Econ 467T
Prof. Montiel

The Celtic Tiger

Introduction

Ireland is not quite the same 'growth miracle' story as we have seen so far in the course. The country might have been considered a 'lagging member' of the OECD in 1987 but its people still enjoyed incomes per capita several times larger than most of the other emerging economies. In retrospect, a miraculous aspect of Ireland's success does not seem to be the fact that they were able to do it, but rather the fact that they *could not* do it for so long.

Indeed, numbers underlying economic turnaround in Ireland after 1987 are impressive. The GDP per capita quadrupled in twenty years, rising from 9 300 USD (current PPP) in 1987 to 40 000 USD (current PPP) in 2006[1], with an average growth of GDP per capita of 5.4%. In 2008 Ireland has become one of the top five countries in the Human Development Index rankings (0.960 in 2008) surpassed only by Canada, Australia, Norway and Iceland. It also had a relatively low income inequality as suggested by low GINI coefficient (0.32) which was better than similar measures in Canada and United Kingdom; however, slightly lower than EU average (0.307 in 2008). The World Governance indicators also show an excellent performance by the state in ensuring political stability, control for corruption, government effectiveness, rule of law and accountability which all place Ireland at the top 10th percentile among 212 countries in the sample.[2]

Overall, almost all human development indices show uniformly outstanding improvement in the quality of life in Ireland. To put Ireland's success in perspective, its magnitude today would be equivalent to Brazil or Serbia achieving incomes per capita of

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[1] World Development Indicators data, Appendix 1 (class notes)
[2] World Bank Development Indicators: http://info.worldbank.org/governance/wgi/sc_country.asp

40,000 USD by 2030. In fact, there were about 15 countries with GDP per capita within 8000 - 11000 USD (PPP) range in 2008, which is roughly where Ireland was twenty years ago. How did the Irish manage to achieve such an impressive growth? What was so special about Ireland in the late 80s? Or, as O'Sullivan (2006) inquired, "did these enormous economic and social changes that have taken place in Ireland have occurred by design of domestic policy-making, or simply by coincidence with external factors?"[3] These and other questions I will address in the following sections of this paper.

Initial Conditions

One of the explanatory variables in Ireland's success equation might have been its favorable initial conditions. First of all, its society is built upon the Anglo-Saxon culture and spoken language is English, which is likely to have facilitated trade and technology exchange with other Anglo-Saxon countries. Ireland gained independence from Great Britain in 1922 but the two countries remained largest trading partners until these days. Ireland also inherited the common law legal tradition from the British which is likely to have made development of country's financial system somewhat easier in the early 1990s. Furthermore, Ireland is a fairly homogenous country with majority of its population (87.4% in 2006) identifying themselves as Roman Catholic and Irish (87.4% in 2006). Nevertheless, there has been a degree of civil unrest stemming from the Northern Ireland conflict which has remained under British control after 1922. A peace settlement for Northern Ireland is being gradually implemented following the Good Friday Agreement in 1998. Overall, Ireland's cultural factors did not seem to have been an impediment to growth potential of the country, and

[3] O'Sullivan, Michael J. (2006), "Ireland and the Global Question," *Syracuse University Press*, New York, pg. 9

perhaps might have even facilitated development through linkages with other English-speaking countries thanks to cultural, legal and institutional similarities.

From the perspective of physical geography, Ireland was also positioned favorably for development. Being an island in the North Atlantic Ocean it has very long (1,448 km) coastlines which promote trade. Climate is favorable for economic activity as well since temperate maritime climatic zone makes agricultural production more efficient, people are less susceptible to diseases and natural disasters are less likely. The country is endowed with some natural resources (natural gas, peat, and copper); however, they are not particularly significant to make a marked impact on the overall course of development in the country. On that note, it is imperative to mention that agriculture has dominated Ireland's production until the advent of new industries in the 1980s.[4] But perhaps most importantly, Ireland is located at a strategic position on major air and sea routes between North America and northern Europe that makes it an attractive location for large multinationals operating in both of these markets. Additionally, proximity to well developed, high-income country such as the U.K. positively affects trade and technological diffusion.

