THE TAXPAYERS NETWORK

721 Cardinal Lane, Suite 105
Green Bay, Wisconsin 54313
920-434-3100
Fax: (920) 434-4177

February 2007

Ireland's Economic Progress

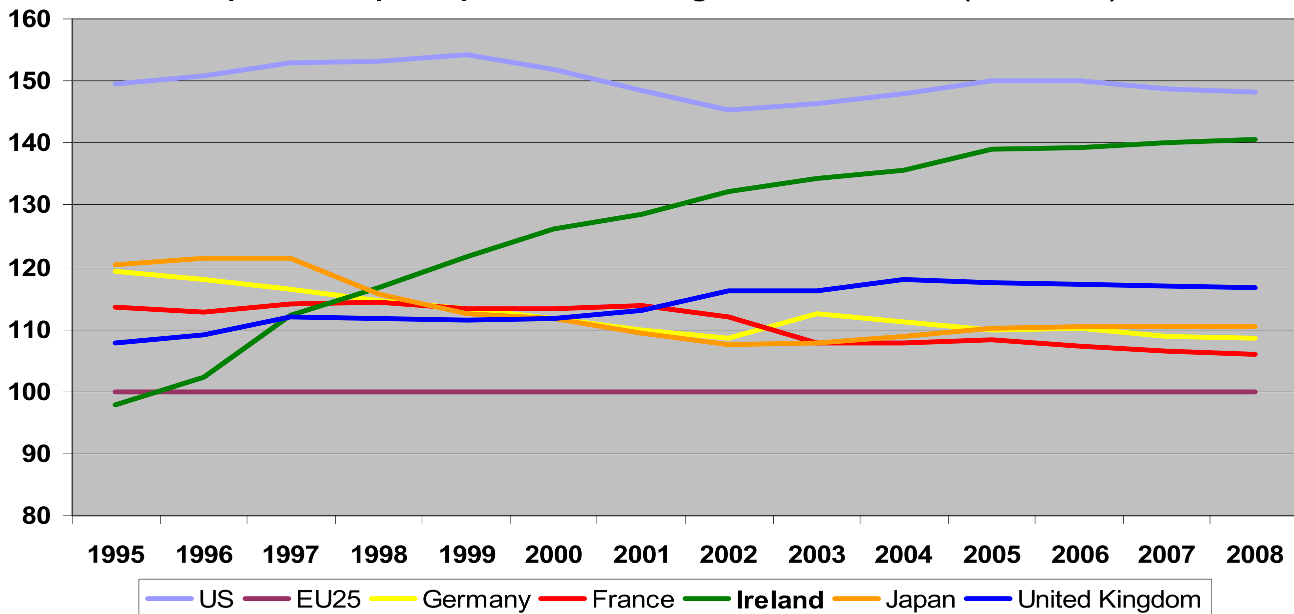
On the Verge of Collapse to Economic Star of Europe in 5 yrs

By Marc C. Duff

For hundreds of years Ireland ranked with some of the poorest regions of Europe. Its economy was predominantly agricultural and the island was largely left behind during the industrial revolution. Not too long ago, in 1949, Ireland had virtually a "peasant economy" in which approximately 46% of the working population was involved in agriculture. Because of this, sadly it could be said Ireland's chief export was its people as millions migrated off the island in pursuit of a decent living.

However, over the past decade the Republic of Ireland has transformed itself from a struggling agricultural nation to experiencing possibly the greatest level of economic growth in the world. This accomplishment prompted the naming of Ireland as the "Celtic Tiger." Now, Ireland's agricultural workers make up less than 8%, while workers in the service sector make up 63% and industrial 29%. As can be seen in Graph 1, in less than a decade Ireland's per capita Gross Domestic Product (GDP) leaped past the economies of Germany, France, Japan and the average of the 25 European Union (EU) countries. Amazingly, Ireland's 2008 economic output per capita is estimated to exceed those of these major industrialized and developed nations by almost 30%!

Graph 1: GDP per capita in Purchasing Power Standards (EU25=100)



Source: Eurostat, Statistical Office of the European Union

The First Step - Rescinding Restrictions on Free Trade

During the 1950s, the policy stance of successive governments was to place heavy restrictions on foreign ownership of Irish firms and heavy tariffs to protect the country's manufacturers. The protectionist policies of the government led to a dismal economic performance in which Ireland's economy grew at only 2% while the European average was 5%. In addition, exports made up only 32% of Ireland's GDP with 75% going to the United Kingdom. Ireland's leaders determined a liberalized trade policy was needed as well as a strategy of export-led diversification and growth.

Starting in 1956, restrictions on foreign business ownership were phased out and export firms were granted tax-free status. In both 1964 and 1965, unilateral tariffs were cut. Then in 1966, Ireland negotiated a Free Trade Area with the United Kingdom which eventually led to them to joining the wider European Union in 1973. As a result, Ireland gained access to a huge continental European market and made the country attractive to U.S., Canadian and Japanese firms wishing to enter the European market using an English-speaking work base. By the end of the 1960s, 350 foreign companies (primarily American) were established and rapidly became leaders in the export sector.

The result of reducing protectionist trade policies was to allow Ireland's economic growth rate to double to an average rate of 4.2%. This growth helped Ireland keep pace with the rest of Europe, which was growing at about 4%. Unfortunately it failed to improve upon the low standard of living of the people of Ireland which was less than two-thirds of the rest of Europe.

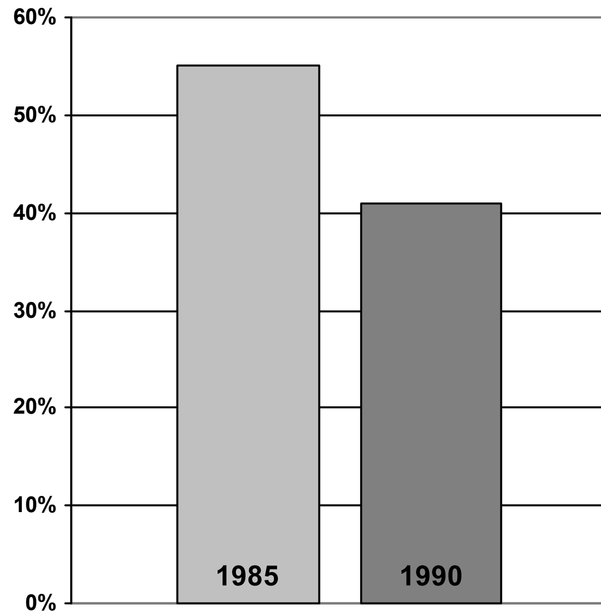
Government Expansionism Causes Fiscal Crisis

The 1970s and until the early 1980s is marked by large increases in government expenditures and debt meant to stimulate Ireland's economy. Between 1977 and 1981, government spending was increased in all areas, wages and salaries were increased, more government employees hired, and an ambitious public infrastructure expansion effort was implemented. This fiscal mismanagement led Ireland's debt, as a percent of GDP, to reach 125% creating a major crisis for the country. This policy was also a complete failure since Ireland's annual economic growth during this period averaged a dismal 1.9%.

