

# The Key Determinants of Ireland's Economic Success





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## Table of Contents

Abstract . . . . .	2
Short Country Overview . . . . .	2
Introduction . . . . .	3
Macroeconomic Performance . . . . .	5
Real Sector Development . . . . .	5
Ireland's Investment Climate Organized According to the Nine Drivers Framework. . . . .	7
1. Macroeconomic stabilization . . . . .	7
Fiscal Policies . . . . .	7
Monetary Policies . . . . .	8
2. Business Liberalization and Deregulation Policies. . . . .	9
3. Stable and Predictable Legal Environment . . . . .	13
4. Effective Corporate and Public Governance . . . . .	14
5. Liberalization in Foreign Trade and International Capital Movements . . . . .	15
6. Healthy Financial Sector . . . . .	17
7. Corruption Minimization . . . . .	17
8. Political Uncertainty Minimization . . . . .	18
9. Country Promotion . . . . .	18
Concluding Remarks . . . . .	18
References . . . . .	20
Appendix 1. Chronological Order of Economic and Institutional Reforms in Ireland . . . . .	22
Appendix 2. The Nine Drivers Framework. . . . .	24

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

## Abstract

*In late 1980s–early 1990s, Ireland experienced exceptionally high rates of economic growth, greatly surpassing those in other European countries. Starting in 1990, the Irish economy grew by an average of 6% annually for ten years. Over the last few years, Ireland has become one of the most attractive countries for foreign investment. Ireland's economic success was determined by a number of factors, from sound government policies to independent favorable pre-conditions for growth. The present Briefing Note purports to determine the key factors of the Irish "economic miracle". The first section of the Note presents an analysis of macroeconomic and structural transformations in Ireland prior to and after 1987, which is considered a turning point in the country's economic history. The sections that follow cover government policies in various sectors of economic activity aimed at creating favorable conditions for Ireland's economic development. The final section presents conclusions and lessons to be learnt from the Irish experience of economic development.*

## Short Country Overview

Ireland (Ir.: Eire), or the Republic of Ireland (Ir.: Saorstát Éireann) is a country occupying approximately 83% of the island of Ireland. The island is separated from Great Britain by St. George's Channel, the Irish Sea, and the North Channel. Ireland is longest from north-east to south-west (486 km). The total area is 84,423 sq. km; the independent Republic of Ireland is 70,285 sq. km, while Northern Ireland (part of the United Kingdom of Great Britain and Northern Ireland) is 14,138 sq. km. The Republic of Ireland is comprised of 26 counties in the three historical provinces of Ireland: Leinster, Munster, and Connaught, and three counties of Ulster (Cavan, Donegal, and Monaghan).

In 2003, the population of Ireland was 3,920,000. The population density is 52 people per 1 sq. km. An all-time population low was reached in 1961, when the country's population amounted to 2.82 million. The capital of Ireland is Dublin, with almost a quarter of the country's population residing there. Dublin is the trade, political, and social center of the country. Cork, the second largest city, has 179,954 inhabitants. Other cities are smaller still: Limerick (79,137), Waterford (44,155), and Dundalk (30,195). The highest population density is in Dublin: 4,098 people per sq. km. From 1926 to 1991, life expectancy increased from 57.4 years to 72.3 years for men and from 57.9 years to 77.9 for women. The most substantial increases in population took place in 1971–1979 and then again in 1991–1996, with a lot of emigrants returning to their homeland.

Ireland gained independence from Great Britain in 1922. Prior to 1949, Ireland was part of the British Commonwealth of Nations; after that, the independent Republic of Ireland was proclaimed, and connections with the British Commonwealth ceased. Ireland is a unitary state with a parliamentary form of government. The head of state is the President, elected by direct vote for seven years, with a limit of two terms. The President has exclusive authority in two important issues: first, he/she can submit a bill to the Supreme Court to verify its constitutionality; second, he/she can refuse dissolution of Parliament to the Prime Minister if the latter has lost the majority in the lower chamber. Of eight Irish presidents, six were members of Fianna Fail, the largest party in the country.