Finally, international situation was also favorable. Importance of the exogenous growth factors was emphasized by O'Sullivan (2006) who pointed out that "Ireland's economic boom coincided with the second largest American expansion of the twentieth century, which was crowned by massive amounts of investment spending in high technology sectors." During same period investments were also growing in Europe following the drop in long-term interest rates. Indeed 1990s marked one of the most successful years for EU. This helped Ireland when it came to finding sources of funding for infrastructure projects, seeking new trade partnerships and attracting FDI. Drawing on these arguments O'Sullivan suggested

[4] Until 1970s over 70% of population was employed in the agriculture sector.

that perhaps "the external factors have had a great influence on the Irish economy and that Ireland merely succeeded in hitching a ride on the coat-tails of globalization."[5]

Overall, initial conditions in Ireland suggest that the country had great potential for growth in 1987. However, it cannot be denied that the same conditions existed long before then. Thus, it still remains a puzzle why the country did not fully utilize its endowments earlier. Perhaps a causal explanation should be sought elsewhere. good section

Intermediating and Proximate Factors

One such explanation could be possibly found in Ireland's institutional indicators. On the one hand, the country is a parliamentary democracy with long track record for quality of institutions. It has been a member of the European community since 1973; thus, indicating strong enforcement of property rights, prevailing rule of law, controllable corruption and contract enforcement long before the take-off in 1987. On the other hand, the good quality of institutions did not always translate into adequately well though macroeconomic and fiscal policy decisions. That is especially true about 1970s and the first half of 1980s – the periods when Ireland accumulated significant amounts of foreign debt and fiscal deficit expanded to almost unsustainable levels.

Political mismanagement is likely to have translated into imbalances in the labor market that pervaded the country in mid-1980s. Although since 1977 productive labor force in Ireland had been expanding at an increasing rate (as indicated by decreasing age dependency ratio, Appendix 2), and free universal and tertiary education[6] ensured the quality of growing labor force, finding employment in Ireland was still a major problem in the mid-1980s. The country was in an obscure situation – it had great human and physical

[5] O'Sullivan, Michael J. (2006), "Ireland and the Global Question," *Syracuse University Press*, New York
[6] Free universal education introduced in 1967, and free tertiary education in 1987.

Growth is about economic capacity, not actual output. The difference between the two has to do with business cycles.

endowments coupled with British institutions, yet those factors of production were standing idle. The unused country's output potential is best reflected by negative output gap that has been observed in Ireland until 1990 (Figure 1). Incidentally, periods with the largest negative output gap were also defined as the periods of highest unemployment. This is generally true