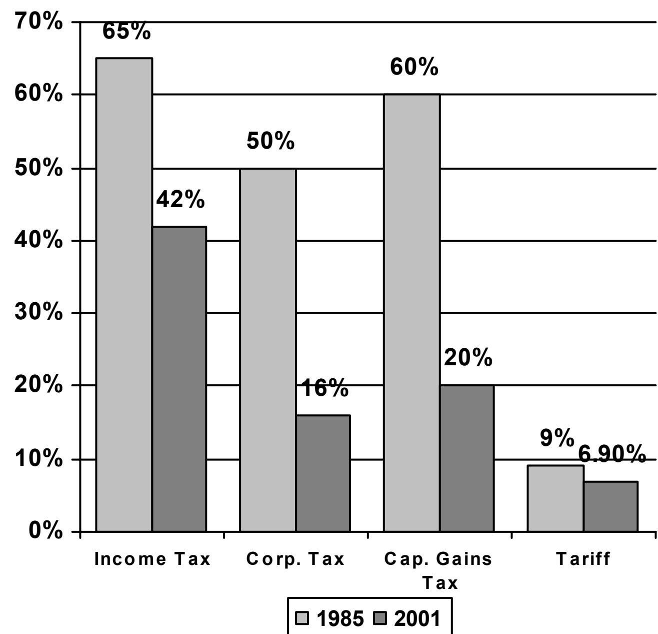
In order to address the serious fiscal crisis and the massive government debt facing the country, taxes were significantly increased creating a further drag on the economy. Ireland's top marginal income tax rates reached as high as 80% in 1975 and 65% in 1985. The corporate tax rate in 1985 was 50% and the capital gains tax was 60%. The unemployment rate reached a high of 17 percent in 1986, emigration soared, and the government's finances were further strained by a monetary policy that devalued the Irish pound. Aggressive reforms and drastic actions were needed to address Ireland's fiscal crisis.

Fiscal Restraint and Tax Reductions Help Prompt Economic Growth

In 1987, Charles Haughey and his Fianna Fail party won the control of the government and implemented deep cuts to bring Ireland's budget and fiscal crisis under control. Expenditures on health were cut 6%, education 7%, agriculture 18%, roads and housing 11% and the military 7%. Several government boards and bureaus were abolished and measures were taken to eliminate 10,000 public sector jobs. In 1988, Ireland's largest budget cuts in 30 years were implemented cutting spending levels 3% and capital expenditures by 16%. As seen in Graph 2, Ireland's government spending as a share of the GNP dropped significantly in a relatively short period of time. Ireland's deficit was erased and its high debt situation sharply improved.



Ireland's economic crisis during the mid-1980s also spurred discussion among employers and trade union leaders on how to prompt a recovery. Ideas included utilizing centralized national agreements on pay. The incoming Fianna Fail party in 1987 seized upon this interest and organized negotiations that included major employer and labor interests. This resulted in a "Social Partnership Agreement" which was included in **The Programme for National Recovery.** This three-year national agreement sought to offset moderated wage increases with income tax cuts and social welfare improvements. The weakened trade unions welcomed the chance to participate in such discussions, which continue to be renegotiated every three years.



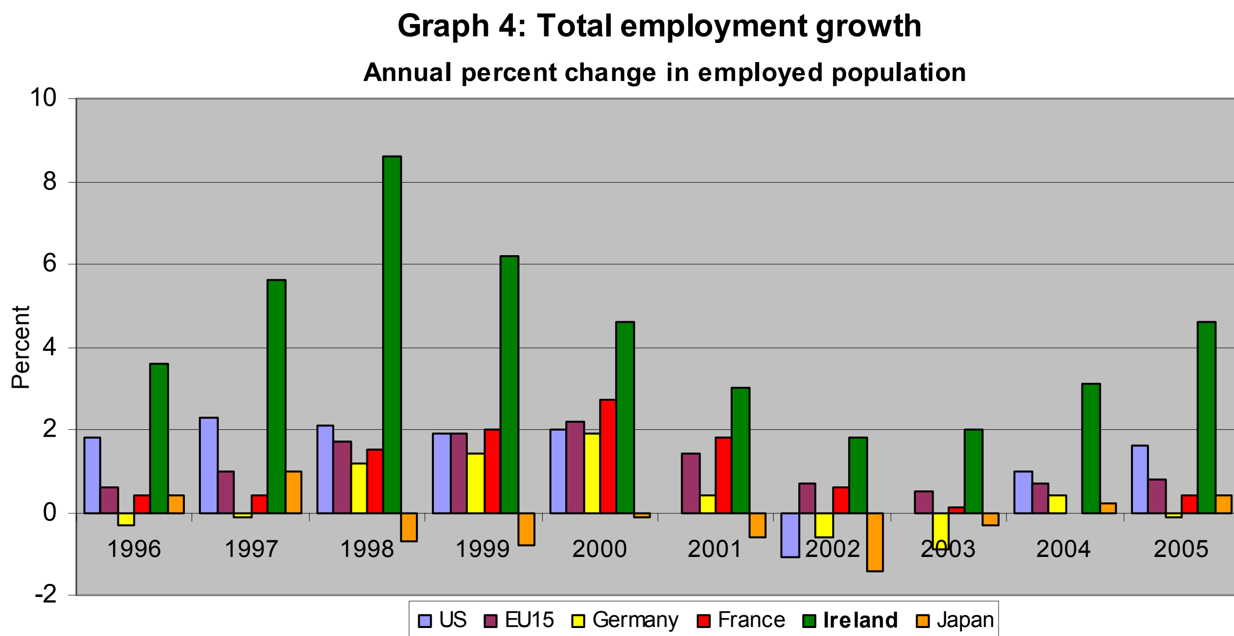
While these agreements are only guidelines, labor requests for wage increases have generally been in line with what was negotiated. As can be seen in Graph 3, Ireland's government kept up its end of the bargain by making dramatic cuts in almost all major taxes.

