# Chapter 2
# The Celtic Tiger

The harder you work, the luckier you get.
Gary Player

## INTRODUCTION AND OVERVIEW

Ireland has been one of the globe's uncontested economic stars since 1987, when a new fiscally responsible, tax-cutting government was elected to office, and a society-wide agreement was struck to hold down labour costs. Ireland may now be the world's brightest star. Until a few years ago, the Asian tigers would have held equal claim to pre-eminent status, but Ireland has suffered none of their economic set-backs. Economic growth has accelerated, even as other parts of the world suffered economic turmoil and during a period when most of Ireland's European trading partners were mired in sluggish growth or recession.

Irish policy-makers regard tax cuts and wage moderation – explicitly designed to reduce costs in the Irish economy and to increase profits – as the corner-stones of recent Irish success. The 1987–88 reforms came at a fortuitous time, a time of real opportunity for the Emerald Isle, but then, as Gary Player might have said, "The better your policies, the luckier you get." Ireland in the late 1980s and the 1990s was able to take advantage of economic opportunities, whereas before it had missed or destroyed opportunity. Until the late 1980s, the question that outside observers asked had not been, as it is now, "How do we copy Ireland's success?" but rather "Why is Ireland forever destined to remain a have-not region, lagging its neighbours?" Ireland suffered deep economic gloom through most of the 1980s.

This sense of foreboding and an understanding of the disastrous mix of policies Ireland developed through the 1970s and

1980s led to the political will needed to carry through fundamental reforms. These reforms cut costs in the Irish economy and made it a profitable place to do business and invest, leading to unprecedented wealth creation and job generation in recent years.

Ireland's economic record through to 1987 was dismal and in part a hangover from the 1970s. Irish governments had steadily increased the public debt through the 1970s, and things were getting worse. In 1977, Ireland elected a government which claimed it could spend its way out of economic stagnation. Between 1974 and 1986, the deficit was over 10 per cent of GDP for all but two years. In 1982, it exceeded 14 per cent of GDP. Yet, despite all this government spending, employment growth was stagnant at best, and all too often negative. Even though Ireland had a high birth rate, the total number of jobs in 1986 was virtually identical to the number in 1971, and there were fewer jobs in industry. In real terms, the Irish economy grew by less than 1.5 per cent on average from 1980 to 1986, less than a third of the preceding rate and less than a quarter of the rate of growth since. Thousands of young Irish left their home country.

The magnitude of the turn-around is hard to grasp. Prior to 1986, Ireland had experienced years of zero job growth and job losses in the industrial sector. But, by 1996, Ireland had one-fifth more jobs than in 1986. Even more remarkably, the number of industrial jobs increased by one-third. More jobs were generated in just three years – a 12 per cent increase between 1993 and 1996 – than in the preceding 30 years (OECD 1997a, 25).

Although employment growth had until recently been one of the weaker aspects of the Irish turn-around, growth in Irish employment has outpaced both the OECD average and the EU average since the mid-1990s. More remarkably, recent Irish employment growth has even outpaced the exceptional rate of job growth in United States (ESRI 1997a, 36). In Ireland, the employment rate – the ratio of employment to the total labour force – rose by 2.2 percentage points between 1991 and 1996. In the other EU-15 nations, it fell on average by 0.7 percentage points (Sachs 1997, 54). From 1995 to 1997, over 50,000 additional jobs were gener-

ated each year. Nearly 100,000 jobs were created in 1998. In 1999, unemployment fell to under 6 per cent, down from 17 per cent in 1987.

Ireland's economic growth has been even more spectacular than its stellar record of job creation. Ireland's GDP has achieved real average growth of over 6 per cent since 1986 and over 7 per cent since 1994. In 1997, it was nearly 11 per cent and in 1998 nearly 9 per cent.

In direct contradiction to the old Keynesian assumptions, this was accomplished during a period, of sometimes intense government retrenchment. This was particularly true at the beginning of the period, when spending cuts actually seemed to spark new growth. Despite large cuts in taxation, the deficit has been slashed, and the debt–to–GDP ratio has steadily declined, as GDP growth responded to tax cuts and wage moderation. Thousands of Irish expatriates are returning, and, for the first time in modern history, Ireland is experiencing a *sustained* net inward immigration. The change in the Irish economy has been truly remarkable: "As late as 1961, Ireland was a backward, poor, agricultural region of the UK economy. Today it is a developed, industrial region of the European economy" (Baker 1997, 3).

What happened? The Irish focused on costs in the economy. The government reduced the costs under its control, steadily cutting taxes since 1987 and lessening the uncertainty costs related to large deficits. These factors alone have made Ireland a more attractive place to invest, both for foreigners and for the Irish themselves. Moreover, the bad years of the 1980s had produced a society-wide consensus that Ireland had to be made more competitive and that profits needed to be boosted.

This was a view shared by the union leadership. In 1987, unions, business, and government negotiated the first of a series of agreements designed to moderate wage increases. This controlled another key cost in the economy, the cost of labour. What the unions wanted in return provided even more stimulus to economic growth and job creation. They wanted further tax cuts so that, given the agreements on wage moderation, their members could

take home more of their pay and government would take less. After-tax real income has grown strongly since, despite moderate wage increases. Finally, fiscal restraint and wage moderation slashed inflation. This reduces costs related to inflation, most notably the cost of uncertainty.

Yet trouble may already be brewing. With the good times, the social consensus could come unravelled. Hard times forged hard decisions. The various sectors of the economy may no longer be satisfied with the same proportion of an ever larger pie, but may want a bigger share, too. If this results in increasing costs that cut into Ireland's high profit levels; the golden goose, discussed earlier, may be headed for the chopping block.

## A History of Ecomonic Weakness

In any society, a bloody upheaval reduces living standards in its aftermath. This was true of the American, French, both Russian revolutions, and countless others. It was certainly true of Ireland in the 1920s, following a bloody war of independence and then a similarly bloody civil war. As the violence wound down, economic times were grim under the government of William Cosgrove, 1922 to 1932. Cosgrove aimed for an open economy and fiscal prudence. While a few economists detect some economic improvement under the Cosgrove government, if it did exist, it wasn't enough.

Éamon de Valera assumed power in 1932. His plan was to generate growth domestically. Tariff walls were thrown up. Import substitution would generate jobs and economic growth. The policy was an utter failure, as Jeffrey Sachs notes:

> The most famous phase in modern [Irish economic] history was 1932–57, when Ireland launched a policy of import substituting industrialization in the depths of the Depression. The notoriety of Ireland's policy was magnified by John Maynard Keynes' endorsement of the inward-looking strategy in his famous Finlay Lecture on "Economic self-sufficiency" delivered at University

> College, Dublin, in April 1933. The policy in retrospect was a debacle. (Sachs 1997, 58)[1]

The imposition of this inward-looking policy brought what weak economic growth there was to a stuttering halt in the 1930s, but it would be hardly fair to draw conclusions from Ireland's performance during the extraordinary Depression or war years.

The closed-door policy remained in effect in the post-war years, and here is where it is possible to take a measure of the impact of this policy. Despite powerful economic growth in Britain, Europe, and North America, in Ireland,

> [r]eal national income virtually stagnated between 1950 and 1958 ... A corrosive pessimism took over. The July 1956 issue of the satirical monthly, *Dublin Opinion,* bore a cartoon on its cover showing a map of Ireland with the caption "Shortly Available Underdeveloped Country ... Owners Going Abroad. ..." It was only when the rest of Europe left the Irish economy standing in the 1950s that the bankruptcy of the old policies became clear to policy makers. (Ó Gráda 1997, 27 and 49)

Ireland, with its closed-door trade policy, had the slowest growth in all of Europe through the 1950s, even as other, more-damaged nations were rapidly rebuilding their economies. Thousands of people were leaving Ireland to seek work in Britain, the United States, and other English-speaking nations.

Then, Irish policy abruptly changed in the late 1950s. The closed Irish economy was opened. Strong economic growth appeared for the first time in modern Irish history. Ireland had entered its first golden age of growth.

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1. Sachs notes that this flew in the face of Keynes's otherwise strong support for free trade.

### *The First Golden Age*

A couple of curiosities surround Ireland's first golden age of economic growth. The central puzzle relates to the magnitude of the turn-around. The only deep policy change was the move from a closed economy to an open economy. Ireland through the 1950s had been fiscally responsible. The move to an open economy certainly boosted economic activity. Through the 1960s, exports grew by nearly 7 per cent a year in real terms and industrial production by over 6 per cent. Yet many economists have been reluctant to attribute Ireland's astounding turn-around – from virtually zero growth to about 4 per cent a year – solely to this one policy change.[2]

However, Sachs (1997) notes the shift to an open-door policy was also accompanied by important cuts in corporate taxes, which attracted a strong inflow of foreign investment for the first time in recent Irish history. And Arrow (1997, 7) discusses how an open economy spurs competitiveness and efficiency through a small economy: "In a small country, it can easily happen that there are too few firms in an industry to permit adequate competition; foreign competition is needed. Competition is important partly to reduce markups and therefore increase consumer welfare but even more importantly to create a steady pressure for efficiency."

The other curiosity is that Seán Lemass, the architect of De Valera's protection policy, engineered this reverse course. Lemass was "determined to overturn the very policies with which he had been identified since the 1930s" (Ó Gráda 1997, 29).

The result was a "fundamental policy change ... in the '60s, gradually moving away from protection to an open export-based economy, with diversification away from the UK market. Membership in the EU from 1973 played a vital role in this modernizing process" (Baker 1997, 3).

In short, Ireland in its first golden age had a policy regime with many elements very similar to the policy regime credited with the nation's growth in the 1990s, in particular a fiscally responsible

2. Recent research, however, shows powerful positive economic effects from openness. See, for example, Sachs and Warner (1995).

government and an open economy. GDP growth was strong (charts 2-1 and 2-2). But this would change.

### *The Bad Years and Their Prelude*

Ireland, like other industrial nations, suffered a set-back with the oil crisis in late 1973. Government responded in Ireland, as it did elsewhere, with increased spending and ever-larger deficits. The economy was well into recovery by 1975, yet the government continued to spend. Deficits averaged around 10 per cent of GDP, and then they got worse (chart 2-3).

In 1977, a new government, led by Jack Lynch, was elected by a landslide. Ireland's fiscal position was already perilous, but Lynch's Fianna Fáil's "extravagant and irresponsible election programme" (Ó Gráda 1997, 31) promised to spend the nation's way to new economic growth. By the early 1980s, the deficit had soared to more than 14 per cent of GDP. This is a period which virtually all Irish commentators now regard with something near horror:[3]

> The 1979-87 period is recalled as one of very poor economic performance on almost all counts: slow growth, rapidly deteriorating public finances, stagnation of per capita disposable income, huge imbalances of payments, deficits and industrial relations turmoil. (NESC 1996, 9)

Although Irish growth was strong through the late 1970s, when large deficits began to develop, Irish economic analysts draw a direct link to the following period of weak growth:

> [I]nitially [government fiscal stimulus] had every appearance of success, with rapid economic growth, a reduction in the unemployment rate (to 7.2 per cent in 1979), and significant net immigration [though short-lived] for the first time in a generation. The costs came with a lag. The government had to borrow heavily, and so the ratio of

3. See, for example, Tansey (1998), Ó Gráda (1997), Haughton (1995), and Sachs (1997). This is also the sense I had in interviews with Irish officials in the spring of 1998.

