THE CELTIC TIGER: ORIGINS AND PROSPECTS

POLICY OPTIONS POLITIQUES

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Over the last half decade, Ireland's economy has grown at the astonishing rate of more than eight per cent a year in real terms—a pace seldom experienced outside the Far East. What has made Ireland grow? A skilled work force, a US boom, and EU subsidies, yes, but more importantly, national policies that have focused on reducing debt, lowering taxes, keeping wage demands reasonable and Irish costs competitive, and opening up to investment and trade. The boom probably can't be kept going at Asian-like rates, but a reasonable pace probably can be sustained, and, in any case, Irish living standards have now caught up to the rest of Europe, so rapid growth is not quite as urgent a necessity as it once was.

Au cours des cinq dernières années, l'économie de l'Irlande s'est développée, en termes réels, au rythme de plus de 8 p. 100 annuellement — chose rare en dehors des pays d'Extrême-Orient. À quels facteurs l'Irlande doit-elle cette croissance ? Elle la doit, bien sûr, à la qualité de sa main-d'œuvre, à la prospérité des États-Unis et aux subsides de l'Union européenne. Mais elle la doit plus encore à des politiques nationales bien ciblées : réduction de la dette, abaissement des impôts, maintien des salaires à un niveau raisonnable, compétitivité des coûts de production, ouverture à l'investissement et au commerce. L'Irlande ne pourra sans doute pas maintenir un taux de croissance égal à celui de certains pays asiatiques, mais elle arrivera probablement à garder un rythme raisonnable. Quoi qu'il en soit, le niveau de vie ayant rejoint celui des autres pays européens, la rapidité de la croissance n'a plus le caractère impérieux qu'elle revêtait jadis.

Writing a decade ago on Ireland's dismal economic performance, an eminent Irish historian concluded that no other European country, east or west, north or south, had recorded so slow a rate of growth of national income in the twentieth century. Professor J. J. Lee's analysis of Ireland's economic ills covered the years from from Independence (in 1922) to 1985. During that period, national income per head had grown by an average 1.8 per cent per year, about the same as in the UK but well below the growth rate experienced in continental Europe. Since then, all has changed. The Irish economy has been transformed from the basket case so brilliantly dissected in Lee's book *Ireland 1912-1985: Politics and Society* (Cambridge University Press, 1989) to the shining exemplar of all things economically bright and beautiful of the 1990s.

Since 1989, national output (GNP) has grown in real terms by 7.5 per cent per year and national output per person by over six per cent per year. This is double the rate that even reasonably optimistic economists would have hoped for at the start of the 1990s. Since 1994, the unofficial birth date of the "Celtic Tiger," growth has proceeded at an historically unprecedented 8.6 per cent per year.

Extreme economic success, like extreme failure, arouses curiosity and demands explanation. The list of publications on the Irish boom continues to expand. "An amazing turnaround" is the baffled verdict of the OECD in its 1999 *Economic Survey* for Ireland. The turnaround was relative to the country's modest growth and the dire condition of its macro aggregates during the 1980s; and it confounded not just the OECD but also the best forecasters, native and foreign. In the early 1990s a growth rate of three per cent would have seemed highly satisfactory. Estimates of potential growth rates using standard estimation techniques have bitten the dust in the process, having been at least three to four percentage points below growth that has been sustained with moderate inflation over six years. Indeed, this experience raises serious questions about the meaning of potential GDP for a small country in a global economy in which factors are mobile.

Initially, commentators thought these post-1993 growth rates were a statistical illusion. There was talk of a *soufflé* economy, the product of transfer-pricing-inflated multinational profits in high-tech sectors rather than "real" bread and butter economic activity. Suspicions were strengthened by the slow reaction of employment to growth: "Jobless growth" was another favourite description of the early process.

Two factors confounded the sceptics. First, tax revenues started booming. This was a sure indication that something real was happening on the ground. Second, growth did generate jobs, albeit after a certain time lag. About 415,000 extra jobs were filled between 1993 and the end of 1999, a rise of over 35 per cent on the initial level. This huge expansion in job opportunities had far-reaching repercussions. One was a fall in unemployment from 16 per cent to six per cent. Another was the reversal from net emigration to significant net immigration. By the end of the decade, illegal immigrants from Eastern Europe and Africa, once an exotic rarity, were entering the country at a rate of about 12,000 per year, a rather disturbing phenomenon in a small, culturally homogeneous country such as Ireland.