As the fiscal situation in Ireland improved, economic growth began to rise. The government then focused attention on additional ways to improve the economy. The first was the signing of the Maastrict Treaty in 1992 that would bring Ireland into the European Monetary Union by 1999. By signing this treaty, investors were assured that Ireland's ability to increase its levels of government debt or other inflationary measures were significantly limited.

Being a part of the European Union also required Ireland to adhere to certain directives from the organization. The EU limits a country's ability to discriminate between products made for export and others for the domestic market. Ireland had a special 10% corporate tax rate that applied to internationally traded manufactured items or services, while the standard corporate tax rate was 24%. Rather than increasing the tax, Ireland decided to cut the standard corporate tax rate to12.5% starting in 2003. As a result, Ireland has one of the lowest corporate tax rates among the world's advanced economies.

The result of the successful "Social Partnership Agreements" along with Ireland's full participation in the EU enhanced the stability of the country. The lower taxes and the cost competitiveness of labor in Ireland, in turn, prompted foreign and domestic business investment. All of these factors helped fuel economic growth and booming employment in Ireland, thus helping to create the "Celtic Tiger." Over the past ten years, over 700,000 jobs were created, with the bulk of the gains located in the market services and construction sectors. Between 1995 and 2000, the main sources of increased labor supply were domestic causing the unemployment rate to decline from more than 12% to less than 5%. Large portions of recent employment growth are now dependent on inward migration into Ireland.

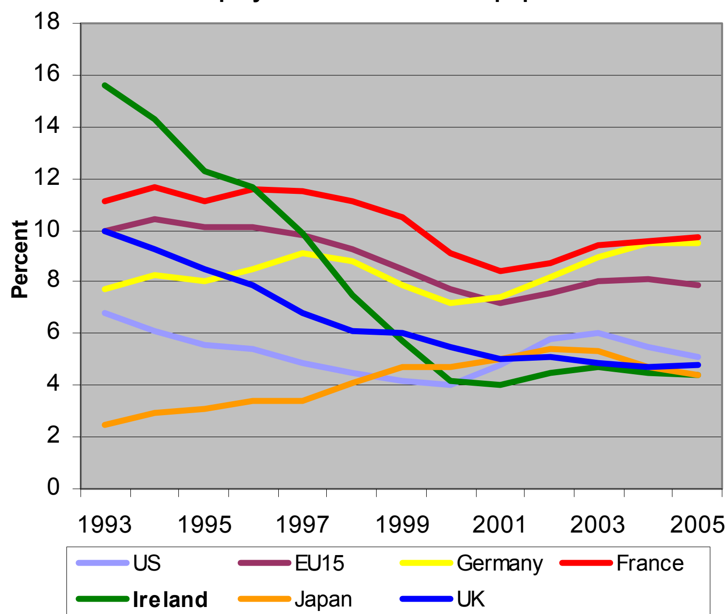
Graph 4 shows how Ireland's employment growth dramatically outpaced many major industrialized countries.



Source: Eurostat, Statistical Office of the European Union

Explaining the Celtic Tiger Miracle

An economic turnaround of the magnitude and durability experienced by Ireland over past decade cannot just be explained as "The Luck of the Irish". The numerous studies of this miracle economic turnaround generally conclude there was no magic government action that unleashed the economic growth. It was instead a series of actions and policies that, when taken together, created a perfect formula for rapid economic growth. The statistics outlining the turnaround are amazing. As seen in Graph 5, Ireland's unemployment rate dropped in less than 10 years from over 15% to a rate of under 5% which is one of the lowest in all of Europe.



Source: Eurostat, Statistical Office of the European Union

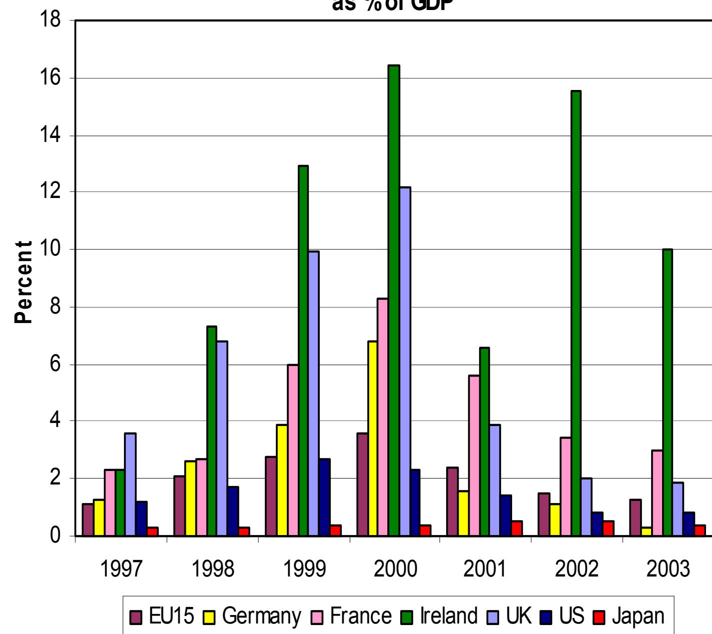
The actions which led to the unleashing of the "Celtic Tiger" economy include implementation of free trade policies; the impact of joining the EU; pro-growth tax policies; generating a favorable regulatory and investment climate; and creating political and economic stability in Ireland.

Favorable Trade, Investment and Regulatory Climate

For decades, Ireland's political leaders pursued policies that have been extremely successful in attracting Foreign Direct Investment (FDI). Ireland accomplished this through a favorable tax and regulatory environment, building a world class financial services system, targeting investments in the high tech and high skilled sectors, and promoting its English-language speaking workforce. In the 1990s, FDI was one of the most significant contributors to high GDP growth Ireland. The OECD estimates that from 1993-2002, Ireland attracted over $70 billion in investments from the United States alone. Ireland continues to attract significant level of investment as, according to UNCTAD, the seventh largest recipient of FDI inflows among developed countries in 2003.

The foreign investment trend by major corporations of moving various services "offshore" has also greatly benefited Ireland. Of the $32 billion market of services that were exported offshore worldwide in 2001, Ireland accounted for one quarter. It is also likely Ireland will be a magnet to the rapid growth in the offshoring of information-technology services, which is expected to rise from $1 billion in 2002 to $24 billion in 2007.

The massive influx of foreign investment made Ireland the second most transnational economy in the world in 2003, just behind Hong Kong. As an indication of Ireland's transition into being integrated with the world economy, Graph 6 shows how Ireland's share of FDI activity as a percentage of GDP has been far greater than the world's largest economies. During this time, Ireland was the leading destination of FDI in Europe and perhaps the world. Over the past 20 years, 75% of FDI in Ireland was in high-tech sectors, including chemicals, computer hardware and software, and high-tech engineering. In 2000, FDI led to job creation of approximately 68,000 in electronics and engineering, 41,000 in the international and financial services sector, and almost 20,000 in pharmaceuticals.