Chart 2-1 Irish Per Capita GDP
Constant 1990 Irish £

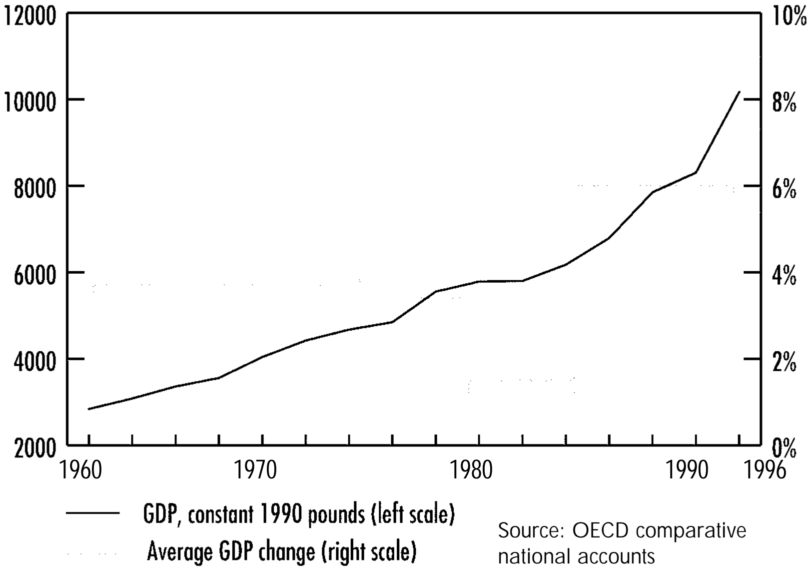



Chart 2-2 Irish Per Capita GPD
Constant 1990 Irish £

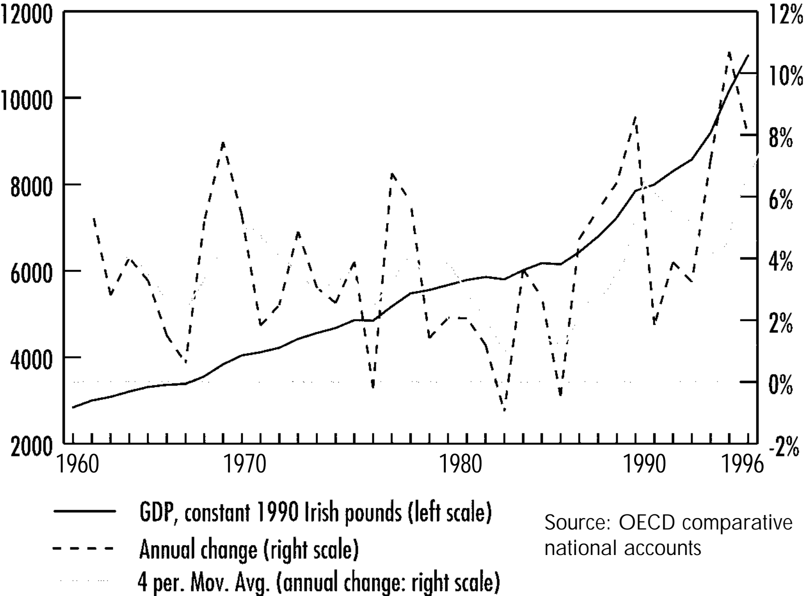
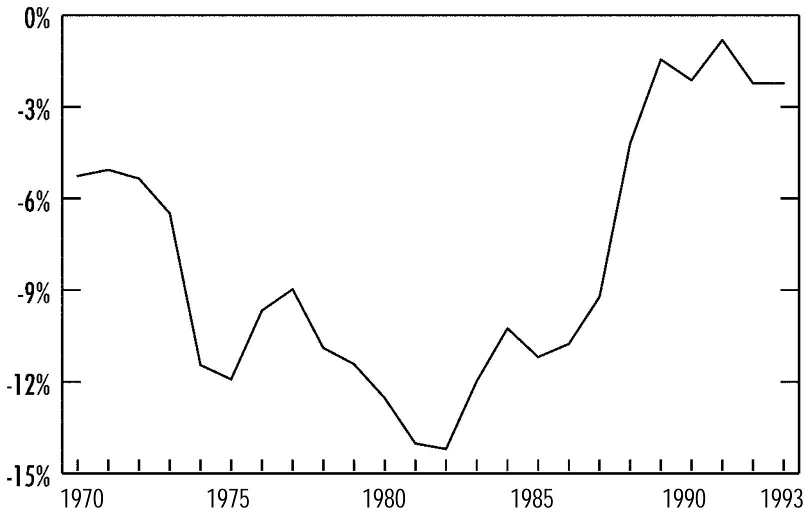


Chart 2-3 Irish Budget Deficit Including Grants (% of GDP)

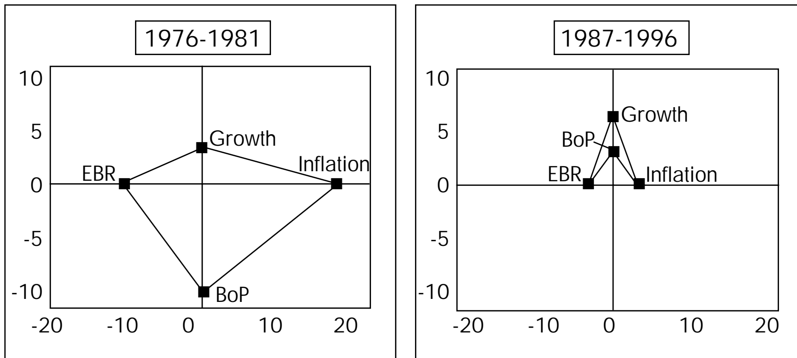



Source: World Development Indicators 1997: World Bank

> debt to GDP rose, from 52 per cent in 1973 to 129 per cent by 1987, by then easily the highest in the European Union. By 1986, the cost of servicing this debt took up 94 per cent of all revenue from personal income tax. Successive governments initially tried to solve the problem by raising tax rates, especially in 1981 and 1983, but these changes hardly increased tax revenue, suggesting that the country was close to its revenue maximising tax rates. (Haughton 1995, 39)

Irish average economic growth from the mid-1970s to the latter part of the decade was only a shade lower than the growth through the post-1958 period, but it came at the cost of unsustainable imbalances, which would lead to the prolonged downturn. Growth weakened in the late 1970s and often turned negative in the 1980s. "The imbalances that accompanied the growth of the period 1976–81 are quite striking when compared to the balanced nature of the growth performance since the mid-1980s" (ESRI 1997a, 38). (See chart 2-4, which reproduces ESRI, 39.)

Chart 2-4 Growth, Inflation, EBR and BoP as Share of GNP of (a) 1976-81 and (b) 1987-96 — ESA 79 Basis




Nonetheless, the government continued to promise new growth through Keynesian techniques. Deficits were kept high, and this fiscal stimulus was to generate new growth:

> Never before or since has an Irish government got it so wrong. The slow growth – the economy would contract by 0.5 per cent in 1982 – put paid to "revenue buoyancy" [the predicted Keynesian stimulus which would solve the fiscal problems] and high interest rates added to the public debt burden. At the time, both the deficit and the rise in PSBR [Public Sector Borrowing Requirement] were rationalized in Keynesian terms. But budget deficits continued to accumulate in the following few years ... raising the PSBR and national debt to clearly unsustainable levels. (Ó Gráda 1997, 70-71)

Both skyrocketing deficits and increasing large government expenditures had a negative impact on growth, through the "crowding out" effect:

> [T]here is the added consideration that fiscal policy may "crowd out" private sector investment. This conclusion would appear to be borne out by the Irish experience.

> Between 1972 and 1987 fiscal policy in Ireland led to a significant increase in the national debt without having the desired effect on growth and employment. (Leddin & O'Leary 1995, 194)

The "crowding out" effect occurs through several channels. Large government borrowing forces up the cost of capital, making investment more expensive. High taxes reduce the money people and businesses have to spend and invest. Government expenditures bid up the cost of scarce resources – labour, land, and supplies – again making investment more expensive. And high taxes coupled with generous social programmes create incentive not to work, furthering inflating the cost of labour.

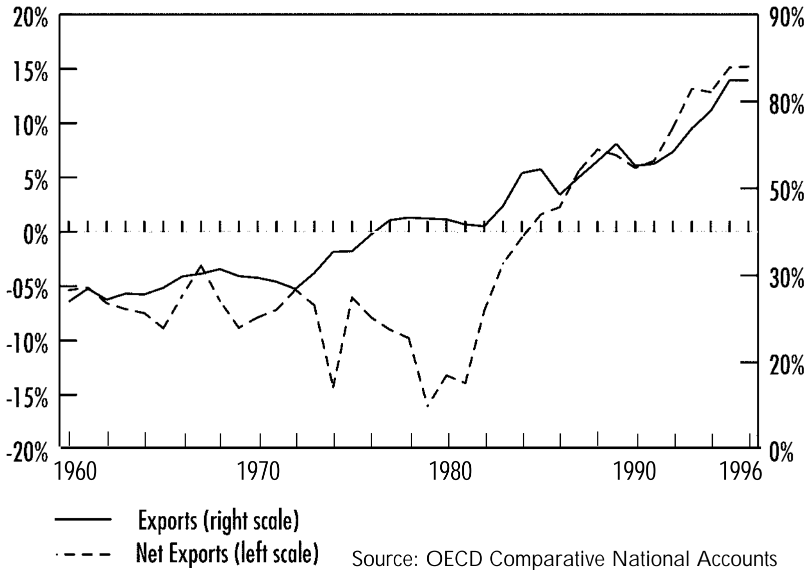
Along with Ireland's deteriorating fiscal position, labour problems were serious. Unions rapidly pushed up wages. Unit labour costs in particular soared. Yet real wages shrank. High taxes and union militancy had virtually eliminated profits, thereby destroying the incentive and the means for further investment. The productivity of the Irish economy deteriorated. Thus, there was simply less pie to share, and that had inevitable consequences for real wages, no matter how high the nominal settlements.

Falling real wages fed back into increasing labour strife. In 1979, more than 1.4 million days were lost to labour disputes. That deepened the economic troubles. The economy shed tens of thousands of jobs. Unemployment would have been far worse had not many thousands chosen to emigrate.

Export growth was essentially flat between 1977 and 1982, but grew thereafter (chart 2-5). But growth between 1982 and 1987 was largely due to weakness in the domestic market. The domestic weakness is, of course, evident in a broad range of economic figures, and it is also reflected in the fact that net exports grew even more rapidly than exports through this period. After 1987, export growth was more balanced.

