THE TRANSFORMATION OF THE IRISH ECONOMY—THE ROLE OF PUBLIC POLICY[1]

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CIT Working Paper 052112. Clemson University Center for International Trade
December 21, 2005

1. BACKGROUND

That a radical transformation has taken place in the Irish economy is indisputable and has been very fully captured in the accompanying paper by Pat McArdle (CIT Working Paper 052212). The impact of this radical change is most vividly seen in the changing demographics of Ireland. The long-term trend in the population from 1851 to 1961 was downward. The population of the Republic of Ireland more than halved so that by 1961 the population was 2.9 million. This trend has been reversed to such an extent that Ireland now experiences net immigration and is recording among the highest growth rates in population in Europe. At the same time the total at work are more than 2.1 million, the highest in living memory. In parallel the level of unemployment has fallen, and the structure of the public finances has been dramatically improved.

The factors that brought about these changes are many and varied. My task is to consider the role of public policy in facilitating this transformation. My analysis is partial and is informed primarily by my own experience in the implementation of development policies in Ireland for more than twenty years.

In my judgement, a number of public policies played essential roles in Ireland's transformation, including:

- The recognition by a coherent group of leaders /opinion formers of where we stood in 1986 and the resulting evolvement of the concept of social partnership
- The societal value placed on education and the acceleration of investment in education, particularly up to and including undergraduate level from the late 1960s
- An evolving policy towards lower taxation rates across a range of areas
- A consistent commitment to the attraction of foreign direct investment (FDI)
- An evolving development of policies focussed on internationalisation of local companies

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[1] Presentation to EUROBANK CONFERENCE "SOURCES OF GROWTH: CAN GREECE FOLLOW THE IRISH EXAMPLE?" October 2005, Athens, Greece.

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More recently this strategy has been modulated towards a more aggressive investment level in transportation and in the scientific research infrastructure of the country.

2. WHERE WERE WE IN 1986?

The trends in the Irish economy over the period 1980 to 1985 presented a very bleak outlook. A small number of indicators capture the essence of the dilemma we faced at the time:

- Almost one in five of the labour force was unemployed (up from one in twelve in 1980)
- The National debt trebled in the same period and the debt/GNP ratio had increased from 88% to 148%, and
- National output in 1986 was no higher than it had been six years earlier.

These, and other data, were the subjects of detailed analysis in 1986 by the National Economic and Social Council. NESC was a body comprised of the main interest groups in Ireland—i.e., trade unions, employers, agriculture and Government nominees. The Council had been established to provide a forum for the discussion of the principles relating to the efficient development of the national economy and to advise the Government on these matters. The Council became so concerned with the scale of the economic problems facing the economy that it decided to carry out a major analysis of the relevant issues and to recommend a range of proposals.

The fundamental conclusion of NESC was that the two major issues facing the economy, chronic levels of unemployment and major imbalances in the public finances, were both symptoms of the same problem—the lack of growth. The Council was adamant that a continuation of existing policies was utterly unacceptable and that radical change in strategy was vital.

The Council saw the clear need to do the following:

- Reduce the debt/GNP ratio
- Restore order to the public finances through cuts in public expenditure
- Enhance the competitiveness of the economy without resorting to adjusting the exchange rate
- Enact tax reform, involving widening the tax base while reducing tax rates and
- Conduct an active industrial policy, including the attraction of FDI as well as the internationalisation of local firms.

The later part of this paper will discuss the manner in which the policy on industrial development was implemented. However, I intend firstly to make some observations on how this overall strategy gained support, the significance of tax policy and the role of education policy.

3. EDUCATION

The nature of the Irish economy and its society had for more than a century a predominant and depressing theme and that was emigration. In the period between the mid 1850s and the mid 1950's, the population of Ireland halved, essentially due to emigration. The birth rate remained high, but increasingly the dependency ratio rose and the labour participation rate stagnated or fell. During the early 1960's an active policy debate began on the potential role that education could have in changing our economic fortunes. The counter arguments asked why we should expend scarce national resources on widespread education when most of those who would benefit would almost certainly emigrate—in essence, the transfer of well educated human capital from an underdeveloped economy, Ireland, to other more developed economies, mainly Britain and the US.

Notwithstanding some of these arguments, the Irish Government introduced free universal access to second level education [equivalent to U.S. high school] in the mid 1960's and followed this in 1969 by significantly widening access to tertiary education [equivalent to U.S. college or post-secondary technical education]. This was followed rapidly by the expansion of the capacity of the existing five universities, the addition of two new universities with a decidedly business /engineering /science orientation, as well as the establishment of nine Institutes of Technology which initially focussed on the provision of technical education at sub-primary degree level [i.e., less than university-level—like South Carolina's system of TECs].