Source: Eurostat, Statistical Office of the European Union

However, inflows of FDI have significantly diminished to the point the country is experiencing negative inflows due to the repayments of loans to foreign parent companies. Some feel this shows the maturity of the Irish economy because they are now becoming global investors rather than just a destination for it.

Several organizations also rank Ireland well regarding its economic practices. The Fraser Institute's Economic Freedom of the World index ranked Ireland as the 6th best in 2006. In this index, Ireland specifically ranked well as being one of the most open to foreign trade. The Heritage Foundation's Index of Economic Freedom in 2007 ranked Ireland as having the 7th freest economy in the World, behind Hong Kong, Singapore, Australia, the United States, New Zealand, and the United Kingdom. The level of economic freedom, as explained below, indicates how Ireland's policies may have helped prompt its strong economic growth.

"Ireland has high levels of business freedom, investment freedom, financial freedom, monetary freedom, property rights, and freedom from corruption. Entrepreneurship is made easy by the light regulatory hand of government…Foreign investment is welcome and restricted only in a few sectors. Financial markets are transparent and open to foreign competition. Property rights are well protected by an efficient, independent judiciary…Ireland's weakest area is labor freedom."

2007 Index of Economic Freedom
The Heritage Foundation

Tax Policies

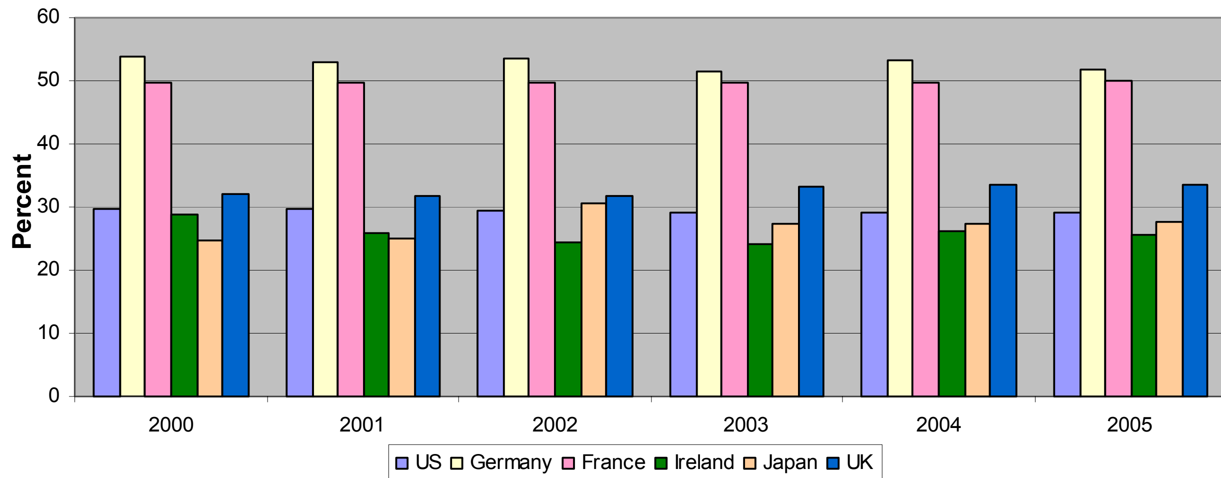
Table 1: Corporate Tax Rates 2004	
Ireland	**12.5%**
UK	30%
France	34.93%
Netherlands	31.50%
Spain	35%
Germany	38.90%
US	**39.50%**
Belgium	33%

Source: Deloitte & Touche 2005

Ireland has some of the lowest corporate taxes in the world. For many years Ireland offered a special 10% corporate tax rate to certain manufacturing and international service companies while having a higher tax rate for other activities. Under EU pressure, Ireland standardized this tax rate to 12.5% and will phase out the 10% special corporate tax.

It is interesting to note that many of Ireland's leaders dismiss the concept that their low-tax policies have had a major impact on their economic growth and success. However, this low tax policy is frequently advertised by Ireland's economic development agencies and highlighted by consulting firms. In addition, many EU countries concerned about their low tax policy have unsuccessfully sought "tax harmonization" policies that would eliminate Ireland's competitively better position. Ironically, many of these major European countries have subsequently moved to reduce their corporate tax rates to stimulate their struggling economies. The cuts were also in response to the tax competition from countries like Ireland and new EU Central and Eastern European members. Between 2000 and 2004, countries with significant cuts in corporate tax rates were Germany, Belgium, Iceland, Poland, Czech Republic and Luxembourg. In 2006-07, Italy also has plans to cut their corporate taxes.

Ireland's workers also benefit from the country's tax policies. When considering the total amount of wages taken in taxes, Ireland's government takes a considerably lower amount. As seen in Graph 7, the total income taxes on wages for Ireland's workers is



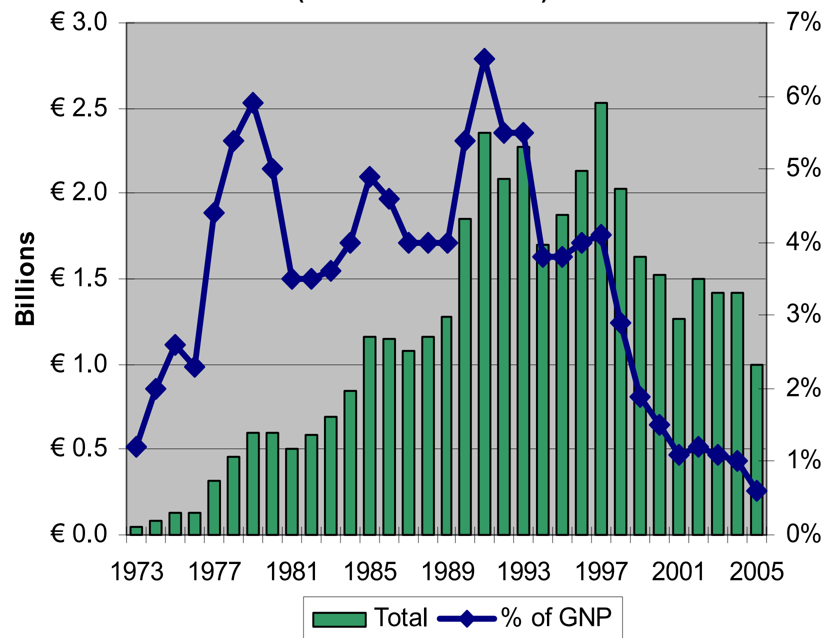
Source: Organisation for Economic Co-Operation and Development, Tax Database

generally less than in the US and significantly lower than what average workers in the other European countries pay. According to 2004 OECD data, Ireland's total tax on average wages was the fourth lowest among the world's major economies, behind only South Korea, New Zealand and Mexico.