This period also bequeathed to Ireland a new problem, one that still persists – urban ghettos largely occupied by long-term unemployed (OECD, 1997a, 58-74). Because of the escape valve

Chart 2-5 Irish Exports of Goods and Services (% of GDP)

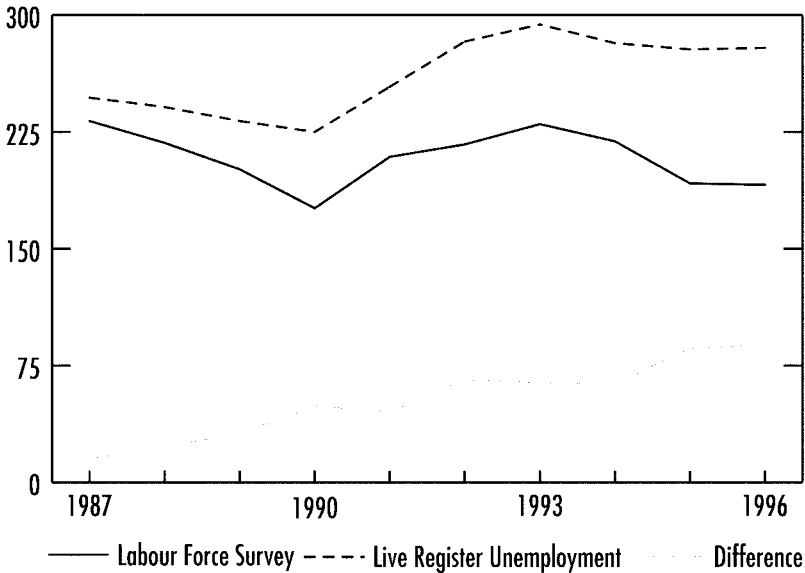



of emigration, even in bad times, Ireland seldom had a high unemployment rate. But, through the 1970s and early 1980s, the government increased personal transfer payments while also boosting personal taxes. The combination of the two made it more profitable for many to collect social payments than to work or emigrate.[4]

The difference between unemployment as measured by the Labour Force Survey (LFS) and the Live Register Unemployment (LRU), essentially those claiming benefits, gives some indication of the number of beneficiaries who were simply not willing to look for or accept work. The LFS is a survey asking people if they are willing to accept work and looking for it; in other words, whether they were unemployed by the official measure. The LRU is simply the count of the number of people claiming unemployment benefits.

4. These problems are discussed in Burda (1997, 95-109) and, more extensively, throughout Tansey (1998).

Chart 2-6 Unemployment Measures ('000s)




Source: Tansey (1998, 92)

For some years, the number of people collecting unemployment benefits exceeded the number of people officially unemployed in Ireland. In 1995, according to the OECD (1997a, 69), the number of people collecting benefits was 50 per cent higher than the unemployment rate (chart 2-6). The widening gap between the two in recent years reflects the increasing availability of jobs in Ireland for those seeking employment. Thus, almost anyone who has wanted a job could find one, lowering the rate of unemployment but little affecting the number of those content to collect benefits.

Of course, Ireland is not unique in this. In many jurisdictions, the number of people collecting unemployment benefits exceeds the number of people officially unemployed. This is true in many European nations, and spectacularly true in Atlantic Canada, where the number of people collecting unemployment was often twice as high as the official number of unemployed (see McMahon 2000). The long-term nature of much of Ireland's unemployment

again reveals a class of unemployed with little connection to the labour market. The OECD (1997, 177) found that about 60 per cent of Ireland's unemployed were long-term unemployed.

"There are whole areas of this city where there is no culture of employment," Manus O'Riordan, head of research for Ireland's largest union association, the Services Industrial Professional Union, told me while I was in Dublin in June 1998. The creation of the "no-employment" culture occurred in just one generation. As earlier noted, unemployment was virtually non-existent in Ireland prior to the 1970s because of the safety valve of emigration in weak economic times. O'Riordan and the union movement do not support a reduction in social payments, but they are vocally calling for further tax reduction. "Taxes are a disincentive to work. We need incentives to work," O'Riordan says. Nonetheless, at that time the Irish government was pushing to reform social payments, to make them less generous and harder to obtain, particularly for younger workers. The government hoped to avoid trapping another generation in the culture of the dole, a sentiment shared by O'Riordan, though he would prefer to work with incentives through the tax code.

I got a first-hand sense of the gloom which had descended over Ireland between 1980 and 1986 in a conversation in the Central Bank of Ireland's disconcertingly modern building in the heart of historic Dublin. I had asked about the early 1980s. Hugh O'Donnell, the bank's chief spokesman, visibly sighed. "Those were dreary times, weren't they, Rafique?" he asked his colleague Rafique Mottiar, a senior bank economist and Irishman for the past 25 years. "We had thought emigration was a problem of the past," O'Donnell continued, "but thousands of people were leaving each year." Mottiar turned to me and added, "It seemed half the college graduating class went straight from graduating ceremonies to the airport, for America." Ireland had become a high-cost place to do business, troubled by militant unions and high taxes, and suffering from private-sector crowding out due to big government, large deficits, and the resulting impact on interest rates.

In a separate conversation, O'Riordan said much the same thing as O'Donnell and Mottiar: "We had declining economic growth and declining employment. Wages were up, but inflation and taxes were up more. Living standards were declining. We knew we had to do something."

However, the doom-and-gloom sense of the time may have had positive benefits in line with the earlier discussion of the nature of reform in a corporatist economy. "This perceived failure of economic policy undoubtedly added to the mood of pessimism which pervaded the public debate at the time. However this air of desperation, particularly concerning employment prospects, itself engendered a profound shift in attitudes which laid the foundation for the subsequent sustained recovery" (ESRI 1997a, 63).

## Doing Something

For most of the post-independence period, Ireland either had a fiscally prudent government (virtually the entire period from independence to the 1970s) or an open economy (the period after 1958). Prior to 1987, they overlapped only in the period from the late 1950s to the first oil shock, the first period of strong Irish economic growth. They were to be reunited in the late 1980s. Two further policy initiatives were added – a social contract explicitly designed to moderate labour costs and increase profits, and a commitment to tax reductions. We'll look at government cuts first and then consider the labour situation.

### *Fiscal Reform*

Although the 1987 election resulted in a minority government, a broad consensus had developed that the public finances had to be put in order. The new government under Charles Haughey acted quickly. Two days after being appointed finance minister, Ray McSharry – soon nicknamed Mac-the-knife – killed a planned pay raise for senior civil servants. This was a small foretaste of what was to come. Reflecting the society-wide consensus, these reforms were continued when Haughey's Fianna Fáil was replaced in government in 1994 by the "Rainbow coalition" of parties

including, Fine Gael, Labour, and Democratic Left. The coalition was headed by Fine Gael leader John Bruton, who became president of the EU Council in 1996.[5]

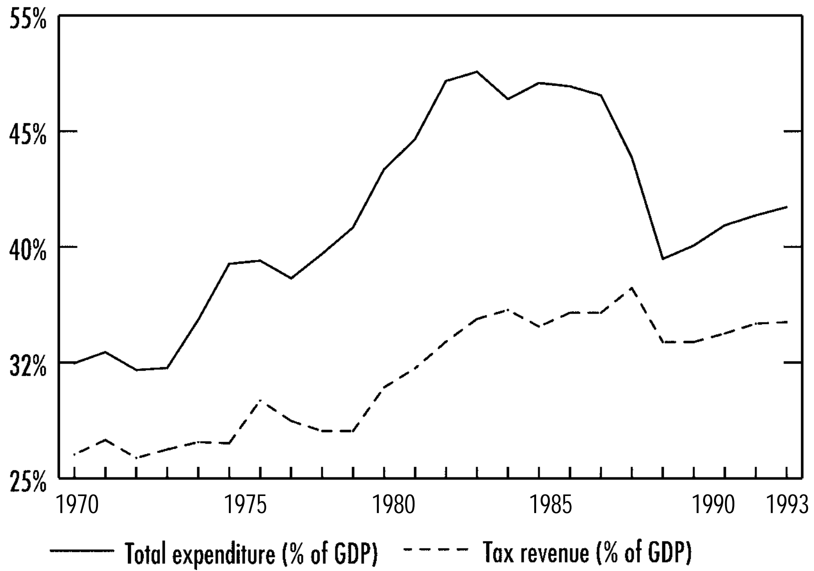
The cuts were, if anything, more severe than those made in Margaret Thatcher's Britain or Ronald Reagan's United States. By 1989, two years after the election, government spending was lower as a percentage of GDP than in 1979. Remarkably, government spending fell from an average of over half of GDP between 1982 and 1987 to around 40 per cent of GDP in 1989 (charts 2-7 and 2-8). This was a much larger and much quicker cut of government as a per cent of GDP than Thatcher had engineered almost a decade earlier in Great Britain. This holds true as well when averaged over years rather than measured from peaks to troughs. In comparing the periods 1980–1984 and 1990–1994, government spending in Ireland declined by 5 per cent of GDP, compared to 2.3 per cent of GDP in Britain (de la Fuente & Vives 1997, 104).

Keynesian economics would predict disastrous results for a retrenchment or negative fiscal stimulus this abrupt and large, particularly when an economy already was in recession. Economic growth had been negative in 1986. It would seem cut-backs could not have come a worse time, just when the economy needed stimulus, not restrictive policies. Even the advocates of fiscal retrenchment expected economic turmoil and economic weakness during an adjustment period. What happened surprised everyone, no matter how optimistic or supportive of Haughey's policy.

Economic growth took off immediately with the budget cuts. Negative in 1986, it was transformed to a positive growth ratio of 4.5 per cent in 1987, the year of the cuts. This was the strongest growth since 1977. But things got even better. Growth steadily rose to over 8.5 per cent in 1990, the strongest yearly growth Ireland had yet achieved in its history. For the first three years of the 1990s, growth fell back to 2 to 4 per cent before ratcheting up to more than 7 per cent for the next years of the 1990s, including over 10 per cent growth in 1995. Sounder fiscal policies, combined with a

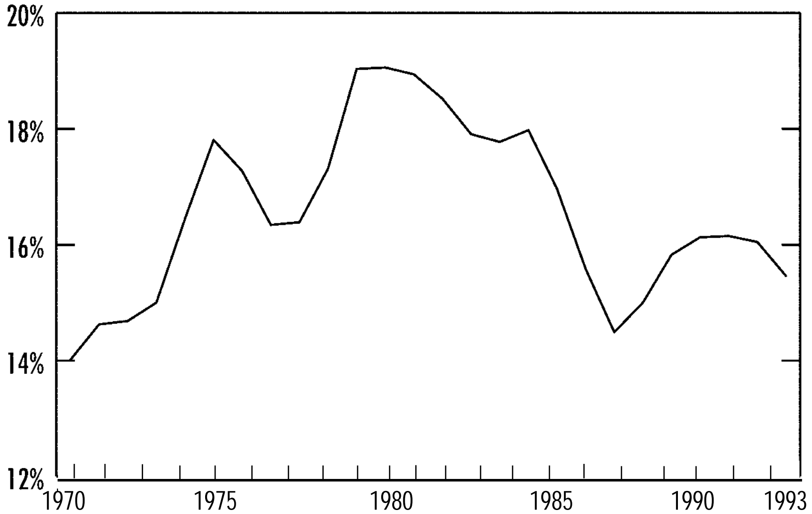
5. Bruton may be even better known for his social reforms, including the removal of Ireland's ban on divorce.

Chart 2-7 Government Expenditures and Revenue (% of GDP)




Source: World Development Indicators 1997: World Bank

Chart 2-8 Irish Government Consumption (% of GDP)




Source: World Development Indicators 1997: World Bank

change in attitude and a growing commitment to wage moderation, seemed to have powered the growth. "The bipartisan commitment to putting public finances in order had apparently restored the confidence of both consumers and private investors" (Ó Gráda 1997, 32).

