again this year and, while there is a common perception that employee involvement through share ownership for example can play a part, in practice it is difficult to envisage mechanistic solutions capable of being agreed at national level. The widely varying productivity levels between the modern and traditional sectors give rise to further complications in attempting to construct such 'solutions'. Already even in the absence of such a 'shock', the higher wage generally commanded in high technology industry is tending to affect smaller, lower productivity companies as labour shortages bite at a number of levels. There are other new uncertainties around potential 'shocks' –

- The full impact of the Asian crisis is yet to be felt (the ESRI Winter 1998 Quarterly forecasts a stronger effect) and *European Commission* and *European Central Bank* (ECB) responses to possible domestic shocks e.g. in agriculture, remains to be seen;
- New uncertainties surround the pressures for harmonisation within Europe – business attaches a huge importance to the maintenance of the relative independence on tax matters currently guaranteed by the unanimity rule within the EU Council;
- Governments in the absence of a large federal European budget, must be allowed a significant degree of freedom to manage fiscal policy;
- These uncertainties are compounded by the emergence of a stronger socialist political presence in Europe with a new economic agenda which we must ensure does not chip away at the *Stability and Growth Pact*;
- New uncertainty surrounds Ireland's political relationship with Europe on a broader front, as discussed by Garret Fitz Gerald, in his paper in Kenmare last Autumn – this is part of the reality of our movement away from being a large net

recipient of EU funds. A significant part of business investment in Ireland has been influenced by the positive nature of our relationship with the EU – it is vital that the new demands of economic management within EMU are also approached positively at political level and that the Eurosceptic phenomenon does not drift across the Irish sea. Ireland’s long-term strategic interest lies in being firmly committed to Europe and its single market;

- Economic management within EMU also has to cope with new uncertainties around the future of social partnership here – much work has been done in attempting to explain the phenomenon of Ireland’s growth and while social partnership is just one part of the explanation it has in my view been an important part.

#### **4. STRATEGIES AND STRUCTURES**

Since economic management must be conducted against the background of these changed circumstances and cannot rely on quick fixes, it must coherently address structural issues. In short, the capacity of the economy must be raised by appropriate supply side policies and the ‘transaction cost’ of doing business in Ireland must be constantly benchmarked against our competitors. Priorities must be set in a way which underpins longer-term objectives – infrastructure, innovative capacity, labour market policy and education and training, competition policy and the further liberalisation of markets, public sector reform - all must be addressed afresh against a tax and incomes scenario which favours growth and employment.

IBEC has taken the lead in identifying the magnitude of the gap in Ireland’s infrastructure, as outlined in our report *Filling the Gap* by Fitzpatrick Associates. Shortfalls are most visible in transport and housing but other areas require significant upgrading. Even on the basis of a slower growth rate over the next five years compared with the last, continued expansion will add to the infrastructure requirement. The effect of present congestion is to reduce competitiveness directly and indirectly, adding to the cost of exports from our already peripheral position in Europe. A new focus is urgently needed to eliminate the bottlenecks in housing supply through accelerated investment in water sewerage and associated road infrastructure. The house price problem is not amenable to quick solutions and action under the Bacon Report only provided some temporary relief. House prices are seen increasingly as a threat to the cost and supply of labour. The only solution is to increase house supply as quickly and efficiently as possible. In this area as in others, sharp increases in infrastructure investment must be accompanied and supported by other policy changes (some politically difficult) within an overall framework.

- Public-private partnership projects will form part of this change and IBEC is working to ensure that these mechanisms come into play in part to compensate for lower EU funding but also to achieve significant efficiency gains.

- Unnecessary delays and consequent costs arise because of administrative/legal/planning bottlenecks in bringing major projects to delivery stage.
- The whole question of user charges needs to be revisited both from the point of view of rationing usage and attracting private capital.
- The management and co-ordination of infrastructure must be given much greater priority as investment rates increase – traffic management is a very visible example, waste management is another.
- A broader long-term vision is needed in urban development which focuses on wider catchment areas around our major cities with an integrated approach to mass transit, housing and industrial development.

Innovation and research and development in Irish industry has been boosted in recent years but competitive advantage within the new EMU regime will be achieved through giving added priority to this kind of activity. Present definitions of R&D for public funding purposes are somewhat restrictive, for example, in respect of incremental product and process development. Further encouragement is also needed to increase the commitment of companies on a broader level across manufacturing R&D and technical innovation. Public private partnership between companies and the research capacity of third-level institutions must form part of this deeper commitment of resources.

