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# Can we learn from Ireland's experience? An Irishman's perspective

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## Introduction

Ireland's economic transformation has been breathtaking. Within a decade, Ireland has been transformed from having income per capita 65 percent of the UK level in 1990 to parity with the United Kingdom and the European Union average. Ireland has become one of the richest nations in the world. One can see, taste and smell the prosperity in Ireland.

This rapid economic growth and the policies that underpin it have attracted significant attention in New Zealand, a reverse of the position a decade earlier when New Zealand's reforms received significant attention in Ireland. Comment on Ireland's success has tended to focus on three factors:

- attracting foreign direct investment;
- the low corporate tax rate for foreign investors, and
- the grants received from the European Union structural funds.

This Policy Backgrounder sets out the key factors underpinning Ireland's growth, the policy approach taken by Irish governments, and the lessons for New Zealand. It reflects my observations as an Irish-born economist who has lived and worked in both Ireland and New Zealand.

## Summary of Key Statistics<sup>1</sup>

Category	1990-1995	1995-2000	2000-2005
	Annual Average Percentage Growth		
GNP	4.5	8.4	4.8
Consumption Deflator	2.7	3.6	3.9
Employment April	1.9	4.9	2.0
Real After Tax Non-Agricultural Wage	1.6	1.8	4.0
	1995	2000	2005
	Percent of GNP		
Balance of Payments Surplus	3.2	-0.7	-0.8
Debt – GNP Ratio	83.5	42.1	18.3
General Government Surplus	-2.5	5.4	0.8
	1995	2000	2005
	Percent of Labour Force (ILO basis)		
Unemployment Rate	12.2	4.3	5.8

<sup>1</sup> Duffy et al (2001)

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## Comparing Ireland with New Zealand

In New Zealand, most discussion of Ireland's economic success emphasises the similarities between the two countries. Both are small island nations with significantly larger neighbours. Both economies have traditionally focused on agriculture. Both have experienced periods of economic decline and turnaround in the past decade. Both inherited British institutions such as the rule of law, democratic government, and secure property rights.

However, the differences are as important as the similarities. Ireland has access to the European single market with a population of over 300 million. Unlike New Zealand, Ireland was never wealthy; it experienced almost 150 years of economic stagnation. Ireland has no 'golden days' to look back upon. When it comes to economic policy, Ireland is relentlessly forward-looking.

The Irish population declined from over 8 million prior to the 1840s famine to less than 3 million by the end of the 1960s. Ireland experienced almost continuous net outward migration from 1840 until the early 1990s. There isn't a family in Ireland that does not have relatives in the United States, England, Australia and New Zealand. The ties to the United States have always played an important role in Ireland's ability to attract US foreign investment.

## Explaining Ireland's Economic Success

### *Unanticipated growth*

As noted in Table 1, the Irish economy grew by an average of 8.4 percent per annum from 1995 to 2000. Such rapid growth was not anticipated. Indeed, during the early 1990s, economists were forecasting economic growth of between 3 and 5 percent. While ex-post many policy makers have taken credit for the economic growth, ex-ante most were concerned about the failure of policy reforms to deliver economic growth, the ongoing problem of high unemployment and continued high rates of outward migration.

### *No silver bullet*

No one factor can explain Ireland's success. There has been no silver bullet. The number of factors includes prudent planning, the correction of previous policy mistakes, a confluence of favourable changes in the environment and other exogenous factors. Indeed, a review of Ireland's future economic prospects remarked:

*"Today we are bemused by the large numbers of curious visitors who have come to Ireland to seek the secret of eternal growth. For those of us who have lived through the experience of the last two decades in Ireland – it is no miracle. The rapid growth today is making up for lost time, and might have happened earlier but for a combination of bad management and bad luck."*<sup>2</sup>

Policy approaches in Ireland were not new or unique. However, other countries' situations may not have been so propitious as to allow such a strong growth response from the reforms.

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2 Economic and Social Research Institute (1999)

### **Key factors explaining Ireland's economic growth**

The consensus among Irish economists is that the key factors, in order of importance, explaining Ireland's economic success are:<sup>3</sup>

- a commitment to an open economy;
- a rapidly growing well-educated workforce;
- strong growth in foreign investment;
- access to the European market and the buoyant US economy;
- the correction of policy mistakes and the achievement of a consensus; and
- the receipt of European structural adjustment funds.

### **A commitment to an open economy**

Ireland has been committed to an open economy since the late 1950s and unilaterally opened up its economy to trade and investment through the 1960s and 1970s.