Economists began to speculate about "expansionary fiscal contraction", or EFC. The apparently contradictory phrase is meant to capture the idea that government activities distort the economy and crowd out other activity. Therefore a lessening of government activity can stimulate, rather than retard, growth. The NESC (1996, 24-25) discusses

> the tendency for various government incentives to produce rent-seeking financial manipulation, rather than increased business initiative. ... Failures seem to have arisen – in periods of both growth or recession – when there was insufficient recognition that the cost and effectiveness of the public sector impacted strongly on the competitiveness of, and the burdens on, the private sector.[6]

De la Fuente and Vives (1997, 124-125) also discuss the reductions in economic distortions to which government retrenchment can lead. Their econometric estimates show a large positive impact from government cut-backs:

> Tax and expenditure reductions can be expected to increase growth by reducing disincentives that tend to depress investment and labor supply. King and Rebelo, 1990, show the impact of these effects can be quite important, especially in the case of a small open economy. Since we are controlling for both employment and factor accumulation, however, our [econometric] estimates are presumably not picking up these effects, or the 'crowding out' of private investment, but a negative externality effect of

6. This discussion is not explicitly tied to the EFC idea, but it covers similar territory.

> government size on the efficiency of resource allocation and on work effort ... [O]ur results are consistent with the view that fiscal adjustment [contraction] was directly responsible for a sizable increase in [Ireland's] growth rate.[7]

EFC is also meant to capture the impact of the confidence-building nature of fiscal responsibility and the resulting expectation of lower taxes. Lower taxes increase after-tax incomes and increase incentives to work, boosting growth. Increases in consumption related to greater income further spur economic growth. Most importantly, the promise of lower taxes, and thus higher profits, could serve as a magnet for investment.

Yet the situation was not quite so simple. The evidence is convincing that reforms designed to redress deficits through expenditure cut-backs produce long-term benefits. For example, Alesina and Perotti (1995) survey OECD nations which attempted to re-establish fiscal balance. They find that nations, which do this through expenditure cuts achieve significantly better results than nations which tackle deficits through tax increases.[8] Alesina and Perotti measure success through debt- and deficit-to-GDP ratios. Most interestingly, a large part of the difference between the two groups of countries is stronger GDP growth in the first group.

But economic adjustment is not instantaneous, and a government retrenchment as large as Ireland's should have created short-term dislocations in the period immediately following the cut-backs before renewed private-sector activity crowded in. But policy-makers had the luck of the Irish in their timing. The Irish pound had been devalued in 1986, making Irish exports more price-competitive. In the long term, devaluation is no way to save an

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7. King and Rebelo (1990) is cited as a reference for this book. De la Fuente and Vives also cite (p.124) a number of other works which support the idea of an EFC, though they do not use the term.

8. Tax increases in Canada, mainly bracket creep due to lack of indexation of income-tax rates, have carried the weight of about two-thirds of Canada's deficit fight. Canada's relatively weak economic performance through this period appears consistent with Alesina and Perotti's results.

economy. It simply indicates falling productivity compared to that in other nations, and implies that economic reforms are needed to improve productivity growth. But it can provide a temporary boost, and this helped Ireland, which was on the verge of fundamental reform.

The devaluation of the Irish pound was coupled with a fall in international interest rates, which promoted investment and helped lead to unexpectedly strong world-wide growth. Growth in the United Kingdom was also strong, due to large tax cuts in that country. These factors combined to strengthen export growth and encourage private-sector investment, just as government was cutting back.

Nonetheless, the EFC hypothesis does capture real economic phenomena. Barry and Devereux (1995) modelled the EFC hypotheses and found that forward-looking behaviour – based on the expectation of tax cuts – would partly offset a fiscal contraction in the short term before new, longer-term growth was sparked by the cuts. But this offset is only partial. More interestingly, they found forward-looking behaviour, when coupled with the positive external shocks, could in fact lead to a result similar to EFC. Moreover, in the long term, government efficiency and taxation levels have a large impact on economic growth:

> [I]t should be recognized that the performance of government is an important determinant of international competitiveness. An efficient government enhances the ability of domestic firms to compete in international markets, by reducing the taxation, and other costs of obtaining policy objectives. (In international empirical studies, an efficient government is highly correlated with strong economic performance ...) (Lane 1995, 125; bracketed comments in the original)

Reforms stabilized Ireland's fiscal environment, reducing the costs associated with uncertainty, costs related to inflation as well as forward-looking concerns about taxes:

> Research suggests ... a stable macroeconomic environment is also a key element of economic growth. This has important implications for attempts to assess the growth performance of the Irish economy over the past three decades since it implies that the severe macroeconomic imbalances of the early 1980s may have contributed directly to the poor growth performance at that time. (ESRI 1997a, 46)

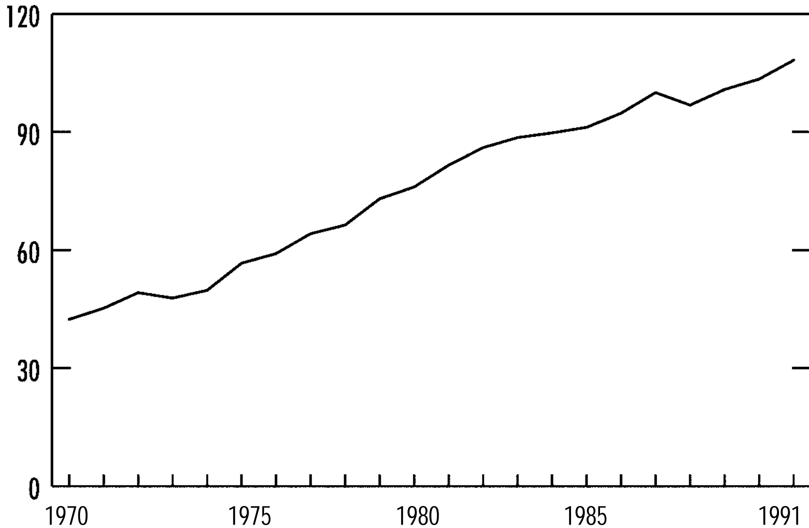
One other important fact emerges from a consideration of Ireland's recent fiscal history. Cutting taxes, far from being a race to the bottom in government services, instead soon increases government revenues through the cut's impact on economic growth. This is true in most jurisdictions which have initiated significant tax cuts, and it is certainly true of the Irish experience. Revenues fell in 1988, immediately after the cuts, but within a year, by 1989, inflation-adjusted tax revenues exceeded the revenues received by government prior to the tax cuts (chart 2-9).

### *Wage Moderation*

As important as fiscal reform was, even more important was a trilateral agreement between government, unions, and business to hold wage growth down and increase profits, and thus boost the attractiveness of Ireland for investment.

The three-year *Programme for National Recovery* (PNR) agreement signed in October 1987 embodied the concepts of labour peace and pay moderation in exchange for tax cuts, as discussed earlier. It has been followed by successive agreements, most recently *Partnership 2000*, which commits the government to further tax reductions. The tax cuts under these programmes have been substantial. For instance, the PNR explicitly targeted tax reductions of £225 million but the cuts were later calculated to have totalled £800 million (Tansey 1998, 147). Using the exchange rates of the time, the saving roughly equalled $1.6 billion Canadian or $1.25 billion U.S., a significant reduction for a nation of about 3.5 million people. As well, the agreements specifically

Chart 2-9 Irish Tax Revenues in Real Terms (1987 = 100)

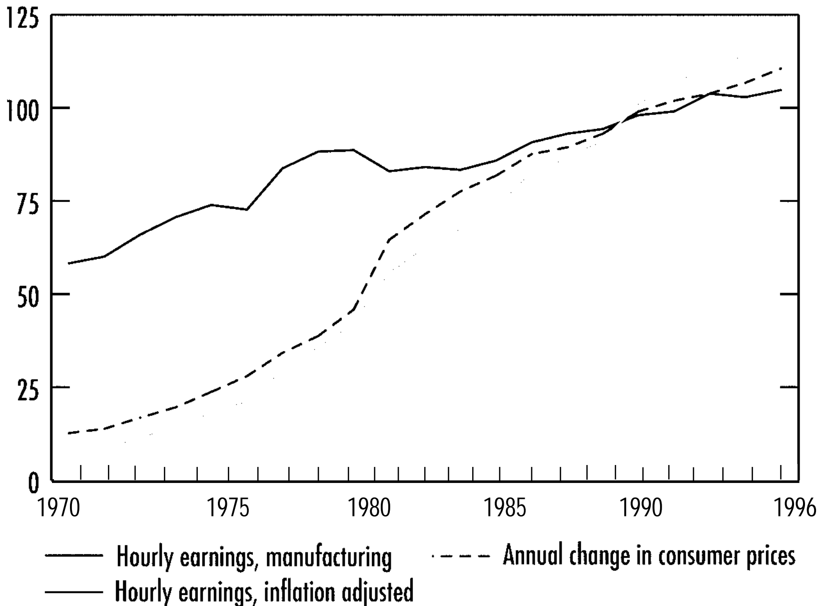



recognized the competitive boost and job-generating impact of moderate wage growth.

Wage increases in Ireland had actually been slowing for some time prior to 1987 (chart 2-10). Nominal increases in the manufacturing wage had hit a high of over 25 per cent in the inflationary years following the first oil shock. They continued to range of between 15 and 20 per cent a year until the early 1980s. In 1984, wage increases dipped below 10 per cent and slid slightly through to 1986. In 1987, wage increases dropped below 5 per cent and then stayed in the range of 5 per cent until 1993, when they fell well below 5 per cent in spite of Ireland's astonishing growth in these years.

The OECD (1997a, 93) suggests the agreements may have had less direct impact on wage moderation than might be thought. It notes that the two most important factors in wage determination are inflation and after-tax income. The fiscal restructuring helped bring inflation down and created an expectation of lower taxes. The explicit promise of tax reductions in the PNR and later agree-

Chart 2-10 Hourly Earnings and Inflation (1992=100)



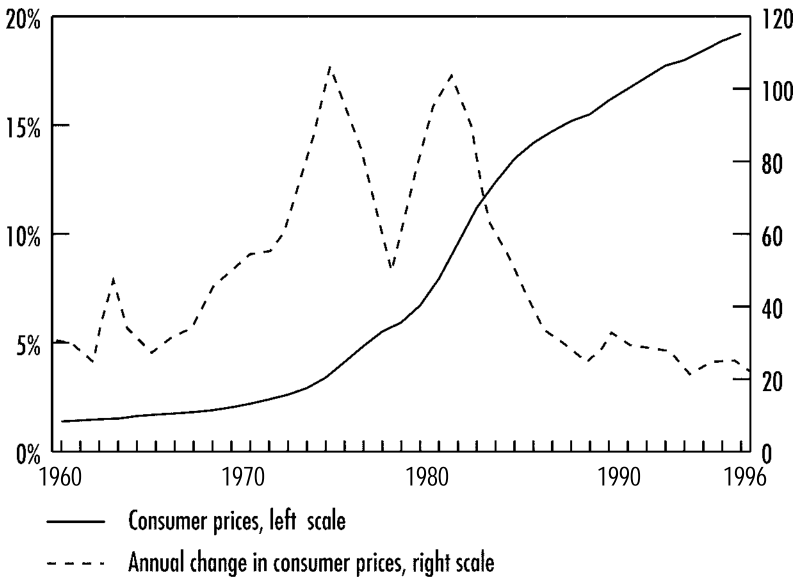

Source: OECD Main Economic Indicators

ments certainly added weight to this expectation. Of course, nominal wages are highly correlated to inflation, which fell from an annual rate of over 20 per cent in 1981 to about 2 per cent in 1988 (chart 2-11).

A number of factors clearly contributed to slower Irish wage growth. Although the PNR may have had less impact than meets the eye for the initial move to wage moderation, it and succeeding agreements have been crucial in maintaining low wage costs through Ireland's period of astounding growth.