The effect of this policy was to radically increase the participation rate in education and to underline the fundamental value placed by Irish society on the role and relevance of education.

This was not an easy policy to pursue, especially in the early 1980's when there was no growth in the economy, when there was severe strain on public finances and when emigration was continuing. Particular emphasis had been placed on increasing the volume of graduates in electronics and software, on the basis that these sectors had the potential for substantial growth. However in 1984 in the case of one of the newer universities, the first graduate class in electronic engineering all emigrated while in the case of one of the older universities over 80% of following year's software graduates were recruited by a single major international firm which transferred them to work at the companies research centre in Europe. In these circumstances, it required considerable administrative and political determination to persist with a policy that did not appear to be delivering immediate returns to the economy.

The pattern of participation in third level education [university-level] changed dramatically between 1965/66 and 2002/03, and the impact in terms of educational attainment was most evident at the end of this period. During this time the number of persons in full-time education in third level jumped from 20,698 to 137,323, an increase of more than 550%. Expressed as a participation rate of the most relevant age cohort (20 –24 years of age) the rate rose from 11.1% to 41.8%. The impact of this long-term trend in improved participation became particularly evident between 1996 and 2002 as measured by the % of the 25-29-age cohort that had achieved a primary [BA/BS] or higher degree. The participation rate, so defined, increased on average from 15.5% to 25.5 % over the six years. It is of particular interest that the comparable data for women in the same period increased more rapidly, from 16.2% to 28.5 %. In 2005 it is reasonable to suggest that close to one in every three women in the 25-29 age cohort in Ireland hold primary-or-higher university degrees.

This level of investment in education meant that, when the sustained growth in the international economy took place during the 1990's, Ireland was particularly well placed—especially in relation to the growth in the IT and pharmaceutical sectors .The nature of the human capital had been substantially enhanced and was on an upward trend. Furthermore, many of those who emigrated, especially in the early 1980's, began to return to Ireland, having acquired very valuable experience in international business for which there was now a ready market in their home country. These skill sets were attractive to international firms setting up in Ireland but also to an emerging cohort of mainly technology based start-ups.

4. TAXATION POLICIES

The changes in taxation policy have been described elsewhere, so as a consequence I will limit my observations to the impact of these developments. Irish development strategy had since 1955 used tax (and in particular corporation tax) as an active policy instrument. There were two guiding principles that evolved over the ensuing decades:

- The availability/access to lower tax rates was based on a transparent process, and
- Where changes in tax rates were envisaged, they were signalled well in advance and all existing commitments were honoured.

The effect of this approach gave confidence to international investors of Ireland's intentions and had the effect of providing certainty without the necessity to provide guarantees. This was underpinned by the acceptance by virtually all shades of political opinion in Ireland of the relevance of this approach to development policy. This issue did not become a matter of policy difference between the major political parties or successive Governments. This approach has been re-enforced most recently in Ireland, as political debate has been initiated in the lead-up to the next general election, which must take place by 2007. The two largest opposition parties have already clearly signalled their commitment to the existing policy on corporation tax.

Low corporation tax rates are most relevant where businesses are already profitable, but not as immediately relevant to the growth of emerging companies where the more critical issue is the attraction of equity investment and the potential reward for risk taking. In this case the lowering of the capital gains tax rate from 40% to 20 % in 1997 was key. I will return to this issue later.

5. BUILDING TRUST AND CONFIDENCE.

When the NESC published its report in 1986, it was clear on two issues: that the recommendations needed to be endorsed and implemented as a whole, and—given the nature of the challenges that had to be faced—it was essential that the policy enjoyed widespread support or at least did not encounter widespread opposition. When steps were taken to reduce Government expenditures in subsequent years, it involved difficult choices that included reductions in public sector employment. For example in IDA Ireland, the agency charged with attracting FDI, the budgetary cut backs that were a key element in the recovery plan required a reduction in staff numbers of 20%.

And as Pat has pointed out in his paper, there were nervous moments between 1987 and 1991, especially as output began to rise but with no apparent recovery in aggregate employment. An active debate began among economists on the issue of "jobless growth".

A process that was key to a broadly-based level of support for the new strategy can be captured in the concept described as Social Partnership. This process involved the representatives of the major sectors in the economy agreeing with the Government on the major key economic priorities. Through this mechanism, wage cost increases in the economy were negotiated. The evolution of this concept of partnership between the major social /economic players and Government is firmly rooted in the work and relationships which developed as the NESC report of 1986 was prepared. The major economic sectors had worked together to analyse the critical issues facing the Irish economy, had arrived at crucial, difficult conclusions and were committed to the implementation of this strategy. Without that shared understanding and trust, the commitment necessary to gain broad public support to deal with the difficulties that would have to be encountered and managed could not have been garnered.