Figure 1: Output Gap and Unemployment in Ireland from 1980 to 2005

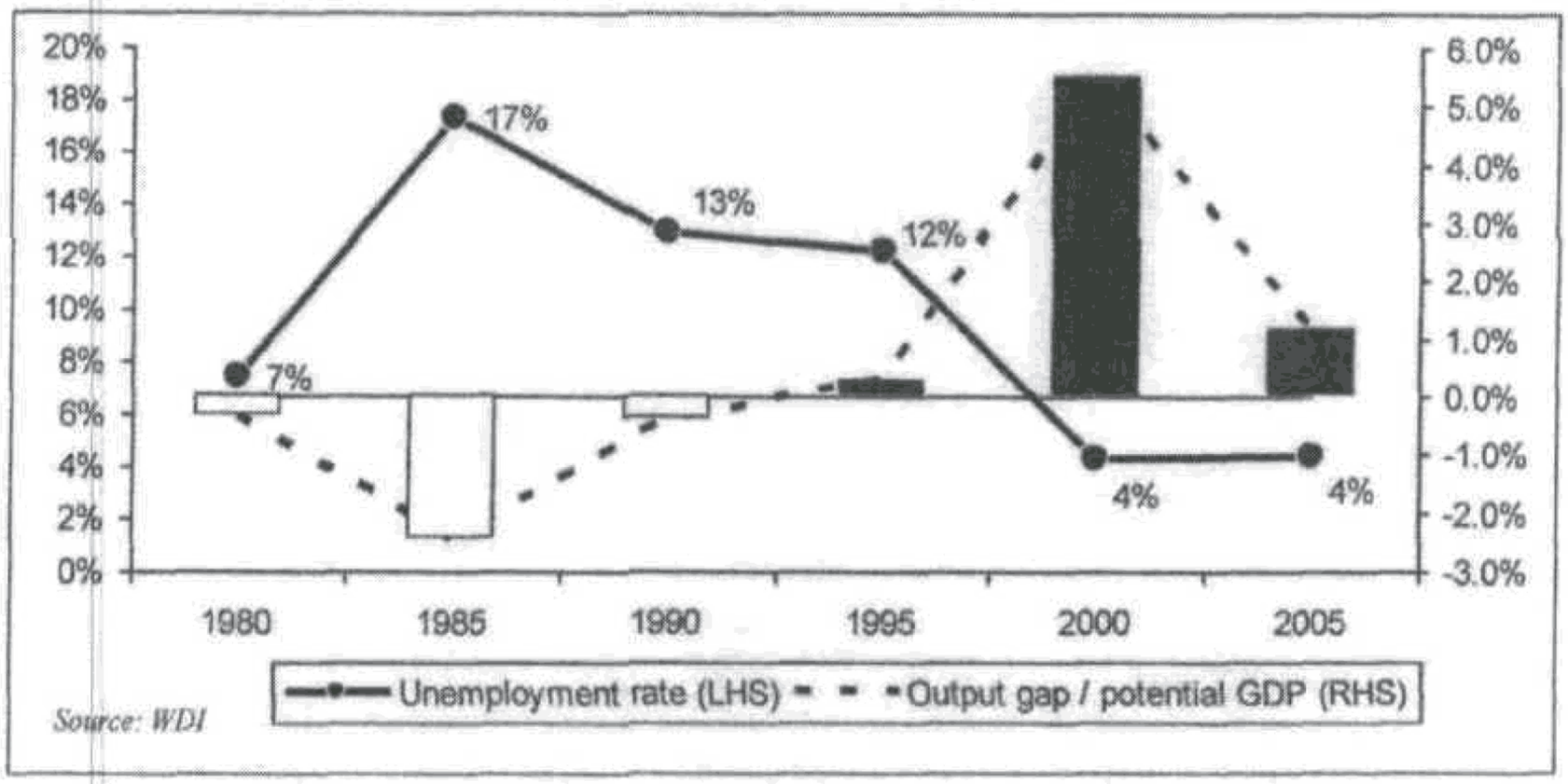


Figure 1 also shows that a major shift in the labor market has taken place in Ireland since 1987 when country seem to have started utilizing its productive capacity. This move also coincided with the growth acceleration in Ireland. What caused such an important change? Thinking strictly logically – three possibilities exist: (1) change was caused by internal or (2) external factors, or (3) a combination of both. Perhaps a closer look into the domestic policies in Ireland will reveal the answer.