Now we move to the central aspect of the wage story, which is neither nominal nor real wages but rather unit labour costs. ULCs are the true cost to business of labour. They take into account wages, inflation, and productivity growth. This reflects the real cost of labour per unit of output and is thus far more revealing than either nominal or even real wages.

Chart 2-11 Consumer Price Index (1990 = 100)




Source: OECD Main Economic Indicators

Stable prices and a commitment to moderate wage increases had a dramatic effect on ULCs. I provide two measures of ULC in manufacturing: one based on OECD wage numbers, and the other on the United States Bureau of Labor Statistics total hourly compensation costs. Total employment is multiplied by average weekly hours and real wage (or total compensation costs) and this is then divided by real manufacturing output.[9]

The results are similar for both series (charts 2-12 and 2-13). I will discuss the numbers produced using total compensation, as this gives a more complete picture of costs. Using an index where

9. The OECD average weekly hours used in this calculation is for the economy as a whole but should serve as a good proxy for changes in weekly manufacturing hours. Assuming a constant number of average weekly hours does not dramatically change the calculations, which are consistent with other work. For example, see OECD (1997a) calculations.

Chart 2-12 Unit Labour Costs and Wages: Manufacturing (1990 = 100)

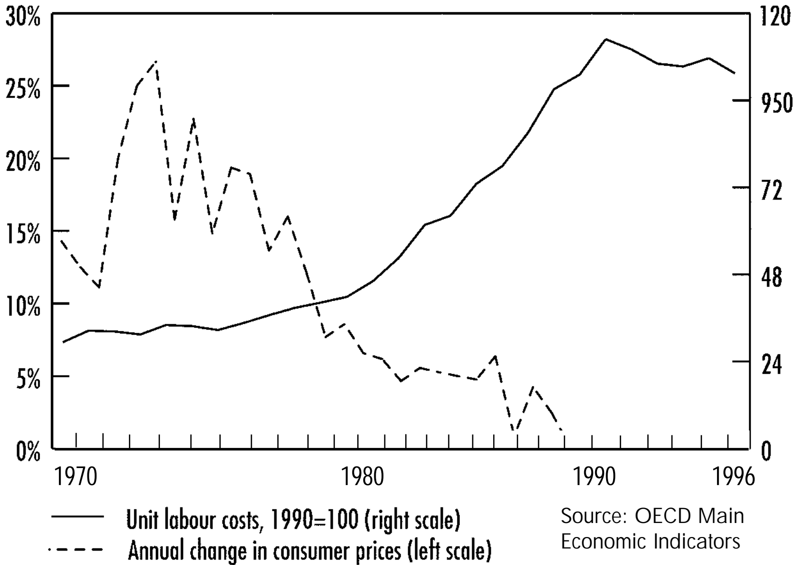
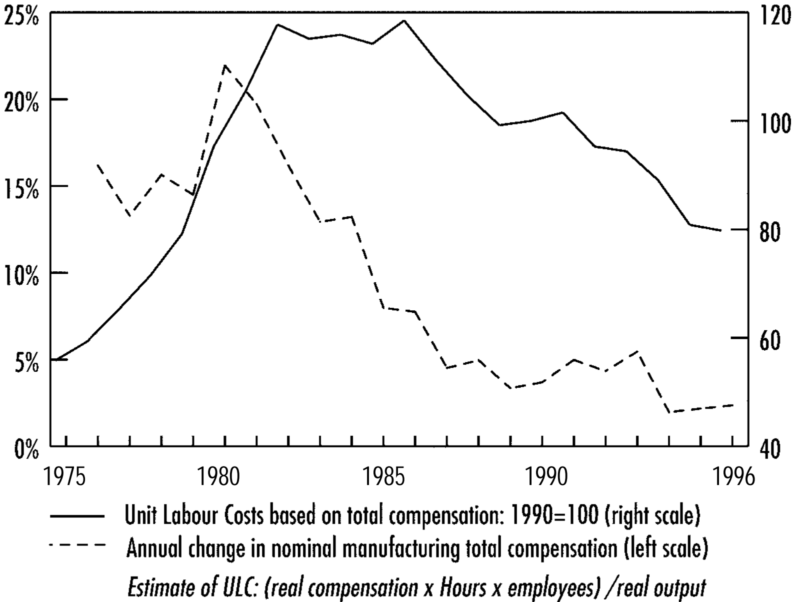



Chart 2-13 Unit Labour Costs and Compensation: Manufacturing (1990 = 100)



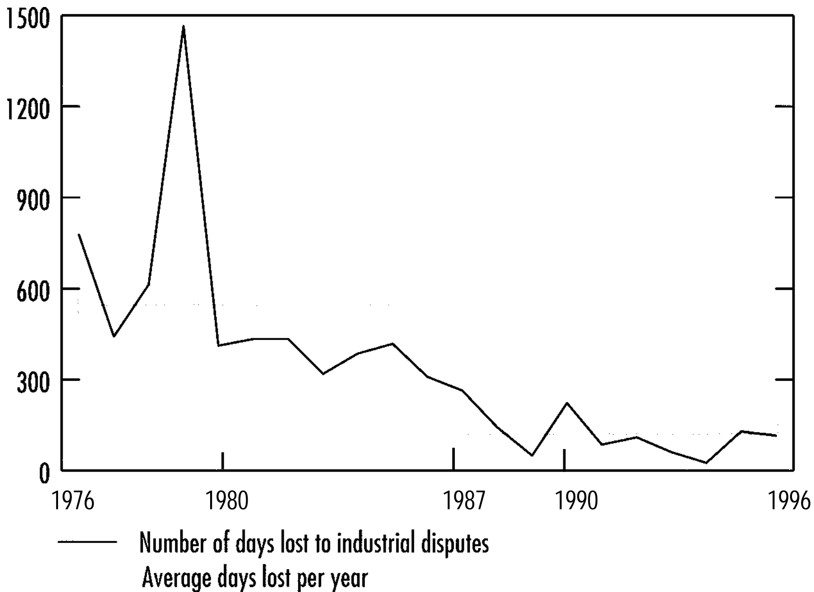

Source: OECD Main Economic Indicators except hourly compensation from US Bureau of Labour Statistics, international comparisons of hourly compensation costs for production workers in manufacturing 1975-77

1990 = 100, ULC peaked in 1986 at 118, following a dramatic rise through the 1970s, which severely retarded Ireland's competitiveness. Following the *Programme for National Recovery* agreement, ULCs declined dramatically, clearly boosting Ireland's competitiveness. From 1988 to 1989, they declined by one-sixth, then after 1991 the index declined another 20 per cent, from just over 100 to just under 80. The relatively low price of labour also favoured job creation over other sorts of investment, as Krugman (1997, 42-43) notes:

> Given the combination of good productivity growth and wage constraint, the success of the economy is in a macro sense not hard to explain. With labor relatively inexpensive, the incentives were in place both for high rates of investment and for those investors to choose employment-creating rather than labor-saving techniques of production – a sharp contrast to what was happening in continental Europe. Also, given the depressed state of the European economy (especially since 1991), Ireland's steady decline in relative unit labour costs has amounted to a de facto devaluation, making its exports increasingly competitive and therefore stimulating demand for Irish products at a time when demand elsewhere in Europe was stagnant.

A key part of this story is the impact on labour of a change of attitude on the part of unions. From the late 1960s to the mid-1980s, the number of industrial disputes had fluctuated around 150 per year, peaking at over 250 in 1974 and again at nearly 200 in 1984 (NESC 1996, 13). Just as wage increases began to fall before the 1987 agreement, so too did industrial disputes, a trend which deepened after the agreement. By 1989, the number of disputes was less than 50, and it has stayed in that range since. The number of days lost to labour disputes tells the same story. Between 1976 and 1986, 546,000 days a year were lost to industrial disputes; between 1987 and 1996, only 121,000 days on average

Chart 2-14 Days Lost to Industrial Disputes ('000s)




Source: Tansey (1998)

were lost each year to industrial action, well less than a quarter of the previous rate (see Tansey 1998, 156; and chart 2-14). Labour peace obviously reduces costs to business.

> Perhaps the most notable shift in attitudes was among the trade union leadership. In adopting a far more long-term perspective than had been common previously, they eased the way of adaptation to change in large sections of the economy, buttressed competitiveness by agreeing to moderate increases in nominal pay, with the beneficial side-effect of a sharp fall in days lost to industrial action, and, by becoming partners in a series of national agreements, broadened the consensus in favour of continuous fiscal responsibility. (ESRI 1997a, 64)

### *Labour-market Regulation*

Efficient, well-functioning labour markets are also a key to keeping costs low in the economy. Ireland's corporatist model gives corporatist actors large influence in setting wages. Yet, as Sachs (1997, 61) notes, in other aspects, Ireland's labour markets are relatively free. Discussing an executive survey carried out by the World Economic Forum (WEF), Sachs writes: "Ireland's labour market regulations are *not* seen as seriously impeding the adjustment of labor hours to fluctuations in demand, at least in comparison to other European countries" (emphasis in the original).

Burda (1997) reaches the same conclusion. While Irish labour markets are not as unfettered as U.S. labour markets, he argues, the level of regulation is about the same as in Britain, where labour markets are considerably freer than in continental Europe. Sachs also refers to the WEF survey to argue that Irish labour regulations, unlike those in much of Europe, are not a major hindrance to job creation, and that minimum wage regulations do not set wages so high that they are an important impediment to hiring unskilled or young workers:

> On specific responses to the executive survey carried out by the World Economic Forum, Ireland's minimum wage regulations are *not* deemed to be important barriers to hiring unskilled or young workers, in contrast to the situation in other EU countries. Similarly, Ireland's labour market regulations are *not* seen as seriously impeding the adjustment of labour hours to fluctuations in demand, at least in comparison with other EU countries. In short, Ireland's labour markets are seen as more responsive to market conditions than in other EU countries. (Sachs 1997, 61, italics in the original)

The OECD survey (1997, 88) reviews two studies of the Irish labour market: one finds that Ireland has the third-least-regulated labour market after Switzerland and United Kingdom; the other finds that Ireland has the second-least-regulated labour market

after the United Kingdom. However, as discussed elsewhere in this chapter, the combination of Ireland's tax and social-welfare payments may discourage unskilled workers from seeking employment, reducing labour-market flexibility at the lower-wage end of the scale, despite moderate minimum-wage regulations.

## A Time of Growth and Change

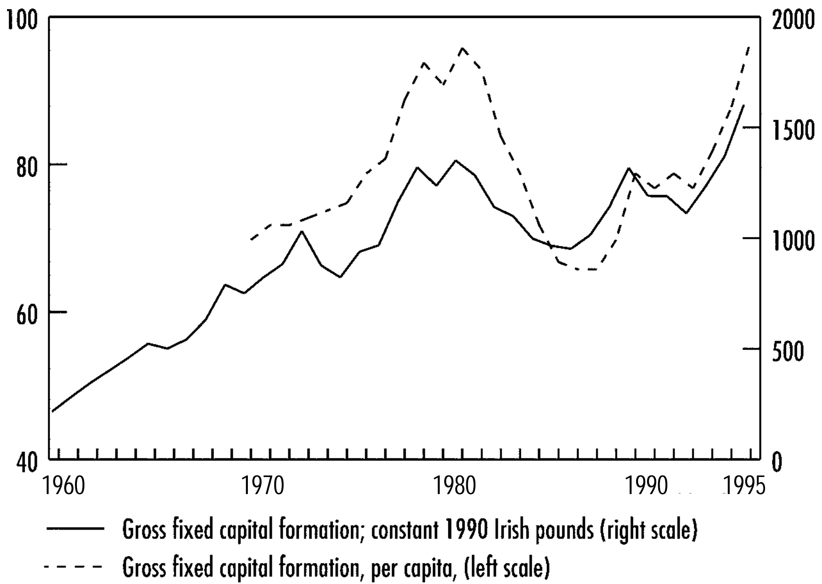
Reduced taxes, fiscal reform, wage moderation, and the promise of higher profits quickly resulted in an increase in investment in both physical and human capital, adding to growth and job creation.