As a result of all the growth, a debt/GDP ratio that soared over 100 per cent in the late 1980s declined rapidly to 47 per cent in 2000, a level well below the EU average. From being one of Europe's poorest countries in 1973, Irish GDP per capita at PPP surpassed the UK level in 1996 and the EU average shortly afterwards. It now stands at 115 per cent of EU average GDP, compared with 58 per cent when Ireland joined the Common Market in 1973. (Note, however, that relative advances in GNP per person are less impressive. Because of large net dividend and royalty payouts to FDI, there is a 15 percentage point gap between Ireland's GDP and its GNP.) Changes in the labour market also contributed to a rise in living standards. Whereas in 1990 every 10 people at work had 21 dependents to support, ten years later, the figure fell to 15 (and it will decline further to 12 in the year 2006). From record-breaking levels of unemployment in the 1980s, by 1999 Ireland's unemployment rate had fallen to half that of France and 40 per cent below Germany's.

It is sometimes said that economists are unable to explain the causes of the boom. This is only partly true. There is general agreement both on the list of factors that contributed to growth and on the fact that they fed on each other—in a Myrdalian process of cumulative and circular causation. The only area of contention to date concerns the weight to be attached to the different causal factors. Thus while the OECD stresses foreign investment and Ireland's education policy, others (such as the present author) emphasise the role of macroeconomic policy and the introduction of competition and lower taxes. Yet another view stresses the role of Ireland's unique social consensus model of wage determination and policy formation. The boom is of such recent vintage that it may be some time before the data will allow us to determine who is right. In the meantime, we will have to be satisfied with lists such as the following:

Macroeconomic stability. New policies in the late 1980s focused on cutting the debt/GDP ratio. The espousal of fiscal rectitude and new consensus economic policies was not in fact new. What *was* new was the decision to attack the debt by controlling public spending, rather than by increasing taxes. For a small, open economy, curbing public spending proved a far more productive way forward. It created room for tax cuts while simultaneously lowering the debt ratio. Another ploy was the introduction of a tax amnesty. Following on the high tax policy of the 1980s and the reorientation in fiscal policy, it proved hugely successful in terms of revenue generation. Domestic interest rates fell steeply as investor confidence grew, thus starting off that rare occurrence in modern economics, an expansionary fiscal contraction. Fears that strong fiscal contraction would prove deflationary were confounded, though precisely why this was so remains the subject of controversy.

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A final item in the macroeconomic story: Lower taxes and a more stable macro background translated into a huge burst of private sector activity. Virtually all of the increase in employment since 1993 was generated by the private sector, about two-thirds of it in the marketed services sector. In my view, lower taxes and confidence in the fiscal integrity of the government were key to this process.

Social partnership. Also in the late 1980s, Ireland adopted a unique model of wage determination, involving extensive consultation and agreement between the social partners. The two key elements were wage restraint in return for income tax cuts and ongoing participation in economic decision-making through social partnership committees. Such a policy is not favoured by economic orthodoxy, but it worked well for both employees and employers. National pay agreements kept the lid on pay claims during a period of unprecedented output growth and thus enabled this growth to translate into higher employment and lower unemployment.

EU grants. The implementation of the European Union's single market programme, combined with Ireland's steadfast commitment to early participation in EMU, gave a fillip to inward investment. European Union Structural Funds gave impetus and direction to Ireland's investment programme, while the Maastricht criteria for EMU entry acted as a strong disciplining force in driving through necessary adjustments in the economy. Moreover, the 1992 Single Market programme involved a panoply of pro-competition commitments, which, though initially introduced with some reluctance by the Irish authorities, proved highly beneficial to the economy.

The US boom. All of the above happened just as the US economy began its longest uninterrupted period of growth since the Second World War. American corporations were profitable, confident and ready to go global. This proved fortunate for Ireland since its other major trading partner, the European economy, was in the doldrums for most of the 1990s.

Foreign investment. The main fiscal incentive for foreign direct investment (FDI) is a highly favourable regime of corporate taxation. This took the form of a preferential tax rate of 10 per cent on all corporate profits for export-oriented manufacturing and traded services. Up to the 1990s, the standard rate of corporate profits tax (CPT) was 50 per cent. In 1998, under EU pressure, a new CPT regime was negotiated, involving the introduction of a 12.5 per cent CPT for all corporate income, effective from 2003. The 10 per cent rate was "grandparented" up to 2010 for all companies already enjoying this preference. In addition to tax incentives, financial grants are offered to new enterprises in respect of capital spending and labour training, though these were being pared back rather than expanded during the 1990s.