6. FOREIGN DIRECT INVESTMENT

The attraction of inward investment into Ireland was initiated in the mid 1950's in response to a severe balance of payments problem, which at that point was a major constraint on the growth of the economy. The concept was to actively encourage exports by offering tax breaks on profits earned from international sales. This provided the first basis on which efforts were made to attract international investors into Ireland. New institutional structures were established that evolved into IDA Ireland which in 1970 was reconstituted as a corporate body, staffed by appropriately skilled professionals, with considerable executive independence but within the context of a policy framework established by Government.

The pattern of inward investment had a number of evolving phases. During the 1960s much of the investment was derived from family owned firms that originated in Europe and focussed on supplying the UK market, with which Ireland had a Free Trade Area Agreement. From 1970, the primary source of FDI into Ireland was the US. This was triggered by Ireland's planned entry into the EU in 1973, the access to the major European markets which membership conferred and the growth ambitions of US firms wishing to penetrate the EU market. The 1980's were a difficult period for FDI as the Irish economy lost competitiveness and as international confidence in the economy weakened. The pace of inward investment recovered from 1989, marked by the decision of Intel to establish a chip fabrication plant in Ireland with an investment value of $350 million. Securing this investment provide affirmation that the economy was in strong recovery mode and gave a clear signal to the international community of the growing confidence in Ireland. The pace of development and the impact of FDI on the economy are reflected in the increase in employment in the sector from 92,000 in 1995 to almost 129,000 in 2004. Exports by the sector now amount to more than $70 billion.

The crucial question is why did FDI grow so rapidly in this more recent period?

The sustained growth in the US economy over the 1990's and the relative appreciation of the US$ created a dynamic where US firms had a real business need and a desire to invest internationally. The growing integration of the European economy created demand conditions which many US firms were keen to exploit. Ireland was well placed to participate in this process. We were seen as country that was fully committed to the integration process and unambiguous in its commitment to European development.

Labour costs were competitive and the transformation in the quality and composition of the labour force, to which I have referred earlier, matched the growing demands of the international firms who chose Ireland. Low corporation tax played a vital role, as to some extent did the use of grant incentives.

To fully understand why this growth took place requires recognition that, in Ireland's case at least, success was based not only on seeing FDI as a process of economic development but as a business process. It is certainly the case that without the economic preconditions that already existed, the opportunity to attract major flows of FDI would not have arisen. But it can be reasonably claimed that the manner in which Ireland sought to attract international investors played a key role also.

At the centre of this was recognition by Governments, administrators, social partners and the relevant agencies that a sustained commitment to attracting inward investment was a key to the recovery of the economy. This demanded a responsive and pragmatic approach by the key elements in the public sector to the opportunities that developed.

It also meant that to some extent Ireland had to "rewrite the rules of the game" and needed to manage the process of securing inward investment as a business process and not only as an economic development process. The largest source of FDI investment was the US and much of this investment was directed towards Europe – but to the larger economies in Europe. To secure a share of this investment required not only that Ireland had something to offer, but we needed to know to whom should it be offered, and we needed to present it with a level of service exceeding that of our competitors. This manifested itself in seeking to find either first mover advantage or opportunities that were not being fully exploited by other locations. This could be described as industrial planning but in reality it was a process of informed and sophisticated market research based upon gained experience. This is illustrated by the identification and early exploitation of the software sector in the 1980's, call centres and shared services in the early 1990's, e-business and biopharmaceuticals more recently.

The business model associated with attracting inward investment is essentially B-to-B or can be described as being very similar to the capital goods sector. It involves, on a world wide basis, a relatively small number of potential customers (compared to the retail sector), the individual transactions are relatively large, and direct contact with decision makers is essential.   Ireland—through its development agencies, its financial institutions, legal and other support organisations such as engineering design—has developed a significant collective competence in selling to and servicing the needs of international investors. Today there are only three locations in the world having special competence in the design and commissioning of biopharmaceutical plants, an area of substantial growth. The presence of such capability in a location gives that country a source of competitive advantage in attracting such investment. Ireland is one of those three locations.

In summary the creation of systems and clear capability in the business of attracting investment, a specific objective of public policy, was a key element in the rapid expansion of FDI in Ireland in recent years.

