Research Repository UCD

Title	The Irish economic 'miracle' : how do we explain the timing of the boom
Authors(s)	Walsh, Brendan M.
Publication date	1999
Publication information	Walsh, Brendan M. "The Irish Economic 'Miracle' : How Do We Explain the Timing of the Boom" 6, no. 4 (1999).
Publisher	Blackwell
Item record/more information	http://hdl.handle.net/10197/1580

Downloaded 2023-04-07T10:52:29Z

The UCD community has made this article openly available. Please share how this access benefits you. Your story matters! (@ucd_oa)

© Some rights reserved. For more information

The Irish Economic ‘Miracle’: How do we explain the timing of the boom?

Brendan Walsh.

Owing to a spectacular performance in the 1990s, the Irish economy has become the envy of the European Union. This is remarkable in view of the country's lacklustre performance in the 1980s. There are lessons to learn from this transformation and indeed the causes of the 'Celtic Tiger' phenomenon are attracting increasing international attention.

Table 1 displays annual average growth rates of output, employment and output per worker from 1994-98, in Ireland and the EU. GNP is a better measure of the Irish trend in economic activity as growth in profits of transnational companies inflates GDP figures.

Table 1 Annual average growth rates, 1994-98 (%)

	<i>Ireland</i>	<i>EU</i>
Output ⁱ	7.7	2.5
Employment	4.5	0.5
Output ⁱ per person at work	3.1	2.0

i GDP for EU, GNP for Ireland

Since 1993, the rate of output growth in Ireland has been three times that of the EU. The annual rate of employment growth has been even more spectacular at four percentage points higher than that of the EU. Over 25 per cent more people are working than in 1993, whilst in most European economies employment has been flat (see Figure 1). The growth rate of output per worker has been far less spectacular than that of total output, but is 50 per cent above the EU average none the less.

The historical decline of the Irish population, together with chronic high unemployment and emigration rates, made job creation a national priority. The recent rapid growth of employment (and resultant striking decline in unemployment) is therefore particularly

welcome. In 1997, the unemployment rate fell below the EU average for the first time (Figure 2). Women's labour force participation rates, formerly way below the European average, have grown and the tradition of emigration appears to have ended. Ireland is now recording the highest immigration rate of any EU country with increasing numbers being job seekers with no previous Irish connection.

As a result of numbers at work increasing faster than the total population, the burden of dependency --traditionally high in Ireland--has fallen. The rising employment to population ratio has broadened the tax base and the high debt/GDP ratio has shrunk rapidly. This has facilitated a reduction in the high tax rates inherited from the 1980s.

The combination of steady productivity growth and a rising employment rate has led to a rapid convergence of GDP per head in Ireland to the EU average (see Figure 3). With the case for continued regional, social, and cohesion funding from Brussels thus weakened, Irish allocation was halved at the 1999 Berlin summit.

Accounting for the success

Irish economists have traditionally been sceptical of the ability of policy makers to use national economic instruments wisely. Mainstream opinion has been hostile to experimentation in fiscal or monetary policy. Few were in favour of breaking the exchange rate link with sterling and most have been generally critical of the active industrial policy pursued by successive governments since the 1960s. This includes the emphasis on attracting foreign direct investment (FDI) through a low corporate tax rate and grants for fixed assets. Some have been sceptical of the wisdom of deciding to join EMU -- foreseeing dire long-run consequences for Europe in the whole project and particular risks for Ireland as long as Britain remains outside.

It is predictable, therefore, that the present boom took the profession by surprise. Once they accepted that the boom was not a statistical artefact due to the accounting practices of the multinational companies, whose operations in Ireland are so important, a consensus emerged about its causes. Most would include the following factors:

- a switch in industrial promotion: this led to more sophisticated targeting of selected overseas industries in the 1990s and the extension of the preferential (ten per cent) rate of corporation tax to 'internationally traded services' (principally financial services). In view of the contribution of the low tax rate to the economy's success, Irish policy makers greet any discussion of 'tax harmonisation' with horror. Ireland has negotiated with the Commission to increase the tax rate on manufacturing profits to 12.5 per cent, while reducing the rate on all other profits to 12.5 per cent. The new tax structure is not regarded as an example of 'unfair tax competition';
- availability of a plentiful supply of educated, English speaking skilled labour: by the 1980s people with second and third level qualifications predominated in the outflow from the Irish school system. They were eager to work in Ireland at low wage rates relative to those on the European mainland;
- EU funds: these have been proportionally more important in Ireland than in any other member state. Ireland has benefited disproportionately from the Common Agricultural Policy since joining the EU in the 1970s. Substantial monies also flowed from the Cohesion, Regional and Social Funds, insulating Ireland from the global recession of the early 1990s;
- the process of applying for funding: this led to a marked improvement in the overall planning of Irish public spending and resulted in effective use of aid;
- a steady decline in the overall tax burden at a time when it was rising in Europe;
- the favourable climate for overseas investment, especially from the US. In addition to low tax advantages and the ready supply of labour, proximity to the New England region and close cultural ties with America played roles in leading US companies locating their European operations in Ireland;
- the return to centralised wage bargaining in the late 1980s: policy makers emphasised the sequence of 'National Wage Agreements' and their success in persuading trade unionists to agree to moderate pay increases over the medium term in return for a promise of steady reductions in income tax rates; and
- readiness to join the new exchange rate arrangements in Europe was indicated in 1979 by the break in the link with sterling. This evolved into full membership of the eurozone in 1999. Maastricht convergence conditions were easily met along the way. Also, being the only English speaking country in the new currency union may be a

significant attraction for foreign investors, especially in the financial and information technology fields.

