How do you improve the durability of a Celtic Tiger?

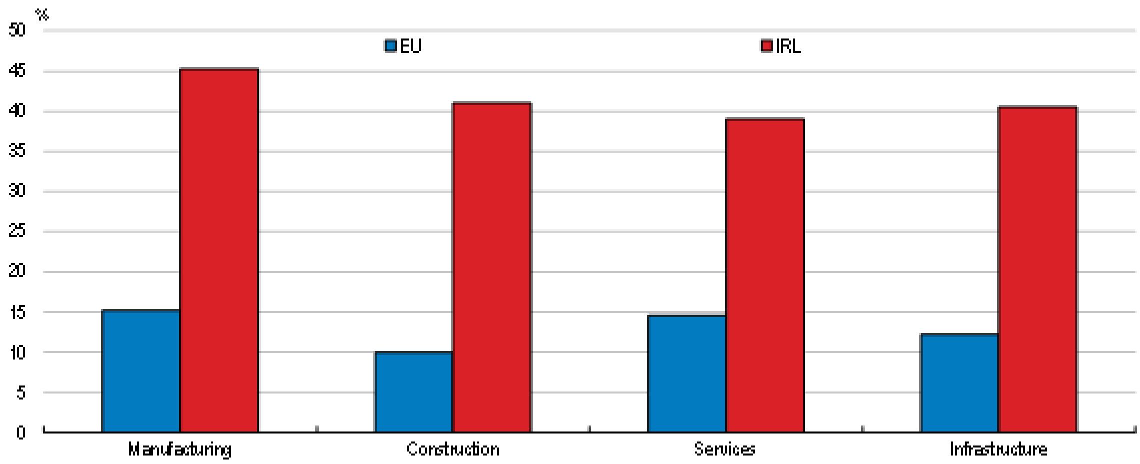
By Ben Westmore and Yosuke Jin, Ireland Desk, Economics Department

The Irish economy is booming and is expected to continue expanding at healthy rates over the next few years. But as the 2018 OECD Economic Survey of Ireland highlights, the outlook is clouded with uncertainty.

Brexit could have serious implications for the Irish economy given the close economic relationship between Ireland and the UK (Figure 1). New OECD estimates suggest that a trade arrangement between the UK and EU governed by the World Trade Organisation's Most-Favoured Nation Rules would reduce total Irish exports by 20% in some sectors such as agriculture and food.

Figure 1. Brexit uncertainty is impacting upon the Irish economy

Proportion of firms expecting a negative impact from Brexit.



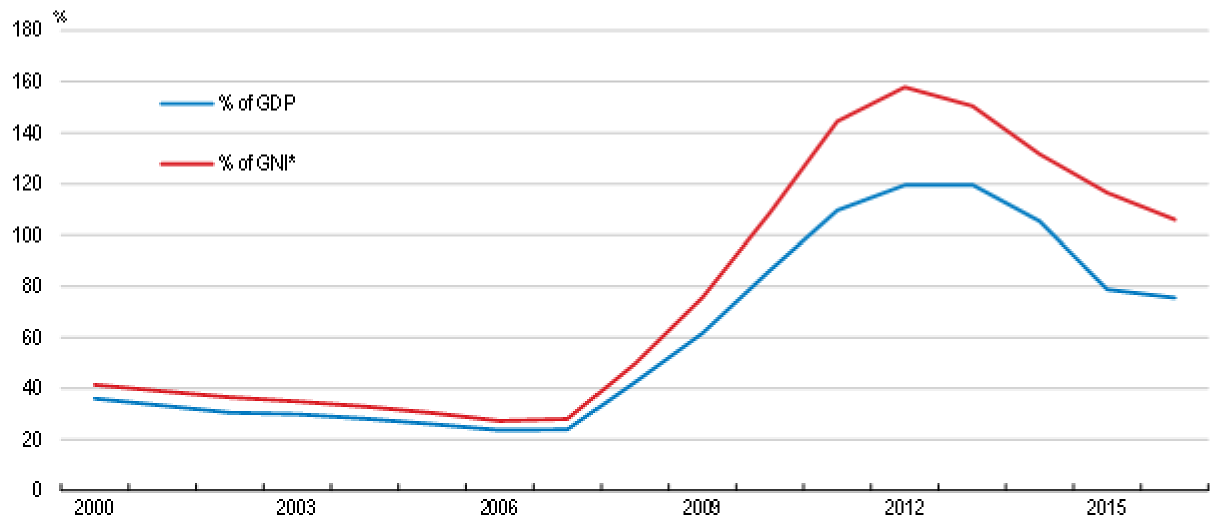
Source: EIB Investment Survey.