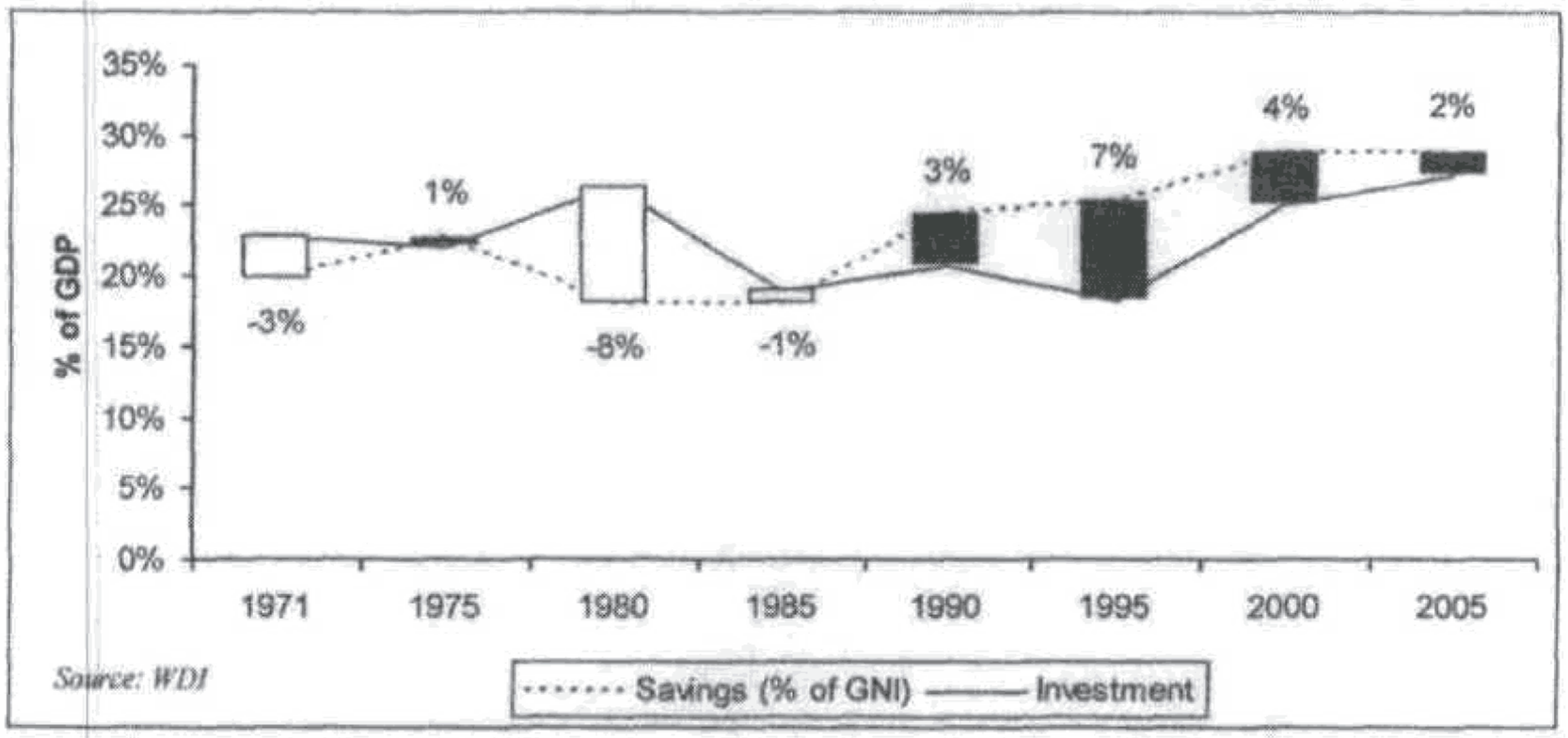
Policies

Policies adopted by Ireland in late 1980s fit the classical description of the orthodox approach: trade openness, FDI promotion, macroeconomic stability, spending on infrastructure and development of the financial sector. However, the urge to adopt such

policies came from the economic mismanagement that induced the country to a near-collapse situation in mid-1980s. In 1986, Ireland faced significant fiscal imbalances with debt to GNP ratio standing at 129%, inflation of 15%, current account deficit at 12% and unemployment at 16%. Poor government finances were adversely affecting business climate in the country and made it less attractive for potential foreign investors. Most importantly, people were 'voting with their feet' and were massively leaving the country. These facts together, arguably, produced a strong incentive for the new government to reorganize and to implement the development state policies. It was also in the interest of the newly elected parliament to do so, or they would have risked their reputation and loss of electorate if the pressing economic issues were not addressed.

First policy that was undertaken by the new government was fiscal stabilization pact dealing with the previously unstable fiscal situation. As Honohan and Walsh (2002) noted, "the specific fiscal steps taken in 1987 were quite orthodox: a temporary freeze on all public sector recruitment, combined with cutbacks in public capital spending." Such policy was necessary in Ireland because investment rates had greatly outstripped domestic savings since 1980s (Figure 2) and, therefore, resulted in significant debt accumulation. High investment rate is also likely to have been a contributing factor to high inflation that was prevalent at that period.

Figure 2: Domestic Savings and Investments in Ireland from 1971 to 2005



In early 1990s, fiscal stabilization policy resulted in reduced investment rates and debt-to-GNP ratio. The new fiscal environment had positive effect on overall business climate in Ireland and was likely a cause of "expansionary fiscal contraction" – a phenomenon whereby domestic consumption rose in response to tighter fiscal policy as individuals *expected* future taxes to be lower.