FDI certainly did respond strongly to the CPT incentive, and the OECD and others are right to stress its beneficial impact. But two caveats are in order before accepting FDI as the key factor explaining the recent boom. First, FDI doesn't come just because taxes are low. There must also be the promise that they will stay low, and this requires a transparently sustainable macro background. Investment packages offered by the government of a badly-managed, heavily-indebted economy are not credible. This underlines the importance of the government's emphasis on macro stability. Second, US subsidiaries in manufacturing and internationally traded services, including financial services, have accounted for only about 10 per cent of the total, economy-wide increase in employment over the last decade. These FDI jobs provided high-productivity employment in fast-growing sectors and, partly because of transfer pricing, their activities yielded substantial tax revenues even at the 10 per cent rate. But even if each of these US jobs generated one further job elsewhere in the economy (a spillover effect of a size that is often assumed), this would still leave 80 per cent of the employment growth unexplained. Foreign companies accounted for 70 per cent of output and 44 per cent of employment in manufacturing in 1990, compared with 80 per cent and nearly 50 per cent in 1998. This is, to be sure, a huge contribution to a sector that accounts for 20 per cent of total employment in all sectors. But it was far from being the predominant factor behind the economy-wide growth.

Supply of well-qualified entrants to the labour market. Human capital investment certainly helps growth in a crucial way, and there is no dispute that in Ireland in recent years more young people graduated, more women entered the workforce and more emigrants returned home. As a result of heavy investment in education, the proportion of the population aged 25-34 with third-level education attainment reached 27 per cent in 1995. This exceeded the OECD country average of 23 per cent (though Canadian readers will not fail to notice by how far even this substantial achievement falls below Canada's corresponding figure of 53 per cent). In terms of attainment in higher education, Ireland ranks second highest in the EU, next to Belgium.

But has the massive investment in education underlying these statistics produced the Celtic Tiger? Some argue not, noting that Ireland has never been short of labour inputs. In the 1980s a third of Ireland's emigrants were bright, English-speaking and motivated graduates. Why were there no jobs for them then, but plenty in the 1990s? It was only when "the business climate" turned right that job openings appeared. Clearly, labour supply was a permissive factor—it was important to sustaining growth—but its role as an initiator of growth can be debated. My own conclusion is that education did not cause the boom, but that the boom would not have gathered momentum and been sustained without it.

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Northern Ireland. The North is rarely mentioned in discussions of the Republic's boom. This oversight ignores the fact that the peace process has helped sustain the boom by giving Ireland a better image abroad and by enabling government to shift focus from security matters to economic development.

Competition and deregulation. The introduction of competition policy had a profound effect in stimulating economic activity in the services sector. For a long time, this sector was comparatively neglected by economic policy—in the mistaken belief that "real" growth happened only in manufacturing, which services sector employment passively followed. The error of this view in a small open economy became apparent after the liberalisation of public utilities and transport promoted by the EU. Access fares to Ireland fell as airline competition was introduced, giving tourism a significant boost. In the same way, explosive growth in the telecom sector followed relaxation of the state-owned monopoly's control of the domestic market. The link between competitiveness of the traded sector and the health of a country's services has only recently been appreciated. (The Irish government set up a National Competitiveness Council in 1997 whose task is to monitor such competitiveness indicators.)

The marked change in the direction and effectiveness of fiscal policy in the late 1980s was absolutely critical to Ireland's subsequent economic success. It played a crucial role in triggering growth by a) creating a sound underpinning for Ireland's low-tax regime, b) generating business and consumer confidence and c) ensuring cost competitiveness. Ireland was fortunate in having had: good economic policies that took the long view; strong ministers to implement these policies; and a far-sighted and supportive Opposition. Recently, the Icelandic economist Thorvaldur Gylfason has offered the provocative proposition that with appropriate economic policies and institutions rapid economic growth is achievable just about anywhere—even in Iceland, one is tempted to add. His analysis of the causes of growth emphasises governance and policy, not the investment ratios, exports or sectoral growth rates favoured by former theories of economic growth. Irish experience is remarkably consistent with his analysis (see his *Principles of Economic Growth*, Oxford University Press, 1999).

Put another way, how to explain Ireland's poor economic performance in the 1980s and previously? High taxes, low confidence, high labour costs, excessive regulation and anti-competitive practices would be prime culprits. These defects inhibited development in the potentially most employment-intensive sector of the economy, the services sector. It is easy to forget how effectively the fiscal stabilisation package dealt with these structural defects. Incomes policy, tax reductions, improved competitiveness and spending cutbacks were part of a seamless policy initiative. The introduction of new de-regulation and competition policies was also important.

In some respects, the Tiger analogy can be misleading. For one thing the Asian Tigers started from a much lower income base than Ireland. That meant that they had the capacity to sustain fast growth rates much longer than we have. They also invested far more heavily. Their investment ratio was typically 30 to 40 per cent of GNP; since 1993 Ireland's investment rate has not exceeded 25 per cent of GNP. Hence, some slowdown is seen as inevitable. As Ireland reaches European living standards, Tiger rates of growth will be less needed, less desirable and, as it happens, less attainable.