Irish per-capita fixed-capital formation tells the story. Through the 1980s, Ireland's investment position deteriorated significantly. In 1980, Irish capital formation was about 80 per cent of the OECD average, over £1,500 per capita in constant 1990 pounds, by 1986, it was just half the OECD average, a little over £1,100 per capita. Recovery was not instantaneous, but by 1996 capital formation was at its highest level in Irish history. It exceeded 80 per cent of the OECD average and was close to £1,800 per capita – a 60 per cent increase (see charts 2-15 and 2-16).

Yet investment in Ireland has been rather lower than might be expected from the nation's strong economic growth and record of job creation. The ESRI (1997a, 41-42) presents some "plausible reasons" why this might be so. Essentially, the ESRI argues that current investment is more efficient, and thus powers growth even at lower levels than past investment. It also claims that investment has shifted from physical investment to soft investment, which doesn't show up in the numbers. The ESRI argues that, while public-sector investment was high through the 1970s and early 1980s,

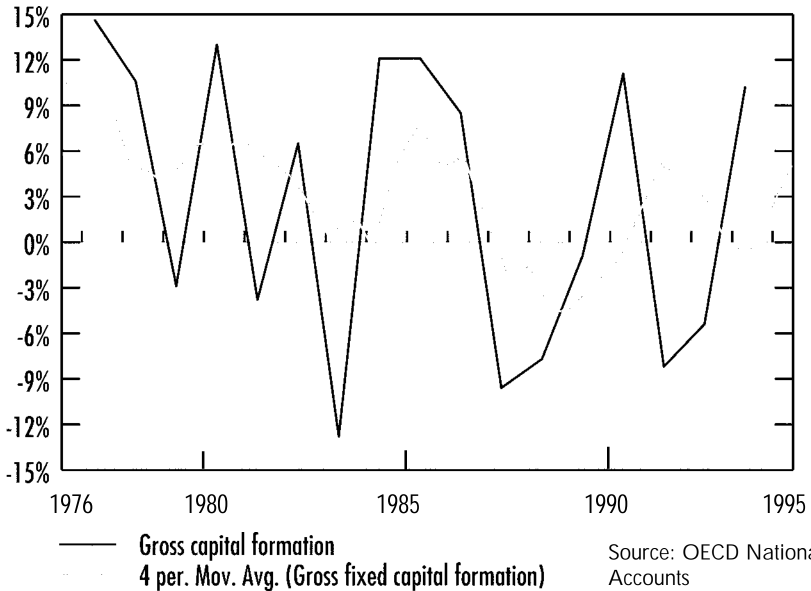
> many of the public investment programs were wasteful. In this regard the introduction of long-term planning ... has helped raise the quality of public investment. The restructuring of the manufacturing sector toward more high technology processes has reduced the physical

Chart 2-15 Irish Per Capita Gross Fixed Capital Formation (OECD = 100)




Source: OECD National Accounts

Chart 2-16 Irish Per Capita Gross Fixed Capital Formation




Source: OECD National Accounts

> capital-output ratio in production. Most of the investment required in the modern manufacturing sector is quite human-capital and R&D intensive with relatively low plant and capital equipment requirements. (ESRI 1997a, 42)

The reforms also had a profoundly beneficial impact on indigenous business, as Eoin O'Malley reports:

> Since about 1987, there has been a substantial improvement in the growth performance of Irish indigenous industry as measured by trends in employment, output and exports. This improvement has been such that it is without historical precedent in twentieth century Ireland. Not only has the record of Irish indigenous industry been improved by comparison of its own previous experience, but its growth performance over the past decade has also been stronger than that of industrial countries generally. (O'Malley 1998, 57)

According to O'Malley, from 1980 to 1988, permanent employment in indigenous Irish manufacturing industries declined from 143,300 to 110,918, but, by 1997, it had grown to 120,700. Unfortunately, much of O'Malley's data begins in 1985, but the numbers are still telling. Between 1985 and 1987, EU manufacturing output grew at an annual rate of 2.1 per cent, compared to 0.6 per cent for Irish indigenous industry. Between 1987 and 1995, EU output growth had slowed to 1.7 per cent annually; Irish indigenous output was growing at 4.0 per cent a year. O'Malley credits the same factors discussed in this chapter – reduced taxes, wage moderation, deficit control, a better skilled work-force – which benefit all business. He also credits a shift in Irish industrial policy away from subsidies and into helping business improve marketing, management skills, and technology. This removes distortions from the economy, by limiting the "grant-repreneur" mentality while helping firms develop their own expertise.

Econometric work by de la Fuente and Vives (1997) attempts

to quantify the impact of reform on GDP growth. Irish economic growth in the post-1985 period has been about two percentage points (1.95) stronger per year than in the preceding 1970–85 period. De la Fuente and Vives find that improved labour-market performance and fiscal restraint were each responsible for nearly a percentage point in increased annual growth, 0.85 and 0.78 respectively.[10] But, in a sense, this understates the impact of sensible government policies in competing with the rest of the world. Given that bad policy regimes are commonplace, de la Fuente and Vives's work suggests the most important factor in distinguishing Ireland's economic performance from that of other catch-up nations is Ireland's fiscal discipline.

On the labour-market side, one remarkable fact clearly emerges: real wages began to rise rapidly even as unit labour costs were falling. The growth of real wages, under agreements designed to moderate wage growth, differs sharply from the pattern of falling *real* wages during the period unions struggled to achieve the largest wage settlement possible. In the period between 1987, when Irish unions agreed to wage moderation, and 1996, real manufacturing wages rose by 20 per cent and have continued to grow strongly in more recent years. In the period of great union militancy — 1980 to 1984 — real wages fell by six per cent.

## *Nourishing the Golden Goose*

The "golden goose" principle seems to be at work here. When wage increases are moderate and leave a comfortable gap between costs and revenues to maintain profits, strong profits attract further investment, which, in turn, increases the value of labour. This creates room for real wage increases while still leaving strong

10. This actually leaves a large part of Ireland's improved performance unexplained by the results. As discussed in other chapters, convergence itself is a strong factor in improving the performance of backward nations. As the Irish economy caught up with advanced economies, convergence weakened as a factor. This should have reduced growth in the post-1985 period by 1.22 percentage points in the model. The other important factor in the model is investment in human capital, which adds 0.40 percentage points to the growth rate.

profits. A virtuous circle is created, benefiting both employer and employee.

However, a vicious circle is also possible. In any given year, labour could bargain for higher wages, which would either substantially reduce or eliminate profits. Either possibility is more attractive for an employer than a lengthy shut-down that would generate negative profits. This inclines employers to accept demands for higher wages, even when these may be damaging in the long run, and it gives unions the power to achieve such increases.

This kills the golden goose. Reduced or disappearing profits remove the incentive for further investment, as well as the resources for investment. Productivity lags. Over time, employers have less and less ability to provide real wage increases. Yet labour will quite naturally expect increases. This can lead to increased labour strife, which further suppresses productivity growth, as the vicious circle turns round. Taken to an extreme, particularly in a fiscally loose climate, which encourages inflation, real wages can begin to fall despite large increases in nominal wages. This is the situation O'Riordan referred to earlier and is indeed the situation Ireland found itself in through the early and mid-1980s.

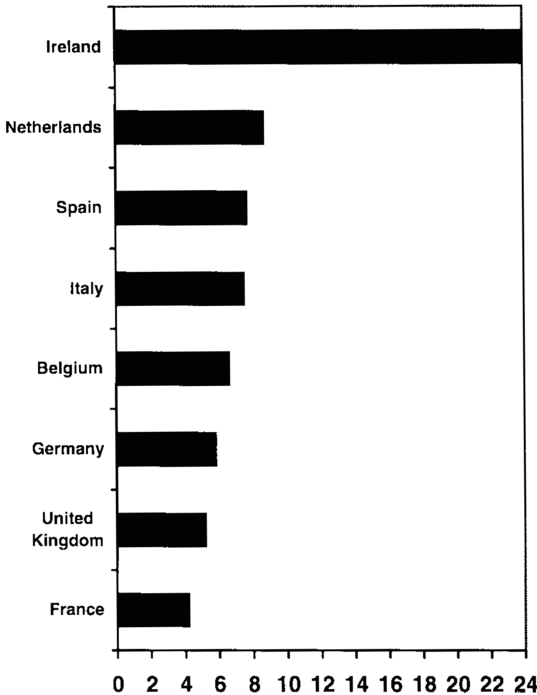
But, for now, Ireland enjoys a virtuous circle, and the goose continues to lay golden eggs. Moderate wage growth continues to fuel profits, which spur investment, which spurs economic growth and productivity improvements, which allows wages to increase without eating away at profits, and so on. The ability to make profits is Ireland's strongest drawing card for investment (OECD 1997a, 13-19 and see chart 2-17)

Before moving on, two aspects of Ireland's recovery – job creation and Irish GDP growth compared to other advanced nations – bear closer scrutiny.

### *The Jobless Recovery*

Ireland's post-1987 economic recovery was soon dubbed the "jobless recovery". While GDP growth soared, unemployment

Chart 2-17 Rate of Return of US companies
Average 1984-93

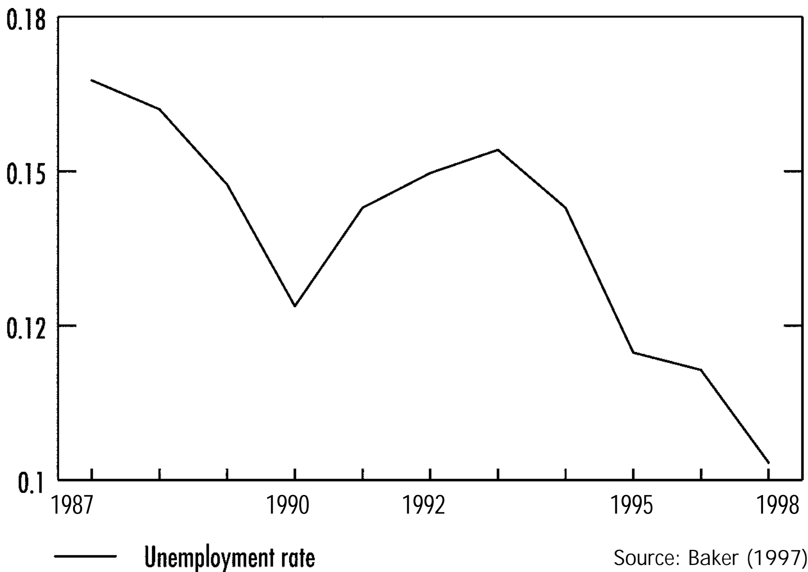



Source: OECD 1997. Economic Surveys 1996-97: Ireland

remained stubbornly high, actually increasing between 1990 and 1993 (see chart 2-18). Part of this is due to long-term unemployment, people who have simply become detached from the labour market and are uninterested in seeking employment. But, in fact, many recoveries are jobless in their initial phases, particularly if the recovery involves a fundamental reordering of the economy.