*"The most important milestone on the development road was marked by the set of decisions taken during the late 1950s and 1960s, to open up both the society and the economy and to relinquish the introspective, protectionist world view that had dominated the conduct of public policy since the 1930s."<sup>4</sup>*

The liberalisation of trade and investment has elicited static and dynamic gains in output and productivity of Irish firms, and has assisted Ireland's transformation into one of the premier host countries for US foreign direct investment in Europe. The bulk of firms that have developed in the high technology sector, both Irish and foreign owned, have located in Ireland to service the wider European Union market.

Central to Ireland's commitment to an open economy has been its membership in the European Union since 1973. While the European Union itself has been less than committed to an open economy on a global scale, the development of the single, continent-wide market has been central to Ireland's economic development.

The process of adjusting to an open economy has been gradual. In 1950 only 11 percent of Irish manufacturing output was exported. This rose to 23 percent in 1970, to 33 percent in 1980, 53 percent in 1990 and to over 80 percent today.<sup>5</sup>

The commitment to an open economy has not been easy. The transformation from a domestically focused industry to an outwardly focused industrial sector involved significant job losses in the 1970s and 1980s, as resources were reallocated within the economy. The process has taken decades and is ongoing, as the economy continues to transform itself.

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3 Duffy et al (2001), ESRI (1999); OECD (1999), Barry, Frank (1999), IMF (1999), (2000), (2001)

4 Tansey P (1998)

5 Doyle E et al (2002)

### ***A rapidly growing, well-educated workforce***

A key factor contributing to Ireland's growth potential was the rapid growth in labour supply and labour productivity. Irish employment grew by an average of 3.4 percent per annum between 1987 and 1998, while productivity growth averaged 3 percent per annum.<sup>6</sup>

In the 1990s there was a rapid increase in labour supply, combined with increased foreign direct investment raising the demand for goods produced in Ireland, and improved productivity from investment in human capital. The increased labour supply came from a baby boom in the 1970s, a reversal of outward migration, an increase in labour force participation among women, and access to a large pool of unemployed workers.

As well as an increased labour supply, there has been a rapid upgrading of human capital as younger cohorts replace their predecessors whose schooling duration was shorter. Ireland is in the unique position among developed countries of being able to rapidly improve its workforce's stock of human capital through the entry of a large number of young people.

For generations, education has been the only passport to greater opportunity and consequently Ireland benefits from an entrenched positive attitude towards education. This view is supported by Organisation for Economic Cooperation and Development (OECD) research that shows persistently higher labour market returns to additional education, in the form of lower risk of unemployment and higher earnings, in Ireland than in the average OECD country.<sup>7</sup>

While hard to prove with statistics, the focus on education is all-encompassing, with parents and students investing significant time and resources to succeed in state exams and access tertiary education. Also given that there is no student loan system, students' education is usually funded by parents.

In the past, Irish parents have made greater financial investments in their children's education than their New Zealand counterparts. This partly reflects that tertiary education in Ireland was fee-based until recently, and indicates a tradition of supplementing free second level education with private tuition.

This focus on education has enabled Ireland to rapidly upgrade its stock of human capital over the last 20 years, and will play a central role in developing human capital in the future.

Given the complexity of human capital development and the very different education environments, it is difficult to draw policy lessons for New Zealand from the Irish experience. However, there are some differences in the education system worth noting:

- The Irish education system has been dominated by the Catholic church which owns and runs many secondary level schools. Catholic schools receive pupil-based funding at a level comparable to that of state schools, a system that is akin to an education voucher scheme.
- There is no constraint on school choice. Irish parents can send their children to the secondary school of their choice, subject to each school's selection criteria and fee structure.

<sup>6</sup> Doyle E et al (2002)

<sup>7</sup> OECD (1999)

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- The state assessment system is primarily examination based. Access to tertiary institutions is based on state exam results, and these results are used to ration the supply of higher education places. This makes state exams very competitive.
- Investment in tertiary education has focused on new institutions in the area of sciences and technical disciplines.

### ***Strong growth in foreign investment***

The massive inflow of foreign direct investment (FDI) was a major positive shock to the Irish economy in the 1990s. While definitive figures are lacking, Ireland's share of OECD total FDI inflows surged in the 1990s, reaching a level out of all proportion with its GDP. In 1997 Ireland ranked ninth in the world as a destination for US direct investment outflows.<sup>8</sup> Ireland accounts for close to 14 percent of all FDI projects in Europe.