Until recently, Ireland has enjoyed very rapid growth combined with low inflation, an unusual economic combination. It would be hard to imagine an economy like the UK, or the EU, expanding for six straight years by eight per cent a year without substantial inflationary pressures setting in. Even if the situation is now changing—the most recent indicator shows inflation running at three percentage points above the euro area average—the record is still remarkable.

Small size is obviously part of the answer. An increase in a small share of a large number can make a huge difference to a small country. Thus Irish exporters can increase their share of the euro market dramatically without creating protectionist waves. Just a few major investment projects can make a huge difference to a small country's growth. Net migration changed from –5,000 in 1993 to +22,800 in 1998, big for Ireland, important for plugging gaps in labour supply and maintaining growth, but buttons for large economies. Small is indeed beautiful and many small countries have exploited this advantage to the full.

How long will the boom last? Actually, the boom is widely expected not to last. Real GNP growth levels are expected to slow considerably—from the current eight per cent to five per cent in 2001 and to just two to three

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per cent from 2015 onwards. The debate is, rather, about whether there will be a soft or a hard landing. Will the deceleration be reasonably smooth? Or will a history in which every boom has been followed by a bust repeat itself? At this stage of the growth cycle, with the Asian collapse of 1997/98 in everyone's mind, analogies with the Tigers send chills up Irish spines.

Things could go wrong in the Irish economy, for two sets of reasons: one internal the other external.

Among the external factors, the obvious fear is that the US economy may suffer a serious downturn. The overvaluation of Wall Street has often been signalled in the past two years but the US stock market continues to shrug off these fears. Still the economy is vulnerable, with too much debt, too little domestic saving and a growing balance of payments deficit. A serious downturn would have a direct negative impact on all the world's stock markets, the Irish market included. A Wall Street collapse would also inhibit US investment in Ireland and weaken US demand for exports of Irish goods and services. A collapse in the peace initiative in Northern Ireland could also spark a downturn in the Republic's economy.

Internal dangers have also been clearly signalled in the national debate. First, Ireland's competitiveness is already being eroded by price and pay inflation. The buoyant economic climate is encouraging intransigence among employees. This could easily trigger a wage-price spiral. The problem is not that pay might increase—there is room for quite generous increases in pay across the board—but that pay rises will "overshoot," that is, rise rapidly in excess of the economy's capacity to finance them. Infrastructure bottlenecks are already raising the costs of locating in Ireland. The 150 per cent rise in housing prices since 1995, even though it affects only a small minority of the workforce—75 per cent of Irish houses are owner-occupied—is further eroding competitive advantage.

Experience shows that periods of rapid growth can be brought to a halt by economic policy mistakes. Minority governments are vulnerable to pressure for more spending from special interest groups. While a reversal of the present government's prudent approach seems unlikely, not least because of the restraining influence of Brussels and Frankfurt, procyclical spending is hard to resist.

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A character in Philip Roth's *American Pastoral* remarked that "What is astonishing is that we, who had no idea of how anything was going to turn out, now know exactly what happened." There is no certainty about what Ireland's economic future will bring, but the mere fact that doubts are being expressed about the durability of the current economic boom is a healthy development. It may bring a measure of restraint to reckless borrowing, investment and pay claims. Another positive factor is that once a higher living standard is attained it tends to be retained. Rich countries, like rich families, tend to stay rich. Recessions happen, but during the boom capital resources have accumulated, the stock of educated, confident people has risen, and investment is in place, ready to make new profits when the economy recovers. None of that will be easily undone.

The economic boom has brought major benefits to the Irish people and serious wealth to a substantial minority. Inevitably, some have done better than others and a small minority may not have seen much improvement in their living standards. In many ways, the economic boom is an exemplar of the good things that follow from adopting new (or "Washington") consensus policies built around the three pillars of macroeconomic stability, globalisation and competition in the market system.

That is not to say all is perfect in Ireland's economy. Further inroads need to be made in the unemployment figures—the current unemployment rate, at six per cent, is still too high. Lowering unemployment will be an effective way of ensuring that wealth trickles down to the less well off. Maintaining social consensus and reasonable pay increases is also important. That will set the scene for reducing unemployment by means of lower taxes and active labour market policies. The education system needs continuous upgrading. There is some preliminary and hesitant thinking about whether active promotion of FDI (a policy that has been a hallmark of the Irish approach since the late 1950s) is really still appropriate in a near full-employment economy. Finally there is need for continuing focus on long-run policy issues: traffic congestion, housing supply, and provision for pensions—problems that all seem more soluble from atop a mountain of growth.

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