Increases in productivity ultimately allow companies – and economies – to become more competitive and generate more jobs, but the first step towards efficiency often involves shedding workers. As well, in a rapidly growing, and thus changing, economy, old skills may not be in demand while there may be not enough workers with the necessary skills in the emerging economy. So, in some occupations where workers are plentiful, there are no jobs, and in some occupations, jobs go wanting because there are no

Chart 2-18 Irish Unemployment Rate




workers. In the initial phases of a recovery, these conflicting trends – of new job growth, on one hand, and job shedding and labour-market mismatches, on the other – may roughly balance each other out or even lead to job loss. Only after the economy has gone through this reordering phase does large net job creation usually occur.

This appears to be what happened in Ireland. Job growth was slow in the opening phase of the recovery. From 1987 to 1993, only about 60,000 net new jobs were created, though this is actually a third more net new jobs than were created in the full period from 1971 to 1987.

Job creation took off after 1993. Nearly 200,000 net new jobs were generated from 1993 to 1997. In 1997, for the first time since the early 1970s, the unemployment rate fell into the single digits (below 9 per cent actually). International comparisons highlight the transformation of Ireland's jobs' performance. Between 1981 and 1986, the number of jobs in Ireland fell by 4 per cent. Job growth in the United States was nearly 10 per cent in this period.

In the EU-12, job growth was modest but positive, at 1.6 per cent. But in the decade following 1986, Irish employment growth has been spectacular (26 per cent), far outpacing job growth in the United States (15 per cent) and the EU (7 per cent). Growth in individual years through the mid-1990s tells the story. In 1994, the number of jobs in Ireland grew by 3.1 per cent compared to a *negative* growth rate of 0.3 per cent in the EU; in 1995, Irish job growth was 4.4 per cent compared to positive EU growth of 0.5 per cent; in 1996, Irish job growth was 4.0 per cent compared to 0.1 per cent in the EU; in 1997, Irish job growth was 3.3 per cent compared to 0.4 per cent in the EU (Gray 1997, xxiii).

The reasons for job growth are straightforward:

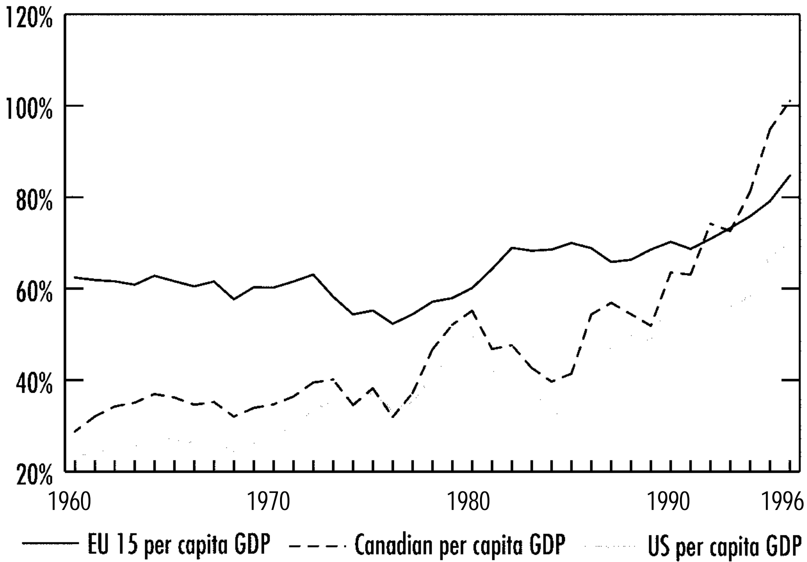
> Given the combination of good productivity growth and wage restraint, the success of the economy is in a macro sense not hard to explain. With labor relatively inexpensive, the incentives were in place both for high rates of investment and for those investors to choose employment-creating rather than labor-saving techniques of production – a sharp contrast to what was happening in continental Europe. (Krugman 1997, 42-43)

Ironically, one reason for Ireland's spectacular job growth in recent years, and GDP growth, too, was Ireland's bad policy regime through the 1970s and most of the 1980s. This muted the convergence effect through this period, and left the Irish economy further behind advanced economies than it otherwise would have been. Since the magnitude of the convergence effect is related to the size of the gap between advanced and lagging economies, the convergence effect itself helps explain Ireland's rapid economic and employment growth after a sensible policy regime was put in place in the late 1980s.

### *Ireland Beats the World in GDP Growth*

Ireland's GDP growth is particularly impressive when international comparisons are made. From 1981 to 1986, Irish per capita

Chart 2-19 Irish Per Capita GDP




Source: OECD Comparative National Accounts

GDP fell substantially in comparison with both Canadian GDP (chart 2-19). Since then, it has risen substantially against both Canadian and U.S. GDP, though this contains a disheartening message about Canada's performance: in the mid-1980s, Canada's per capita GDP was 2.5 times the size of Ireland's; now, Irish per capita GDP exceeds per capita GDP in Canada. Irish per capita GDP has risen to about 70 per cent of U.S. per capita GDP. For most of the 1980s, Irish per capita GDP hovered at about 70 per cent of the EU-15 average, but since 1992 it has risen rapidly to 85 per cent of EU per capita GDP.

One difficulty with Irish GDP measurement is the problem of transfer pricing. One of the ways Ireland pushed costs down for investors was by a dramatic reduction of corporate taxation to 10 per cent in the manufacturing sector. This proved a magnet for investment, but it also created incentives for accounting practices which could distort the true picture of the Irish GDP. Foreign companies had an incentive to attribute as much of their profits as

possible to production in Ireland, bloating the GDP accounts. This at first appeared to be a serious problem. In the mid-1990s, economic commentator Jim O'Leary argued that Ireland's economic statistics "had about the same empirical status as moving statues, flying saucers and the statue-of-Elvis-found-on-Mars stories"(Ó Gráda 1997, 33).

This created intense concern in the mid-1990s, with Tansey and others calling for a completely new set of national accounts designed to eliminate the distortion. However, a series of later investigations has revealed that the problem, while it exists, is relatively small. Tansey hardly mentions it in his 1998 book. But this nonetheless points to another problem with Ireland's GDP measure. Because the country has attracted so much foreign investment, there is a considerable outflow of profits each year:

> For most European countries, GDP and GNP are virtually interchangeable. However, in Ireland's case, the scale of annual outflows of factor income – primarily in the form of repatriations of multinational corporate income – have driven a wedge between GDP and GNP. As a result, GDP – broadly, national output – is about 13 per cent higher than national income as measured by GNP. The difference between the two represents the annual amount of income generated by production in Ireland that is transferred abroad. (Tansey 1998, 30; see also the discussion in OECD, 1997a, 18)

It is important to distinguish between the problem of transfer pricing and the GDP–GNP gap. Transfer pricing involves fanciful accounting practices which attribute to Irish-based multinational plants economic activity has actually taken place elsewhere, in order to benefit from Ireland's low rate of corporate tax. This turns out to be a relatively small distortion. The GDP–GNP gap involves economic activity which takes place in Ireland, but the profits of that activity are then exported to other parts of the firm's global structure in returns to shareholders or investments elsewhere.

A sizeable portion of Ireland's output in this way is transferred as profits into foreign hands. It is worth noting that I have not found a single article, book, or publication in Ireland that criticizes this flow, nor did I talk to one person in Ireland who mentioned it as a problem. The view seems to be that the output wouldn't be there in the first place were it not for foreign investment. This was the route to growth taken by the United States through most of its history, particularly when it was a developing economy.

## Other Factors

A number of other factors contributed to Ireland's economic growth since 1987. Most important in the long run is an improved education and training system. In the shorter term, a devaluation of the Irish pound in 1986 was, as discussed earlier, a key factor in the almost painless transition to fiscal responsibility. A further devaluation of the pound in 1993, coming on the heels of Ireland's participation in the European single-market project in 1992, doubtless helped Irish growth in the latter part of the 1990s, though many believe this devaluation presents a problem. Ireland's strong productivity growth hardly justified devaluation, which threatened to overheat the economy and lead to inflation. Fortunately for Ireland, wage agreements held, and inflation remained under control.

### *An Educated and Growing Work-force*

The Irish education story is particularly important, though it is too far outside the range of this book, which focuses on macroeconomic policies, to discuss it at length. Ireland was late in granting free secondary education to youths. This occurred only in 1968 and helped lay the groundwork for recent growth, although not until other macro-policies were in place. The first cadre benefiting from free secondary education entered the work-force in the early to mid-1970s, but many of them, particularly those with post-secondary education, emigrated because of poor economic conditions in Ireland. Nonetheless, by the time of the policy turn-

about of the late 1980s, Ireland's populace had broader and better education than ever before in the nation's history. The availability of educated workers for the jobs being created, particularly in the high-tech sector, sustained and furthered Ireland's recovery.

Ireland also advanced its technological, technical, and trades training programmes and institutions, as well as establishing new apprenticeship programmes. As can be seen from chart 2-17, the availability of skilled workers and the educational level of the work-force are both powerful attractions for investment. In Europe, only Germany scores higher for availability of skilled workers, and Ireland leads the pack on relevance of education.

Many Irish commentators believe the increasingly well-educated and well-trained Irish work-force will continue to propel growth, particularly as younger workers enter the work-force and older, less-skilled workers retire. This also highlights Ireland's favourable demographics. Through the 1990s, the labour force should increase by about 2 per cent a year, though Ireland's slowing birth rate will reduce labour-force growth in future years.

The current increase in the work-force – rather than creating a drag on the economy, as it sometimes has in the past, when the labour force grew more rapidly than employment – should help sustain Ireland's growth as the demand for skilled labour increases. Although shortages of skilled workers are already apparent, the growth of the labour force will mitigate the negative effects. Reforms of the social-welfare system, designed to make work a more attractive alternative to social-welfare payments at the bottom end of the income scale will also boost labour-force growth. This, too, is positive, since shortages of low-skilled workers have begun to appear, though they are not as acute as shortages for high-skilled workers. As well, training programmes have been targeted to help these workers to increase their skills.

The situation is summed up in the ESRI's *Medium-Term Review: 1997-2003* (1997a):

> Over the last decade the Irish labour market has been

> profoundly affected by a number of different factors which have altered the supply of labour. These factors include changing demographic trends, rising female participation rates and the medium and long-term effects of changes in domestic policies in the education system and the social welfare system. These policy changes have had the effect of increasing the supply of skilled labour and gradually reducing the supply of unskilled labour. This has led to an increase in the stock of human capital and the rate of human capital accumulation. (47; for a more extensive discussion, see pages 7–33 in the same publication)

### *European Union Funds*

Two other factors are often cited for Ireland's recent success, though they have played a relatively small role. These factors are EU subsidies to Ireland and Ireland's business subsidies. Canadian commentators, in particular, tend to focus on these elements of Irish recovery, perhaps to justify similar policies in Atlantic Canada.

EU subsidies have clearly helped Ireland, but both the size of the transfers and their use distinguish them from the Atlantic Canadian experience. Total transfers rose from just over 5 per cent of GDP in 1986 to a peak of 7 per cent in 1991, and have now fallen to about 4 per cent of GDP. This compares to net transfers to Atlantic Canada which peaked at about 40 per cent of GDP and are now equal to between a quarter and a fifth of GDP (see *Retreat from Growth* (McMahon 2000)). The actual per-capita transfers are even more unbalanced, since, through much of this period, Atlantic Canada's per capita GDP exceeded Ireland's. If such transfers were a significant part of the story, Atlantic Canada should have raced ahead of Ireland instead of falling well behind.