Influence of European Union Membership

While Ireland gained political independence in the 1920s, the country was thought of as a backwater to the UK. EU membership had a very positive impact on Ireland, including giving the country the realization they could be a player on the European and world stage. The requirements that came with EU membership and participation in the European Monetary Union also sent the message that Ireland's fiscal and economic policies would be stabilized.

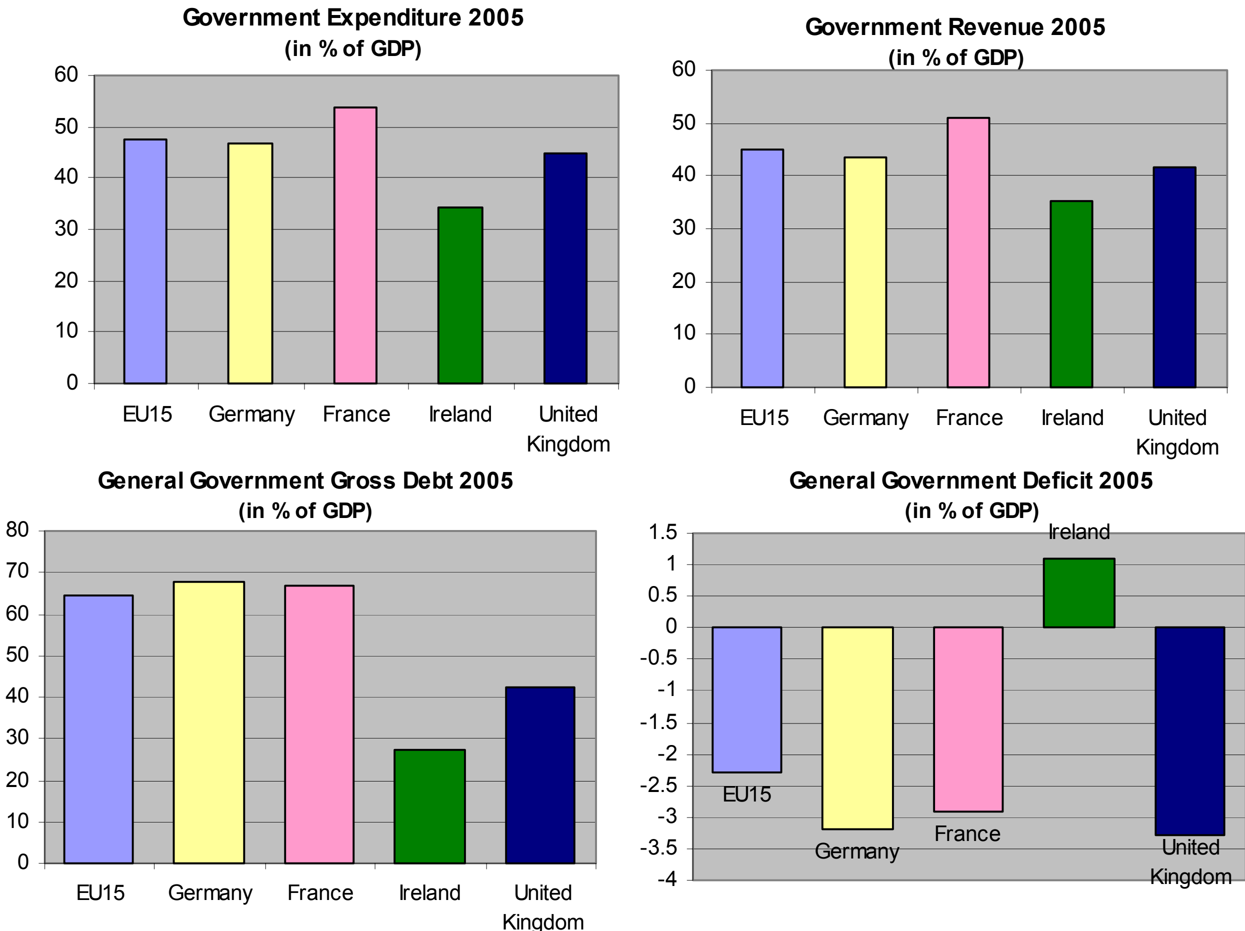
Ireland was one of the poorer members when it joined the EU and benefited greatly by the country's access to the EU's various financial aid programs. As Graph 8 shows, the importance of the transfers grew in the 1980s and the early 1990s, but declined sharply since then. As a share of GDP, the funds Ireland received from the EU peaked in 1991 at 6.5%, with a sharp decline thereafter, falling below 2 percent beginning in 1999. Compared to other EU countries, Ireland has been one of the most-favored recipients of EU funds on a per capita basis.



The agricultural sector has been the greatest beneficiary of EU assistance with approximately 70% of EU transfers being in the form of direct payments to farmers. Aid from the EU also helped construct highways around Dublin, heritage centers, airport improvements, and other infrastructure. During the 2000-06 period, Ireland will receive approximately $4.5 billion in EU Structural and Cohesion funds to assist with infrastructure investments. However, studies indicate the impact of "structural" EU assistance on Ireland's income growth was minimal, on the order of one-half of one percentage point a year.

Government & Economic Stability

The government and economic stability Ireland achieved, not only through its membership in the EU, gave additional assurance to the world's investors. Ireland's major political parties and national leaders have all been committed to government policies that provide stability and generate of economic growth. It has continued in its efforts to limit government expenditures and revenues and as a result, Ireland maintains the lowest levels in these categories among all the EU15 countries. The figures for 2005 can be seen in the graphs below.