Although it is impossible to establish the precise contribution of each factor, it is unquestionable that much of the 'Irish miracle' was influenced by foreign firms. Foreign firms located in Ireland account for about 47 per cent of industrial employment, 77 per cent of net industrial output, and 83 per cent of total exports from Ireland. Because they are concentrated in relatively high tech sectors and are anxious to attribute as much of their profits as possible to a low-tax jurisdiction, they have dramatically raised the average net output of the Irish labour force.

While foreign firms have vastly expanded the country's manufacturing base, the majority of Irish workers are still employed in Irish-owned firms and the growth of employment has been most spectacular in the services sectors. The boom reflects a broadly-based growth of employment and productivity. Furthermore, the flow of FDI has not been all in one direction. Irish firms have also become significant investors in Britain, Europe and America in sectors such as banking, food ingredients and processing, paper and packaging and building and construction.

The timing of the boom remains something of a puzzle. Many of the contributory factors have been in place for years. For example, the low manufacturing tax rate has existed since the 1950s and the sizeable net inflows of European funds since 1973. There has been heavy investment in education since the 1970s and in the 1980s there were worries about a 'brain drain', as highly educated young people sought employment abroad.

The truth is that a unique historical combination of luck and appropriate economic policies lie behind the miracle. The right combination of policies emerged from a long period of trial and error. To their credit, Irish politicians were reasonably quick to abandon failed policies and embrace successful ones. Perhaps the real miracle has been the consistent commitment to economic growth and unwillingness in recent years to allow other considerations to obstruct it.

[Future prospects: pride before the fall](#)

Some see hubris in Ireland's boom with a hard landing as its inevitable consequence. They point to the property market as a potential fault line in the economy. A collapse in residential and commercial property values could lead to a loss of consumer and investor confidence and a flight of capital from the country. The trigger might be a cyclical downturn in sectors such as microelectronics, pharmaceuticals, or international financial services, with severe recession the inevitable consequence.

The consensus, though, is that Irish house price behaviour can be accounted for by fundamental factors such as the growth of the number of households, the rise in disposable income and the lowering of interest rates. While the current rate of inflation cannot continue, few anticipate a major collapse like that in the south of England after the Lawson boom.

Those who opposed Ireland's entry into EMU warned of the economy's vulnerability in the event of a sudden sharp depreciation of sterling relative to the euro. Since its launch at the start of 1999, however, the weakness of the euro has led to a different concern. Combined with the fall in interest rates caused by entry into EMU, it is contributing to the 'overheating'

of the economy. The Central Bank of Ireland is unable to do anything but warn of the dangers inherent in the property boom, while the European Central Bank takes scant notice of Irish conditions in deciding on the stance of its 'one size fits all' monetary policy in Frankfurt.

The risks of overheating can be exaggerated. A significant cause of the recent crises in Asia, Russia and Latin American lay in their attempts to maintain pegged exchange rates despite intense speculative pressure. The adoption of the single European currency has removed this from the Irish equation. The hidden weaknesses of the banking systems that were another crucial factor in these crises are absent from the Irish economy. Irish banks are now very highly rated internationally.

The factors likely to choke off the Irish boom are those that constrain the growth of booming regions globally. Chief among these, are increased shortages of labour and affordable housing and growing urban congestion. Ireland urgently needs major additional infrastructure and increased public spending on health, education and environmental protection after the legacy of the austerity package of the late 1980s. Although output has expanded rapidly in the 1990s, the house building sector has not been able to keep pace with demand and there is widespread talk of a housing crisis. The shortage of serviced land in the main urban centres constrains growth further.

Similarly, the breakneck expansion of car ownership, combined with an antiquated and inefficient public transport network, has resulted in chronic congestion in cities and towns. Once again the principal bottleneck is in the physical planning process. The Irish countryside is under siege from settlements paying scant attention to considerations of aesthetics and waste disposal in a newly affluent society.

The supply of labour is no longer as elastic as it was in the 1990s owing to non-repeatable factors such as the sharp rise in women's labour force participation rates and the results of the late 1970s baby boom. Further increases in women's labour force participation rates will only be elicited by compensation for rising work-related costs, notably childcare and transportation. As the supply of returning emigrants dries up, the significant immigration of workers from abroad will also suffer from housing shortages and restrictive policies toward non-EU citizens.

If demand conditions remain buoyant the labour market will continue to tighten. The 'Partnership 2000' national agreement limiting pay increases to around 2.5 per cent a year over the period 1997-99 is expiring. While increases have held remarkably well in the private sector, there is clear evidence that the public sector has breached them. Doubts as to whether the agreement will be replaced are being raised by some ominous omens on the industrial relations front.

Higher rates of pay increases need not result in a deterioration of competitiveness if they are offset by high rates of productivity growth. However, the growth of productivity will probably be less impressive in the future than it was in the 1990s. Irish manufacturing has been transformed by the inflow of high-tech FDI and each additional project has a reduced impact on average productivity. Employment in service sectors is growing in importance and productivity gains are generally much smaller here than in manufacturing. Moreover, there will be increased competition for mobile investment when the EU is enlarged to include countries such as Poland, where skills levels are high and wage costs low.

A soft landing

For all these reasons it is implausible to argue that the Irish economy can maintain the boom. The evidence suggests that the point is being approached where the constraints on growth will become increasingly binding. There are, however, grounds for believing that a soft landing is a more likely outcome than a crash. As the boom enters its sixth year, the momentum that has built up and the general air of optimism about the future are encouraging. The contrast with the dismal 1980s could hardly be greater. What is most encouraging, though, is the growing awareness of the need to focus on raising living standards --broadly defined to include environmental and quality of life indices, as well as the traditional indicators -- rather than being obsessed with maximising the growth of the economy for its own sake.