EU transfers need to be broken into two key component parts, each of roughly equal weight. One component is EU agricultural subsidies. These boost rural incomes but have little impact on investment and may retard economic adjustment by keeping

rural populations artificially high. Yet, despite these subsidies, Ireland's rural population and income continue to shrink. (See *Retreat from Growth* (McMahon 2000) for a fuller discussion of rural development.)

EU structural funds are the other key component. These are meant to build economically important infrastructure. Unlike in Atlantic Canada, where transfers seem to have added little to useful economic infrastructure – aside from failing coal mines, heavy-water plants, a money-losing steel mill, and a proliferation of fish plants and fishing vessels chasing often-declining stocks – Irish policy-makers, particularly the ESRI and the NESC, carefully track the use of EU transfers to ensure they are directed to useful investment, though some fungibility is probably inevitable. Nonetheless, Irish policy-makers set high standards for the use of EU structural funds. As the ESRI says in its 1997 evaluation of EU structural fund expenditures:

> Our evaluation … begins with the premise that the opportunity cost of public funds is high. All public spending must be measured on a competitive basis against the best alternative use of funds. It is not enough to say that a particular expenditure is within budget and contributing to the goals set for it. We must try to assess whether it could be better spent. (ESRI 1997b, xv)

### *Economic Development Subsidies*

Ireland's use of industrial incentives through the Industrial Development Agency (IDA) Ireland to attract investment has also generated much attention in Atlantic Canada, but considerably less attention in Ireland. The IDA's performance never came up in the interviews I conducted in Ireland unless I introduced the topic. In the several thousand pages on the Irish experience I have reviewed, the IDA is seldom mentioned, and, when it is, the discussion often concerns some controversial aspect of its performance (Ó Gráda 1997, 54; 113-128).

In fact, subsidies were reduced as part of Ireland's fiscal reforms in 1987, yet the loss of subsidies certainly did not slow the powerful growth, the strongest in Ireland's history, that followed these reforms. The IDA's subsidy muscle was strongest in the early 1980s, yet growth was slow despite IDA intervention. By the early 1990s, IDA subsidies were at about half the level of a decade earlier, yet growth was strong.

In the OECD (1997a) report on Ireland, the IDA is mentioned only once and then only as the source of information for a chart. The IDA is not listed in the index of any of the books I've reviewed on Ireland.[11] Interestingly, IDA officials themselves do not credit the subsidy game as being a particularly important part of the Irish economic story, save in one regard – as a defensive strategy against other jurisdictions which offer large subsidies. In fact, the IDA is highly critical of the subsidy game:

> [T]he trends in continental Europe – and especially in more centrally located areas – for increased financial incentives to secure foreign investment is of concern to us, both from a cost-efficiency point of view and its logic. (Irish Development Agency 1995)

IDA officials rightly take pride in their marketing abilities – bringing to the attention of foreign firms the strengths of Ireland as a profitable place for investment. Here, their marketing arsenal is full and effective. It focuses on costs in the economy – the tax structure, in particular the 10 per cent corporate tax rate,[12] and labour costs. It is worth noting that these low cost factors are simply part of the economic landscape and thus avoid the pathologies

11. Though this may be somewhat deceptive. The IDA is mentioned briefly in both Ó Gráda and Gray, and more extensively in O'Sullivan (1995), though it is not found in the index to these books. Nonetheless, Irish analysts simply do not consider the IDA a key part of the Irish economic story in the way Atlantic Canadians once fastened their hopes on various subsidy agencies to attract investment.
12. This, and much of the Irish tax structure, is under review. In particular, the EU has been clear in its displeasure with Ireland's tax competition, which is seen on the continent as a key reason for Ireland's economic success.

of politically motivated subsidies discussed in the next volume. In its marketing, the IDA ties the cost advantages of Ireland to its open economy and the attractiveness of the European market. According to IDA officials, subsidies do not attract companies to Ireland; they are merely a defensive measure against subsidies granted elsewhere.

As O'Sullivan notes, Ireland's industrial incentive policy has been in place since the early 1950s, but rapid economic growth only followed the macro-economic reforms. During Ireland's weakest period of growth, 1981 to 1986, Ireland's industrial aid, as a percentage of manufacturing gross value added, reached 12.3 per cent, more than twice the European average, but obviously these aids were ineffective in spurring economy-wide growth. They declined to 6.4 per cent in the period 1986 to 1988, compared to a European average of 4 per cent. They were lowest as Ireland's growth took off between 1988 and 1990, at 4.9 per cent, compared to a European average of 3.5 per cent (O'Sullivan 1995, 383; she does not present numbers for the years after 1992).

De la Fuente and Vives (1997, 104–5) provide a GDP-based calculation of subsidies which also shows a roll-back. From 1980 to 1984, subsidies equalled 3.5 per cent of GDP; from 1990 to 1994, a period of strong growth, subsidies equalled 1.1 per cent of GDP. As de la Fuente and Vives show, the subsidy cut-backs were not motivated by improved economic times but by Ireland's aggressive moves to cut back government in order to lower taxes, which in turn generated new growth.

In any event, it is difficult to credit subsidies, at their lowest level, with Ireland's strong growth in recent years, when one considers the much higher subsidies in the 1980s during Ireland's experiment with a large interventionist government, a period of dismal growth and job creation. The clear consensus among Irish economists is that fundamental economic reforms – wage moderation, tax cuts, reductions in the size of government, etc. – spurred the recent growth, not industrial incentives.

## KILLING THE GOLDEN GOOSE

Good times are already beginning to chase away the memories of bad times – and the memories of why tough medicine was needed to cure Ireland's economic malaise. Although the union leadership remains committed to wage moderation, the membership has become restive. Large minorities of union membership now vote against wage-moderation agreements, and inflationary fires have begun to burn under the Irish economy.

Government policies are part of the problem. After large reductions in government expenditure as a percentage of GDP between 1986 and 1989, expenditures have begun to creep up again. Tansey, one of the key architects of the 1987–88 turn-around, is highly critical of the government's action (Tansey 1998, particularly pp. 175-240). Real growth in spending has been exceeding even the red-hot growth of the economy, and so the expenditure-to-GDP ratio has steadily edged upward since 1989. Although this ratio remains substantially below the levels through the first seven years of the 1980s, government is clearly expanding its role in the economy again.

Increasing spending could not come at a more difficult time. If anything, Irish growth has been too strong, threatening an overheating. To the extent that the old Keynesian mechanisms work at all, the prescription would be restrained government spending. The fiscal side of the equation becomes even more important now that Ireland does not have monetary mechanisms to dampen economic activity. That, of course, is because of European monetary union in which Ireland is an enthusiastic participant. But growth on the continent is sluggish. Thus, the continental interest rates which European monetary union will bring to Ireland are far lower than are suitable for Ireland's red-hot economy.

The other side of government, taxation, has steadily moved up as well. Although a number of agreements have limited taxes, the tax take again has risen even faster than growth, perhaps because, as the Irish become richer, more of the GDP is taxed at higher

marginal rates. Ireland's newest labour pact contains the promise of further tax cuts, so how all this will balance out in the long run remains an open question.

The number of jobs in Ireland has soared, and the unemployment rate has fallen dramatically even though the labour force is growing dramatically. From 1994 to 1997, over 50,000 additional jobs were created each year. In 1998, the number of jobs in Ireland rose by nearly 100,000. Unemployment has fallen each year, and by mid-1999, it dropped below 6 per cent.

This is partially revealed by the gap between Live Registered Unemployment and the Labour Force Survey, as discussed earlier. Doubtless even the survey overstates real unemployment, as some who are not truly seeking work will claim to be. Shortages are already showing up in the labour market, putting further pressure on wages. While the unions try to police wage settlements, some employers are making under-the-table payments to employees to maintain their services. While labour shortages are most extreme in high-skill jobs, like computer programmers, shortages of many different types of workers are common, as reflected in an article from the *Irish Independent* (20 June 1998, 6):

> Top chefs such as Michael Martin at Dublin's Clarence Hotel constantly receive job offers. Michael Martin estimates he receives 10 job offers a year ... "We like to play by the rule book here, but there is a lot of poaching of staff now in Dublin. I know of places where they are offering under the table payments of £600" [Martin is quoted as saying].

The same article notes that bricklayers can earn over £250 a day, or over $100,000 Canadian over the course of a year. The headline "Skilled workers who can't afford a job" reflects the fact that the labour market is so tight that skilled workers can often earn more freelancing than in full-time work where wage scales are covered by Ireland's labour pacts.

Sachs (1997, 63) notes the "risk to Ireland's export-led growth

model. Ireland must maintain cost competitiveness, with changes in wage levels appropriately reflecting changes in productivity and world-wide demand for Ireland's products." The wage agreements discussed earlier are typically in part based on research on such things as productivity growth. But if such agreements come unravelled, Ireland is in a more precarious position than in the past. Previously, for example, in 1986 and 1993, Ireland was able to use devaluation when domestic costs reached uncompetitive levels. With the move toward a single European currency, this will not be possible in the future.

So, as suggested in the first chapter, the corporatist turn-around may be time-limited. The key costs Ireland struggled to reduce in the late 1980s may soon start growing again. Despite strong economic growth, taxes have increased as a percentage of GDP; uncontrolled economic growth could lead to another bout of inflation and its associated costs; and the labour agreements are in danger of coming unravelled.

Yet, whether or not the Irish economy continues to grow at its present pace or becomes derailed, it has pointed to key aspects of policy which can lead to accelerated economic and employment growth. The question is whether these will be maintained in future years.

## Conclusion

For generations, Ireland had been the most economically backward nation in northern Europe. Unable to generate enough prosperity and jobs for even its small population, Ireland exported people rather than goods and services. Independence did little to change this dismal situation – Ireland still lagged behind all its neighbours, and economic refugees continued to flee the island.

Ireland's experiment with a closed economy and job generation through import substitution was an unmitigated disaster. It isolated Ireland from the powerful wave of growth and prosperity that swept through western Europe after the end of World War II. The results were so dismal that even the architects of the closed-

door policy reversed course to open the Irish economy to world competition at the end of the 1950s.

Thus began Ireland's first golden economic age. Ireland generated jobs and wealth faster than it ever had in its history. But this was short-lived. Growing public expenditure, an increasing tax burden, mounting government intervention in the economy, rising debts and deficits, and union militancy pushed up costs in the Irish economy. Profits virtually disappeared and so did investment. Unemployment rose and "the culture of employment" was lost to a whole sector of Irish society, people who joined the rolls of the long-term unemployed. As bad as things had been in the past, this proved to be the most dismal economic period in twentieth-century Irish economic history, for the earlier glimpse of prosperity had turned to ashes.

Bad times concentrated policy thinking. Irish society as a whole reached a consensus in the late 1980s that costs had to be reduced in the economy. Unions adopted wage moderation as their creed. Government slashed expenditures and taxes. Profits rose rapidly, creating a magnet for further investment.

The results were remarkable. They didn't simply better Ireland's own dismal economic history; Ireland's record of GDP growth is now the strongest in the developed world. In the early and mid-1980s, Irish unemployment had climbed to nearly 20 per cent. Now Ireland faces a labour shortage.

Tax cuts and wage moderation, far from reducing tax revenues and real wages, led to dramatic increases. Revenues are higher now than when tax rates were at their peak. The Irish have gone from being one of the most poorly paid people in the developed world to one of the best paid. What many feared would be a "race to the bottom" became a rapid climb to new economic heights.