Another important push came from the move toward centralized wage bargaining system with unions that brought labor peace and restricted wage growth. Honohan and Walsh (2002) have shown that starting by the early 1990s wage competitiveness of Ireland started to improve. "The agreement between government and trade unions was possible in 1987 mainly because the devastating job losses and soaring unemployment of the early 1980s reduced unions' powers."[7] The sort of "social cooperation" between government and workers shows itself through much lower strike rates after the new wage bargaining system was launched in 1987. As Honohan and Walsh (2002) notes, "employers welcomed the outbreak of industrial peace and the saving of time and energy at the level of the firm achieved by the centralization

[7] Honohan, Patrick and Brendan Walsh (2002), "Catching Up with the Leaders: The Irish Hare," *Brookings Papers on Economic Activity* 1: pp. 1-57

and coordination of wage bargaining."[8] Such centralized wage bargaining system directly benefited employers and foreign investors; therefore, Irish government also introduced various tax reductions for workers that compensated for the loss of their wage bargaining power. This two-sided policy was effective because it created incentives for job creation while protecting consumers' purchasing power. It was an especially good policy because it targeted the main problem in the country – lack of employment – without putting an overly large burden on consumers.

The central wage bargaining policy also provides another explanation for 'expansionary fiscal contraction' phenomenon. It is likely that negative effects of the policy on tax collection and fiscal deficit were more than offset by the positive effects gained from the total growth in employment. Specifically, as more people were able to find employment, fewer of them found themselves relying on the social security benefits from the government. On the other hand, as number of employed people grew, there were also more people paying taxes. At the end, this two-fold effect resulted in a momentum effect on country's fiscal accounts: net tax collection increased allowing further debt reduction while reduced debt pressures provided government with more flexibility in further tax reductions and more bargaining power with the unions, subsequently more competitive wages and so on.

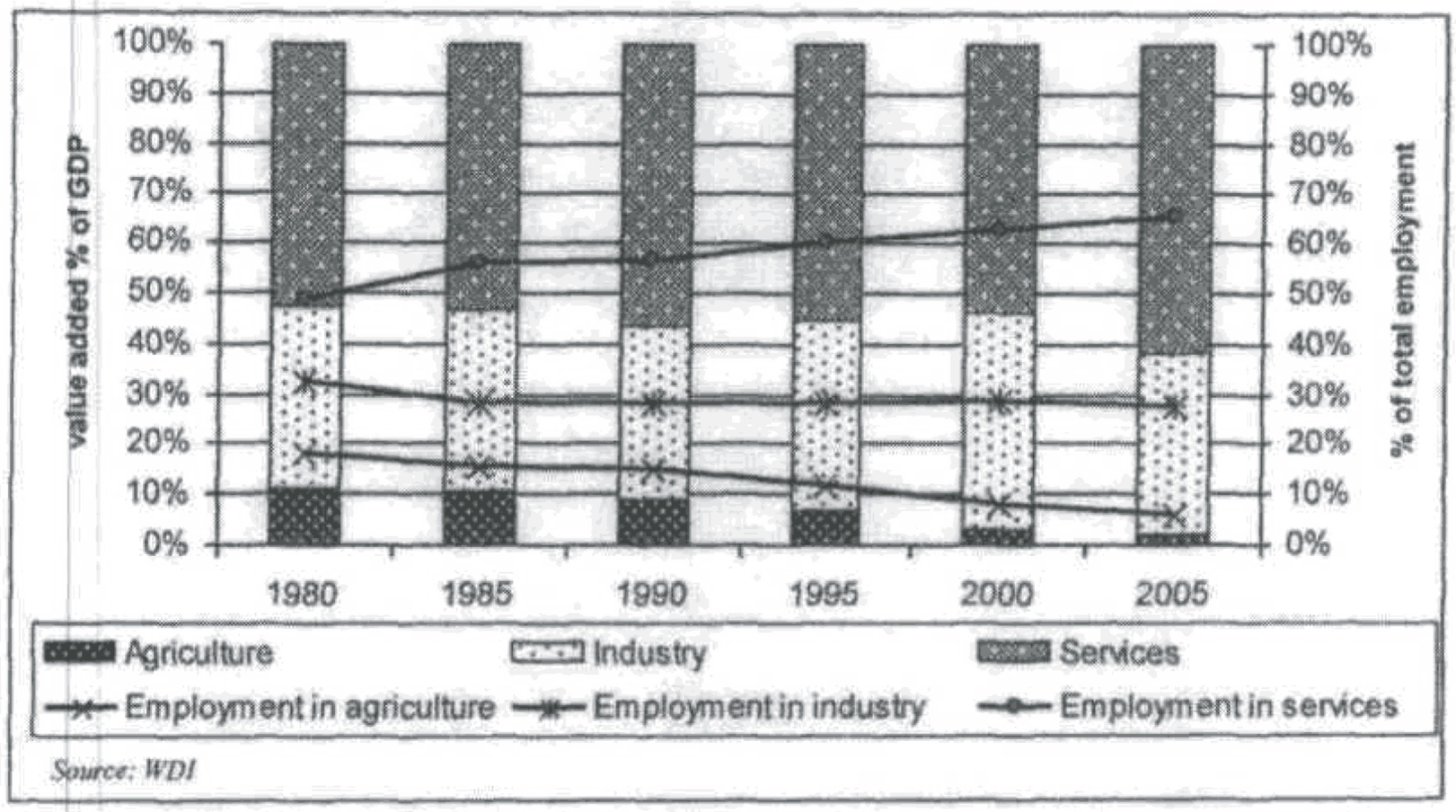
Where did the jobs come from?