Source: Eurostat, Statistical Office of the European Union

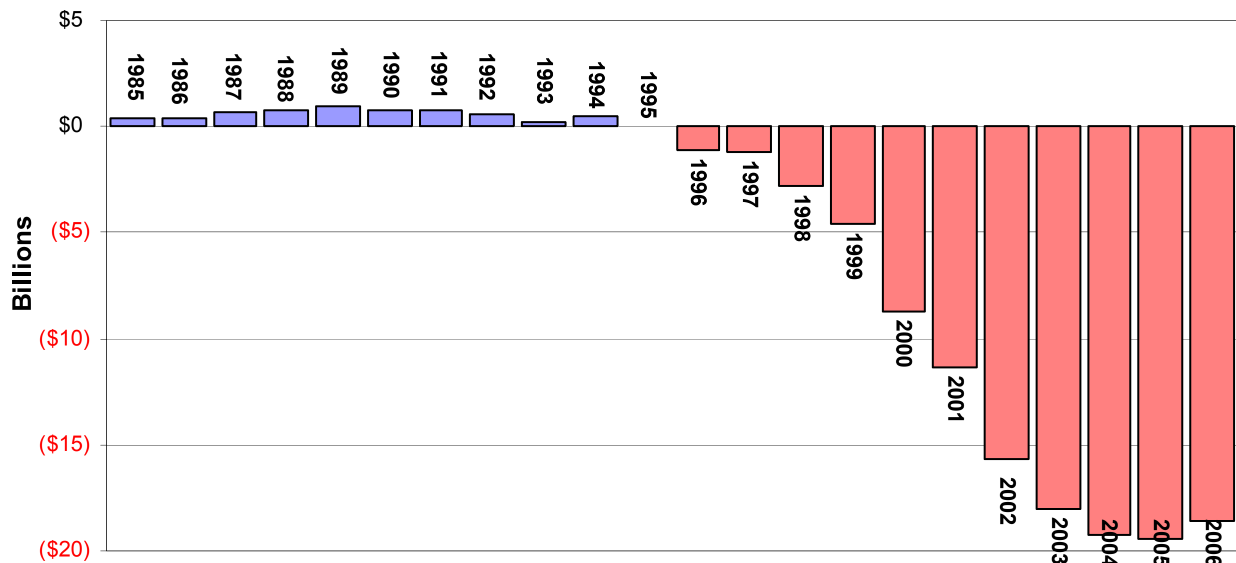
After Ireland was almost bankrupted by debt and deficits a little over a decade ago, they completely rebounded and now operate at levels far less than other European Union countries, like Germany. In fact, while Ireland easily meets the EU standards to maintain budget deficits at less than 3% and debt at less than 60%, it is the major countries of Germany and France who violate this guideline…a policy they played a major role in drafting. Ireland's maintenance of low debt and minimized deficits is a strong indicator of sound government economic policies which should only further economic growth and stability.

Export Development

Ireland has had an open trade policy and an interest in export development since 1958. Only recently did all of Ireland's economic policies come together and make the country a major exporter. Exports of goods and services amounted to 37% of Ireland's GNP in 1973; rose to 56% in 1983 and to 90% in 1995. There are over 1,100 foreign-owned manufacturing/international services companies in Ireland including over 570 from the US, 175 from Germany and 160 from the UK. Overseas-owned companies employ over 108,000 people in Ireland. The foreign-owned sector accounted for 87.6% of Irish exports in 2004. Clearly Ireland's successful export policies were a contributor to its "Celtic Tiger" economic growth. Only recently has export growth slowed in Ireland due to a slowdown in the global economy.

Ireland offers a series of incentives to firms interested in setting up an export manufacturer or international service provider. Grants are provided for fixed assets, worker training, technology acquisition, rent, and feasibility studies. Loans are available through the Industrial Development Authority and the State Export Board provides assistance for export marketing.

The trend of Ireland's trade balance with the US clearly shows its success in developing export markets. Ireland was largely an importer from the US until 1996 when the trend dramatically reversed. Exports to the US accounted for nearly 18.7 percent of Irish merchandise exports in 2005. The US generated a significant trade deficit with Ireland, amounting to over $19.4 billion in 2005. Ireland's trade surplus of 14.7% of GDP in 2001 also shows its export success considering the EU15 average is only 1.6%.



Source: U.S. Census Bureau, Foreign Trade Division

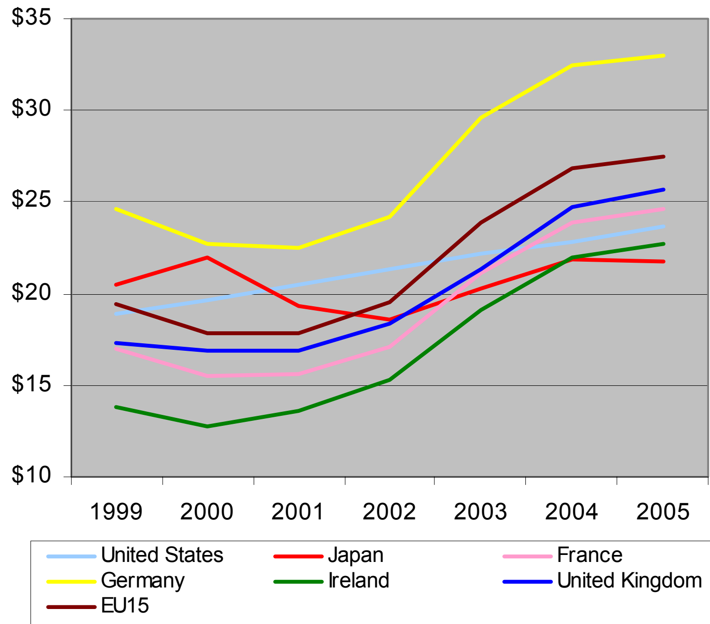
Labor Costs & Productivity

Since 1987, Ireland's utilization of its partnership with employers and labor has enhanced stability through consensus and leading to reduced labor strife. During the 1960s and the 1970s there was a long and protracted period of labor unrest in Ireland, causing a significant number of days of lost work. These unique agreements also created a framework, supported both by employers and labor, for reaching a national agreement for wages, taxation and economic policy. Few dispute the positive influence these partnership agreements have had on Ireland's economic growth.

Another factor is that labor costs have been less expensive in Ireland than in many other countries. As seen in Graph 9, for a period of time Ireland's hourly compensation costs were 25% less than the US and EU15 average. Considering labor costs are a significant factor in the profitability of a facility, Ireland becomes a more attractive location for foreign investments seeking entry into the European market.