7. INTERNATIONALISATION OF LOCAL FIRMS

The growth rate of local Irish companies over the past fifteen years was not at the same pace as that of the international firms. Not withstanding this overall trend, substantial international Irish companies emerged in building materials, food ingredients, consumer foods, paper and software. Public policy in relation to the internationalisation of local Irish companies, particularly in the 1980's, was not as innovative or pursued as aggressively as was the case in relation to FDI. A number of initiatives were taken to address the availability of equity finance, especially for early phase companies. Among them was the establishment of a Government owned equity house, NadCorp. This was not a success, but it laid the groundwork for an initiative to create a more active early-phase equity market in 1994 following the establishment of Enterprise Ireland which had the responsibility of supporting the internationalisation of Irish companies. The concept was to establish a fund or funds in which the public sector and the private sector would co-finance and share the risks and rewards on an equal footing. The first attempt to commence this process started in 1994 with a proposal to establish a single fund. The rationale was that a larger fund could operate more efficiently from a cost viewpoint. This fund did not materialise because it was not possible to bring together a sufficient number of investors. A second attempt was made to establish a series of funds with typically an initial fund size of $25 million financed on a 50:50 basis between the public and private sector. In this instance the private sector partner had sole responsibility for the investment strategy within broadly defined sectors.

This approach was successful, both in terms of establishing the funds and in creating a competitive VC environment such that companies had alternative suppliers of venture capital. This initiative had the effect of increasing the availability of funding, deepening the level of VC capability in the Irish economy, and increasing the number of VC funds from 2 in 1994 to almost 20 in 2004. Under this programme a total of more than €250million was invested in 200 early phases, mainly technology-based firms.

From the perspective of the development of public policy, the investment in VC funds had of course risks attached to it, but it was one of the early examples where strategy proposals for this sector focussed more clearly on the needs of the local companies and not on adapting instruments that were more relevant to overseas companies. This was a significant learning experience and provided an impetus for further initiatives, including more active support for local Irish companies in identifying market opportunities and assisting them in gaining access to such markets. It led also to the establishment of incubators units for Irish companies in key international locations such as Silicon Valley, New York and Tokyo where the provision and availability of appropriate office accommodation, in familiar surroundings meant that the marketing executives from emerging young technology companies could immediately focus on business development and not on the complexities of securing leases in unfamiliar surroundings.

The decision by the Irish Government in 1997 to reduce the level of Capital Gains Tax from 40% to 20% was a significant departure in policy. The impact of this decision was not only to more than double the tax yield, but also—more importantly in my view—to create liquidity in the investment market and to signal investors that commercial risk taking and wealth creation would be rewarded. For emerging young technology companies and their investors, this was a very welcome development, and it strengthened the initiatives already taken to develop an active and competitive venture capital market.

8. WHERE TO NOW?

The particular focus on attracting FDI and on investing in third level education, especially up to primary degree (BA/BS) level, meant that resources were not as available for other developments. Some spare capacity existed in the road infrastructure toward the end of the 1980's, but as the economy expanded rapidly the need to accelerate investment in the road infrastructure became more acute. To achieve the needed road infrastructure investment has required the development of public private partnerships as well as the presence in Ireland of international contractors who have added to our delivery capacity.

The changing nature of our labour costs and the need to create a new source of competitiveness gave rise to a decision by the Government to create a new organisation, Science Foundation Ireland, in 2000 and to establish it on a statutory basis in 2003 to support and attract academics researching in key technologies related to information technology and biotechnology. The establishment of SFI followed the acceptance by the Irish Government of the conclusions of a major technology foresight exercise, which concluded that Ireland's competitive position had to be underpinned by enhanced investment in research in a number of key areas. The five-year budget allocation for this programme is over $750 million, and it has provided a significant uplift in the scale and depth of relevant research taking place in Irish universities and creating closer collaboration between industry and the research community.

9. FINALLY

The scale of the transformation in the Irish economy has raised employment and real income levels. New challenges have materialised, particularly in relation to infrastructural deficits and raising our universities to a "fourth level".

Unravelling the past is a complex process, and it was the interplay of circumstances, opportunity, some long-term investment, determination and a focus on a small number of key issues, which provided the basis for the success that was achieved. Public policy played its role in this process.

Our challenge is to now drive to a new level of development, which will require an equal level of determination and effort. Public policy will have to continue to reinvent itself. Delivering change in a context of success can in some instances be even more difficult than when faced with an impending crisis. Policy makers cannot be daunted by this but, perhaps have to be alert to the words of The Black Prince:

"*It should be borne in mind that there is nothing more difficult to arrange, more doubtful of success and more dangerous to carry through, than initiating changes in the State's arrangements*
The innovator makes enemies of all those who prospered under the old order, and only lukewarm support is forthcoming from those who would prosper under the new"
(Machiavelli)

That is what makes developing and implementing public policy so challenging and interesting!

4 October 2005
King George Hotel
Syntagma Square
Athens