Ireland's access to the European Union markets was crucial because US firms faced tariffs and non-tariff barriers in exporting from the US to the EU. From the late 1980s, Ireland benefited from a sharp increase in US FDI flows into the EU to take advantage of the single market. And the Irish policy environment was positive, offering low taxation, low compliance costs and a legal regime similar to the United States. The work force was low cost, highly skilled and English speaking. Ireland relentlessly pursued US foreign direct investment taking full advantage of well-established links from decades of migration. Also playing a part was the unprecedented boom the US high tech sector experienced through the 1990s.

### ***The key is access to the EU markets and a buoyant US economy***

Access to the EU single market was the most important factor in attracting FDI. Ireland pursued a policy of attracting US foreign investment for several decades with mixed success. It was only when it was combined with the advent of the single EU market that growth in FDI took-off. Luckily for Ireland it also coincided with the beginning of the longest period of sustained economic growth in US history.

### ***What about the Industrial Development Agency?***

In New Zealand emphasis has been placed on the role of the Irish Industrial Development Authority (IDA). Undoubtedly the IDA played an important role in attracting US firms to invest in Ireland, but its role must be placed in an historical context. Ireland had pursued a policy of attracting foreign investment for over 25 years. Prior to the 1990s the policy had very mixed results, with as many successes as failures.

Every other country in Europe and many other regions have agencies pursuing identical policies to the IDA. Competition for United States FDI is fierce. The success of the IDA reflects the benefits of first mover advantage and being in the right place at the right time.

The IDA sought to focus its work on a number of key dynamic sectors, in particular information technology, health care and pharmaceuticals, in the early 1990s. It went all out to attract key

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<sup>8</sup> Gunnigle, P and McGuire, D (2001)

multinationals to Ireland as a production location for the EU market. Its most notable success was Intel. Once the IDA attracted key producers in the identified sectors, it became easier to attract competitors as the benefits of similar firms being close together came into play. The IDA benefited from having the policy foresight to focus on high tech sectors prior to European competitors. This combined with existing capability in attracting FDI, a favourable policy environment and very well established networks in the United States.<sup>9</sup>

### ***What about tax?***

The key policy used to attract FDI was a 10 percent corporate tax rate on income for manufactured exports. There is little doubt that this low tax rate made Ireland very attractive to US multinationals. However, as was true for the IDA itself, the tax break existed for many years with mixed success. In fact, the corporate tax rate for manufactured exports was 0 between 1957 and 1981 when it was increased to 10 percent, and then 12.5 percent, yet the Irish economy persistently under performed.<sup>10</sup> Also, a number of other European countries have low tax rates for non-resident multinationals, but have not had the same success as Ireland.

### ***Mistakes were corrected and consensus achieved***

Both Ireland and New Zealand share a history of poor economic management through the 1970s and early 1980s. In both cases economic crisis forced newly elected governments to take action.

### ***Fiscal policy***

For many years, Ireland's fiscal mismanagement was spectacular. By the mid-1980s, the fiscal deficit had reached over 12 percent of GDP and the public debt ratio stood at 110 percent of GDP, second only to Israel.

In 1987, the new government was forced to begin a process of fiscal consolidation. This was achieved by reducing expenditure. Over the two year period 1988-1989, the ratio of expenditure to GDP was reduced by 9 percent.<sup>11</sup>

The public wage bill was brought down through a reduction in the number of employees. Luckily these actions coincided with a dramatic improvement in the external environment, reflecting falling world interest rates and strengthening external demand.

The response to the 1987 fiscal crisis renewed confidence in Ireland's economic management, both domestically and among foreign investors, and alleviated concerns about the longer-term sustainability of the low-tax environment.

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9 Industrial Policy Review Group (1992) – normally referred to as the Culliton Report.

10 In 1957 Ireland introduced a 100 percent exemption for exports of manufactured goods, with firms being able to access the benefit for 20 years. On entry to the EEC in 1974 this scheme ceased and was phased out in 1990. In 1981 a 10 percent tax rate for manufactured exports was introduced. This has been phased out in favour of a single corporate tax rate of 12.5 percent for all taxpayers, domestic and foreign.

11 IMF (2000)

Government expenditure as a proportion of GDP consistently declined over the past ten years, from a high of over fifty percent to a recent low of under thirty percent.

### **Monetary policy**

Ireland had high inflation through much of the 1970s and into the 1980s. Luckily for Ireland, it was able to resolve this by joining the EU exchange rate mechanism and in effect piggy-backing on the credibility of German monetary policy. Ireland has now made the transition to a single European currency with relatively few problems.