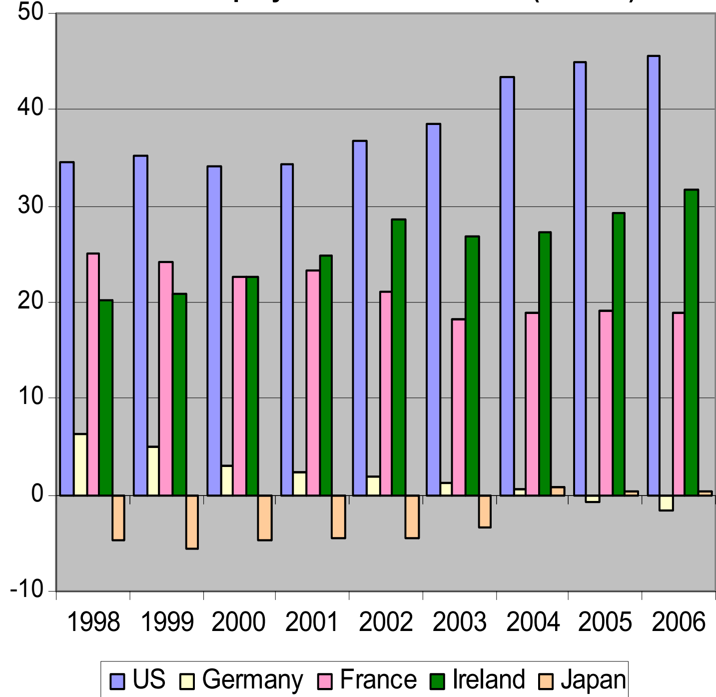
Statistics also show firms will obtain far more productivity for their money by utilizing Ireland's workers. As seen in Graph 10, GDP output of Ireland's labor is significantly more than the EU25 average, exceeding 30% in 2006. It is also interesting to note how Ireland's productivity far exceeds that of both Germany and Japan while growing to be competitive with the US.

Chart 9: Hourly Compensation Costs for Production Workers in Manufacturing



Source: US Dept of Labor, Bureau of Labor Statistics

Graph 10: Labor Productivity - GDP in PPS per Person Employed Relative to EU25 (EU25=0)



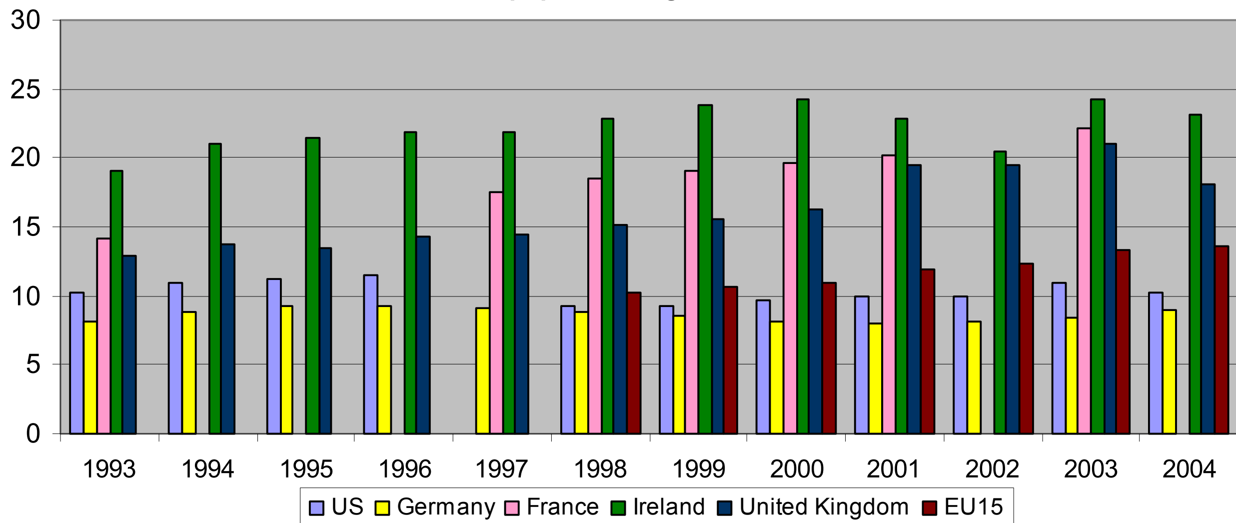
Source: Eurostat, Statistical Office of the European Union

Education

Another strategy adopted by Ireland in the mid-1960s was to utilize education as a tool for economic development. It was recognized that a well educated and trained workforce was necessary in order to attract the foreign investment necessary to produce and develop high tech and skilled jobs in Ireland. The first policy Ireland implemented in 1966 was to provide free post-secondary education, similar to what most European countries had done after World War II. As a result, significant improvements were made not only in generating a highly skilled and technical workforce, but also in the academic performance of all of its primary education students.

During the 1980s Regional Technical Colleges (RTCs) were expanded and two new universities constructed. RTCs emphasized programs in electrical engineering and information technology to meet the workforce demands of foreign technology firms, like Apple and Wang, which were evolving in Ireland. Since 1993, as seen in Graph 11, Ireland's share of science and technology graduates was the highest among economically advanced countries. Modern languages also were stressed, with the goal of having all secondary graduates proficient in two foreign languages. Ireland's strategy was successful as their system of education was ranked 5th by the IMD World Competitiveness Yearbook 2004 for meeting the needs of a competitive economy.

Graph 11: Total Tertiary Graduates in Science and Technology per 1000 of population aged 20-29



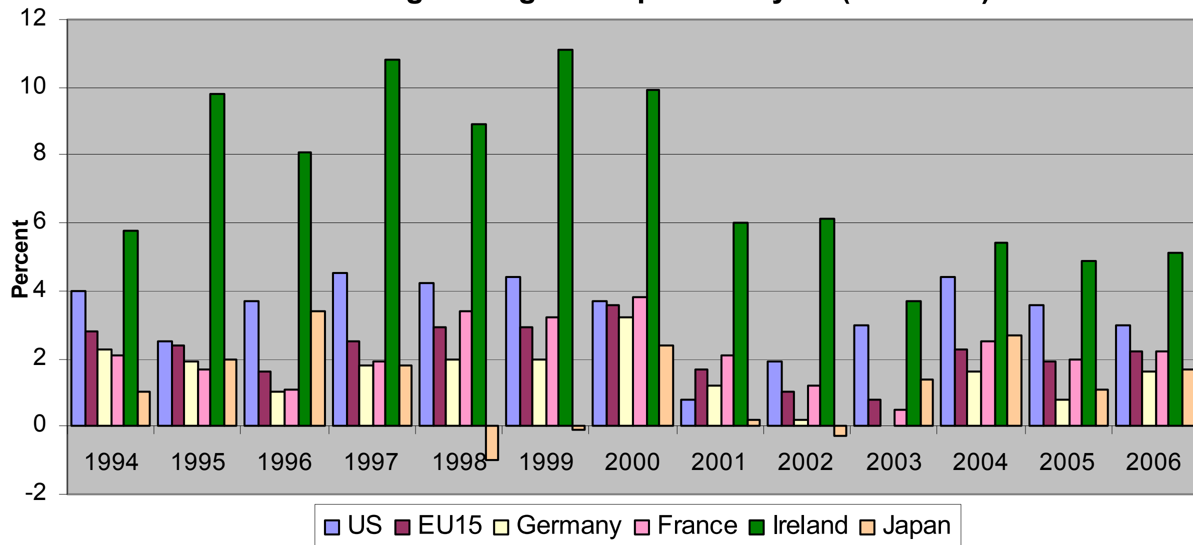
Source: Eurostat, Statistical Office of the European Union