In addition to Brexit risks, rising international tax competition is a concern for Ireland. The Irish economy has been highly successful at attracting foreign direct investment, with foreign-owned firms accounting for close to half the country's gross value added over recent years. As a result, reductions in effective corporate tax rates in other countries may have a negative impact on the Irish economy if they encourage some multinational firms to relocate their operations elsewhere.

In this context, the importance of raising the resilience of the Irish economy cannot be overstated.

Public finances have improved noticeably, but government debt remains high and tax receipts have become more subject to volatility (Figure 2). Further reducing public debt would create scope for budgetary policy to support the economy in the event of a negative shock – such as a disorderly Brexit. This could be achieved by broadening the tax base in a growth-friendly way. For example, VAT preferential rates and exemptions should be phased out and the property tax yield raised through more regular revaluations of the tax base.

Figure 2. Gross government debt ratios are declining but remain high



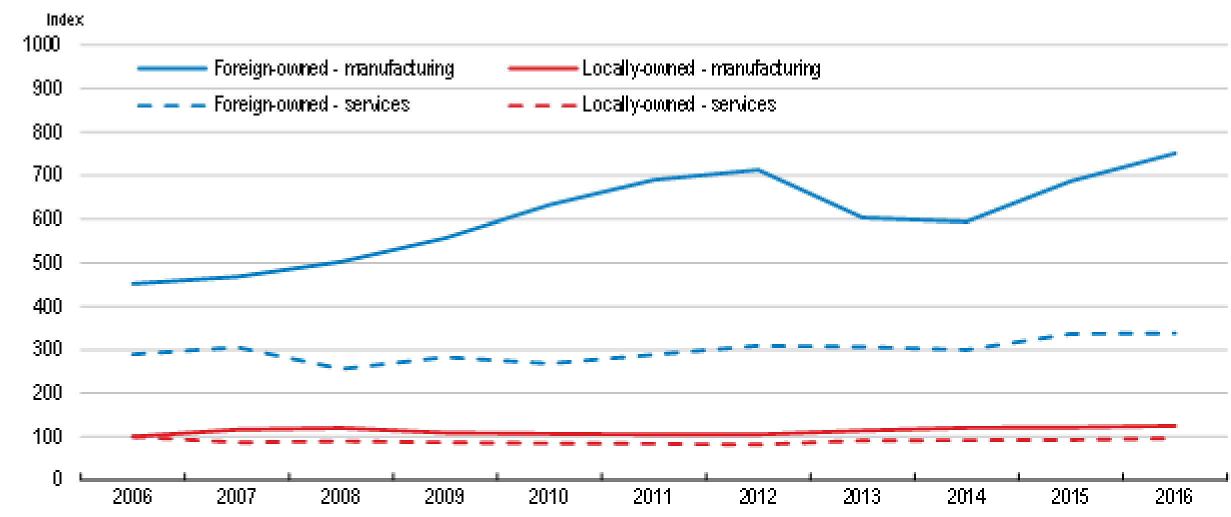
Source: Central Statistics Office and OECD.

Financial sector vulnerabilities also need to be further addressed. While non-performing loans on bank balance sheets have declined by around 60% from their peak, the stock remains high. Measures that reduce judicial inefficiencies relating to the repossession of collateral and further encourage NPL write-offs will promote the efficient allocation of capital as well the ability of the banking sector to withstand any further adverse economic shocks.

Above all else, the long-term durability of the Irish economy will rely on policy reforms that encourage a broad-based recovery in productivity. Most Irish firms have experienced declining productivity over the past decade. This has largely reflected the poor performance of local firms, with the large productivity gap between foreign-owned and local enterprises having widened (Figure 3). New firm level analysis undertaken in tandem with this *Economic Survey* confirms this is the case (Department of Finance, 2018; the findings of this work will be discussed in more detail in a blog post over the coming days). The resilience of the Irish economy hinges on unblocking the productivity potential of these local businesses. Pruning back regulatory barriers to entrepreneurship, such as costly regulations related to commercial property and legal services, is a start. However, productivity spillovers between foreign-owned firms and local businesses also need to be fostered by encouraging the accumulation of high-level managerial skills and research and development intensity in the latter.

Figure 3. The large productivity gap has widened

Labour productivity index (Irish firms in 2006=100)



Source: Department of Business, Enterprise and Innovation.

Creating a more sustainable growth environment will raise the ability of policymakers to confront key challenges that exist for the wellbeing of the population. Particular areas that should be a focus include health, housing and getting people into work. To address these challenges, universal healthcare coverage should be provided, stringent housing regulations that are constraining dwelling supply rationalised and some social benefits withdrawn more gradually as labour earnings rise.

References

Department of Finance (2018), “Patterns of firm level productivity in Ireland”, forthcoming.

OECD (2018), *OECD Economic Surveys: Ireland 2018*, OECD Publishing, Paris.