Successful economic management within EMU will be crucially dependent on labour market policy. *Partnership 2000* spelt out a range of commitments in respect of actions to combat unemployment – many of these have been overtaken by events in the market. New institutional responses are called for and the *Employment Action Plan* initiatives now seem to be delivering good results. The key, however, to ongoing success in reducing unemployment and keeping it low is in the responsiveness of employment services to changing circumstances. IBEC has called for more market oriented training initiatives at this time in place of general programmes with poor links to the market. Looking outward, labour markets in Europe are not performing well. They are over regulated and bear extraordinarily high non-wage costs as a result – one vital reason why Ireland with its lower costs has been so successful in attracting foreign direct investment. This is an advantage we should defend strongly and not be tempted to introduce additional uncompetitive rigidities – minimum wage legislation is an example. Comparisons of employment performance within Europe and between Europe and the US should in themselves provide sufficient evidence to deter policymakers from taking this route.

Education investment has paid off for Ireland and we are by no means at the optimum yet. New investment is needed but with new emphases - to deal with early school leaving, to prepare young people for the information society and to adapt to lower numbers at second level through quality improvements and better use of scarce resources. Adaptability is a phrase frequently used by foreign investors when

describing the Irish workforce - this is a characteristic which may well become even more important as economic integration in Europe proceeds. Initiatives like the IBEC *Schools-Business Links* programme are designed to improve the understanding of business as part of the education process. Training at work is increasingly seen as an extension of education. Productivity in the indigenous sector will be improved by devoting more resources to the training of people at work. The tight labour market has already brought several changes in response among employers - more is being spent on recruitment and initial training.

The process of liberalising markets in energy and telecommunications is under way and will yield competitiveness benefits to the economy. The momentum of this change must be kept up and the active commercialisation of appropriate areas of public service should form a bigger part of the *Strategic Management Initiative*. The clear benefits to business of what has already happened should encourage this acceleration. The challenge facing state companies within EMU are significant and include the new rules on regional aids. Private sector involvement is a key element in preparing for these challenges.

Finally, some observations on the taxation front and harmonisation. Europe does not need across-the-board harmonisation in all spheres to achieve the full potential of its single market. In the social sphere some welcome hesitation is evident in Europe's previous relentless drive towards over-prescriptive legislation. Codes of conduct or supportive action often make much more sense to managers and employees alike. Stable management of EMU will not require across-the-board tax harmonisation. Differing structures and requirements of member states are still correctly reflected in the present position on unanimity insofar as taxation is concerned. Tax systems should, however, respect principles of transparency and equity and this is being dealt with by the Commission under its *State Aids* powers and under the *Code of Conduct* on business taxation. Ireland's total tax requirement as a percentage of GNP is less than that of Germany or Denmark for example, reflecting both demographic reality and the way public services have been organised. Low taxes have been shown to be good for business and employment in Ireland - our tax structure as a recently industrialised peripheral small open economy may not be appropriate for the more mature economies but downward pressure on all tax burdens in Europe would yield good results. Retention of the commitment to move towards the 12.5 percent rate of Corporation Tax is strategically very important for Ireland. Operating under this regime will bring a new dynamic to the Irish economy, will definitely spur further development of services but it will place Irish manufacturers under stronger competitive pressure from imports as the 'pitch' levels. This factor should give added impetus to the drive for greater productivity in indigenous manufacturing - not at all helped, in our view, by moves such as increasing the burden of social insurance contributions on employers in the budget.

There is also further scope for lowering taxation on labour as employment grows and, hopefully, as part of a further national consensus on pay. Commitments under

the present programme have been more than met and it is important now to shape tax policy within this framework against the realities in the labour market – a need to achieve really significant reductions in structural unemployment, shortage of labour in a number of skilled areas and the need to increase participation by women. Further alleviation is needed at lower pay levels but disincentives are building up (especially for second earners) at higher levels where skills are in short supply.

The EMU constraints force management of the economy much more to the micro level where productivity, education, competition and efficiency are vital. Government's role will be to give support through appropriate regulation and fiscal measures, including adherence to the Stability and Growth Pact, and through ensuring that public services act to optimise the performance of the private sector rather than reduce its capacity. Consensus among the social partners in supporting these kinds of strategies is even more important now than when the economy was struggling – expectations, however, must be tempered by the cold realities of the new scenario in Europe.