Because of Ireland's strong "Celtic Tiger" economy, many of the brightest and most energetic young graduates were able to find employment on the island rather than being forced to leave the country to find prosperity. Those Irish who previously left to find meaningful work were also able to return. However, some warn reforms are needed to Ireland's educational system so it generates skilled workers not just for niche producers, but also to meet to changing global knowledge based economy.

In Conclusion

Ireland's transformation from a historically poor agricultural country to one of the top economic performers in the world has been amazing. As seen in Graph 12, Ireland's economic growth over the past decade has consistently been double or even triple the performance of the world's largest and most respected economies. This growth has propelled Ireland from being a nation that was 20% poorer than its European counterparts to being one of the most prosperous in the world in less than a decade.

Graph 12: GDP Growth rate at Constant prices
Percentage change over previous year (1995=100)



Source: Eurostat, Statistical Office of the European Union

While the booming economy in Ireland occurred over the past 10 years, it was a series of policies or events dating back to the 1950s that allowed the "Celtic Tiger" economy to occur. Many of Ireland's economic strategies are valid for consideration by U.S. policymakers who are seeking to promote economic growth and respond to the competitive global marketplace. These policies or events can be summarized as follows:

Actions Leading to Ireland's Economic Prosperity

- Embracing Free Trade
- Implementing a Low Tax Policy
- Fiscal and Political Stability in Government
- Obtaining Consensus on Economic Reforms
- Aggressively Seeking Foreign Investment in Targeted Industries
- Participation in the European Union and its Currency
- Development of an Export Led Economy
- Developing a Stable, Trained, Cost Effective and Productive Workforce
- Government, Industry and Academic Cooperation on Science, Research and Development

It should also be recognized that despite Ireland's phenomenal economic success, uncertainties and challenges lay ahead. The economic surge has caused significant cost-of-living increases in Ireland, to the extent that Dublin is now one of the most expensive cities in Europe. Another problem is that employment demands have made the country's job growth dependent on inward migration. Economic prosperity also has placed strains on the country's infrastructure. As a result, from the year 2000 until 2006, Ireland plans to spend over $60 billion as part of its National Development Plan, including $35 billion in infrastructure investments on roads, public transportation, environmental programs, housing, health care facilities and educational institutions. This investment might explain why Ireland's general government expenditure as a percent of GDP has risen 7.5% from the year 2000 to 2004.

The recent addition of the 10 Central and Eastern European (CEE) countries to the EU has also caused concerns for Ireland, as well as the addition of Bulgaria and Romania in 2007. These new EU member states may compete with Ireland's lower cost labor and attract foreign investment away from Ireland as corporations seek a presence in the CEE region. From 1994 to 2003 foreign investment in the CEE countries rose by almost ten times to €175 billion, with inflows reaching €20 billion in 2004. The EU is expecting to send over $40 billion in economic aid to these countries, some of which might have ended up in Ireland. As discussions continue in the EU over financial aspects of the 2007-13 budget, Ireland expects to see as much as an 85% reduction in Structural Fund receipts. However, recent statistics show Ireland continues to grow economically and gain significant levels of foreign investment despite the entrance of the CEE countries. In addition, while Ireland's economy is thriving, many others on the European continent struggle with high taxes, unemployment, deficits, debt and stagnant economies.

Despite the apparent difficulties that lie ahead, Ireland has built such a strong economic base that it will likely never turn back. It's commitment to sound and stable economic policies, including low taxes and restrained government spending, set it apart from most of Europe. Countries throughout Europe and the world are studying the "Celtic Tiger" phenomenon and using it as a model to reform their own economies. According to the Economist Intelligence Unit Business Environment Rankings, Ireland will remain as one of the most attractive business locations in the world throughout the period 2004-2008.

All indications are that The "Celtic Tiger", in one form or another, will be on the prowl for a long time to come. National leaders now believe the "Celtic Tiger" economy has now entered a second phase. While the first phase was driven by extensive foreign investment and the growth of an export economy, Ireland is entering a second phase driven by domestic consumption, residential construction and infrastructure improvements. In 2004, construction overtook manufacturing as the largest single employment sector in Ireland, accounting for 13% of employment which is twice the level in the US and Germany. Ireland has also seen an increase in the share of employment in public services. Ireland is also becoming a global player in making foreign investments, showing it is developing maturity economically. These factors clearly show Ireland's miracle transformation continues to lead it down a path of sustained economic strength and prosperity.

Sources for this Article:

1. Benjamin Powell, *Economic Freedom and Growth: The Case of the Celtic Tiger,* Cato Journal, Vol. 22, No. 3 (Winter 2003).
2. Patrick Honohan & Brendan Walsh, *Catching Up With the Leaders: The Irish Hare,* Brookings Papers on Economic Activity, 1:2002.
3. John Bruton, *Ireland's Economic Miracle,* The Gazette, May 10, 2000.
4. James B. Burnham, *Why Ireland Boomed,* Independent Review, Spring 2003, Vol. 7, Issue 4.
5. Dick Roche, Ireland Minister of State, *The Irish Economy – An Analysis of Success,* Speech to UNESCO Education Seminar, Brasilia, September 23, 2003.
6. IDA Ireland, *Guide to Tax and Financial Incentives in Ireland,* March 2003.
7. Heritage Institute, *2005 Index of Economic Freedom,* Ireland.
8. Frank Barry & Aoife Hannan, *Will Enlargement Threaten Ireland's FDI Inflows? Quarterly Economic Commentary*, Dublin: Economic and Social Research Institute, December 2001, pps 55-67.
9. Forfás
10. UNCTAD

About the Author: Marc C. Duff is the Senior Research and Policy Director for The Taxpayers Network. He served in the Wisconsin State Assembly from 1989 until 2002 where he was a member of the state's budget committee and previously chaired the Committee on Environment. He received his Master of Arts in Public Policy and Administration from the LaFollette Institute of Public Affairs at the University of Wisconsin – Madison.