We have shown that government policies played an important role in increasing wage competitiveness of Irish labor market and improved overall business environment, however, the patterns of job creation in Ireland are also revealing. As figure 3 depicts there were several trends taking place in Irish economy since 1990. First, the number of service jobs was

[8] O'Sullivan, Michael J. (2006), "Ireland and the Global Question," *Syracuse University Press*, New York, pg. 6

increasing; however, the value added by the corresponding sector was decreasing (57% in 1990 and 55% in 1995). On the other hand, employment in industry remained stable but value added increased (35% in 1990 and 38% in 1995). In agriculture, both trends were negative.

Figure 3: Sectoral Changes in Ireland's Value Added and Employment from 1980 to 2005



Source: WDI

The first logical conclusion is that there must have been significant productivity improvements in the industrial sector. That could be particularly attributed to the development of pharmaceuticals industry, which "contributed 0.3% of economy-wide employment but produced equivalent to 14% of country's GDP in 1999."[9] The development of the industry is likely to have had linkage effects by increasing demand for service jobs and, therefore, resulting in the subsequent growth in the service sector.

However, it would be difficult to imagine that linkage effects could account for all change that was taking place in Ireland without implementation of industrial planning policy. It is more likely, I think, that Ireland's natural competitive advantage in outsourcing services

[9] Honohan, Patrick and Brendan Walsh (2002), "Catching Up with the Leaders: The Irish Hare," *Brookings Papers on Economic Activity* 1: pp. 1-57

(English language, proximity to developed markets, Anglo-Saxon culture etc.) was realized as soon as business environment improved following the fiscal prudence policies. In some sense, government policy removed the barrier that was preventing business of utilizing the competitive advantage that has already been there long time ago.

Conclusion

At this point we can summarize the general features of Ireland's success story. The country was not "just lucky", but good timing played an important role in its success. On the other hand, well-timed decisions did not seem to have originated from a particular insight of the new government in 1987, but rather from internal and external pressures that have accumulated as a result of bad policies adopted by the previous government. It is even difficult to assess how many of the policy outcomes (especially ones related to expansionary fiscal contraction) were expected and how many of them took policy makers by surprise. However, whether due to distinctive policies or favorable external environment, but in Ireland everything "clicked" after 1987. With a bit of good fortune, favorable initial conditions and well-timed policies Ireland was able to pick up the "big bill" that was waiting for it at the start of the last decade of the millennium.

This is truly an excellent paper, — a great way to end the course. You have used everything you've learned, applied the growth matrix, and adapted the paper template to perfection. The result is a very convincing interpretation of the origins of the "Celtic tiger"

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Bibliography

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Appendices