### **Social consensus was critical**

The poor performance of the Irish economy and the fiscal crisis in 1987 led to social attitudes coalescing around a consensus across all political parties and trade unions that greater self-reliance was required, that restructuring was inevitable, and that competitiveness had to be safeguarded by moderate wage claims negotiated in a centralised setting through a partnership approach.

Successive three-yearly wage rounds since 1987 have been crucial in preventing social discord resulting from needed changes in work practices and in preventing excessive wage increases from setting in motion a severe squeeze on traditional labour intensive industries. Not surprisingly, in an economy that has reached full employment, the social consensus achieved in previous wage rounds has come under immense pressure.

### **EU Structural Funds**

Ireland received large transfers from the EU from 1989 onwards. These funds helped to support demand, ease economic adjustment and upgrade physical infrastructure, thereby boosting potential output and adding to Ireland's attractiveness to foreign investment. However, while they are part of the economic growth story, they are not a key element.

## **Lessons for New Zealand**

It is hard to succinctly explain Ireland's economic success, let alone try and draw policy conclusions for New Zealand. We must keep in mind that:

- New Zealand does not have free access to a market of three hundred million;
- New Zealand's conversion to an open economy occurred some 30 years after Ireland;
- New Zealand does not have the demographic advantages of Ireland;
- New Zealand does not have the family and personal connections among business people in the United States; and
- New Zealand does not have Ireland's 'first mover' advantage in attracting foreign investment.

***It is hard to succinctly explain Ireland's economic success, let alone try and draw policy conclusions for New Zealand. Ireland's experience is unique and not replicable.***

However, we can draw the following lessons:

- Ireland has not discovered the holy grail of economic growth but has pursued orthodox and sustainable economic policies, taken full advantage of its access to European markets, and succeeded only after 80 years of trying to improve its lot;
- Ireland followed all the rules for good economic policy: it let markets work, it liberalised trade and investment, it controlled inflation and public expenditure, it invested in human capital, it created a business friendly environment through low taxation and compliance costs, and it continues to pursue a process of deregulation and privatisation;
- Ireland's success does not support a case for the government taking a greater role in the economy – Ireland's growth experience has been characterised by a declining participation of the government in the economy;
- the net benefits of Ireland's industry policy over the last 40 years are far from certain;
- Ireland's long-term experience of industrial policy suggests it is a hard road to hoe, with few easy gains and lots of potholes, particularly for a late arrival like New Zealand;
- Small open economies cannot afford to heavily tax foreign capital because such taxes generally push up the return required by foreign investors and thereby discourage investment;
- Ireland recognised that hard decisions were required to ensure economic growth and achieved political consensus to take unpalatable actions that were necessary;
- Irish policy is focused on improving the economy in the future, not undoing the perceived mistakes of the past;
- education is very highly valued and will be an ongoing source of competitive advantage for Ireland; and
- economic success requires hard work. Irish people find they are working longer hours and that, to stay ahead, they have to invest continuously in their own education and the education of their children.

## **Has the Celtic tiger run its course?**

The length and extent of the rapid the economic growth experienced in the 1990s could not be sustained indefinitely. From 2001 to 2003 the Irish economy experienced a period of relatively slow economic growth, largely reflecting the slowdown in both the US and European economies. The slowdown in growth raised the question of whether the recent downturn was the end to the Irish success story. Fortunately, the downturn was only temporary with real GNP growth expected to recover to around 5 percent in 2005.

The Economic and Social Research Institute in their review of the medium-term prospects for the Irish economy conclude that the factors that gave rise to the rapid growth are not yet exhausted.<sup>12</sup> Policy settings remain focused on sustaining economic growth and Ireland will continue to benefit from strong

***Ireland has not discovered the holy grail of economic growth, but has pursued orthodox and sustainable economic policies, taken full advantage of its access to European markets, and had a lucky break after 80 years of trying to improve its lot.***

<sup>12</sup> Duffy, A., et al (2003)

growth in the labour supply, with the bulk of the growth concentrated among those with third level education. The ESRI estimates that the Irish economy has the potential to grow at around five percent per annum until the end of this decade, before lowering to a more sedate pace of around three percent per year. The key medium-term policy challenges are the infrastructure deficit and shifting the focus of economic policy away from attracting foreign direct investment into the manufacturing sector towards developing a modern market service-oriented economy.

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