The Prime Minister is head of the Government. He/she is proposed by the majority of the Irish House of Representatives and appointed by the President. Having lost support of the said majority, the Prime Minister must resign. The Parliament is two-chamber. The lower chamber, the House of Representatives, consists of 166 members elected by a general vote by all people aged 18 and older. Elections are based on a system of proportional representation. Parliament is elected for five years; however, it can be dissolved by order of the Prime Minister. The upper chamber, the Senate, consists of 60 members who are to be elected within 90 days after elections to the lower chamber. 43 are elected by the lower chamber and members of local councils; 6 are elected by the Trinity College of the Dublin University and the National University of Ireland; 11 are appointed by the Prime Minister. The House of Representatives has priority in legislation. All local councils are elected bodies.

The major ports in the country are Dublin and Cork. A well-developed airline network connects Ireland to Great Britain, Europe, and North America. The Dublin airport is a large international terminal. Transportation to Great Britain and France is ensured by ferries. Ireland possesses a modern digital telecommunication network, connecting it directly to 160 countries in the world, including all of the most important financial centers. Regular messenger services are provided by the National Postal Service and a number of other companies. Until 2002, the national currency was the punt, which was part of the European monetary system later transformed into the euro zone. On January 1, 2002, Ireland introduced Euro notes and coins into circulation. The official and business language is English, although Irish is also a state language.

## **Introduction**

Since independence until the mid-1950s, Ireland's economic development was weak compared to other countries of Western Europe. The government's attempts to form a viable industry under strict trade restrictions failed and led to general economic stagnation in the country. By the mid-1950s, when unemployment and emigration from the country reached unprecedented levels, the government resorted to radical changes in international trade and capital movement policies. Ireland started gradually removing trade barriers and actively attracting international capital, aiming to revive economic activity in the country. Over the 1960s and early 1970s, economic growth sped up, though not enough to close the gap in living standards with continental Europe. In 1973, when Ireland joined the European Union, it was still one of the poorer countries in Western Europe. Gradual economic integration of European countries and simultaneous introduction of unified standards of governance and legislation created positive preconditions for economic growth in Ireland. However, the government's errors in fiscal policies seriously hindered economic growth in the country.

Ireland achieved truly revolutionary economic success in 1990s, when its economy was growing at an average of 6% per year for the whole decade. Western experts referred to this upsurge in economic activity as the Celtic

Tiger phenomenon. Traditionally, the turning point in Ireland's economic history is considered to be 1987, when the government ventured to implement a set of fundamental reforms aimed at stabilizing the economy. First, it implemented fiscal reform to cut budget spending and reduce the burden of public debt. Tax amnesty greatly expanded the fiscal revenue base; within a year, it had already brought the first visible results, stabilizing the country's balance of payments. At the same time, public investments in all social services and development of human assets, the key national resource, remained substantial. Throughout the whole "revolutionary" period (1987–1999) Ireland maintained strict fiscal discipline. Fiscal revenues were growing faster than expenditures, so gradually the fiscal deficit was reduced, and later a surplus was achieved. Certainly, with fiscal stabilization inflation gradually slowed down to a level less than the average for other EU countries. Ireland also managed to obtain significant financial resources from the European structural programs, which were invested in creating a modern infrastructure, supporting the country's businesses, and increasing the efficiency of production. Thus, creating a steady macroeconomic environment with a favorable investment climate helped achieve overall conditions for rapid social and industrial progress in the country.

Trade and investment liberalization in the country and within the European Union led to unprecedented growth in Irish foreign trade and massive inflows of foreign direct investments. A surge in exports, with imports restrained by a low punt rate, resulted in a classic pattern of economic development under favorable exchange rate conditions. A small island state with no considerable natural resources managed to increase its export volumes eight times in just over twenty years. In the early 1980s, Ireland's exports were \$8.4 billion; in 2000, its merchandise exports reached \$77 billion. Tax incentives helped create a favorable environment for foreign capital. Substantial inflows of foreign direct investments from a great number of multinational (mostly US) companies to the country contributed to the expansion of industrial capacity. In 1997, 1,100 foreign companies operated in Ireland, every tenth of them in the IT sector. The largest world software producers have affiliate companies and branches in Ireland (Microsoft, Compaq, Intel, Novell, Oracle, Informix, Symantec, Corel, Ericsson, Netscape, etc.).

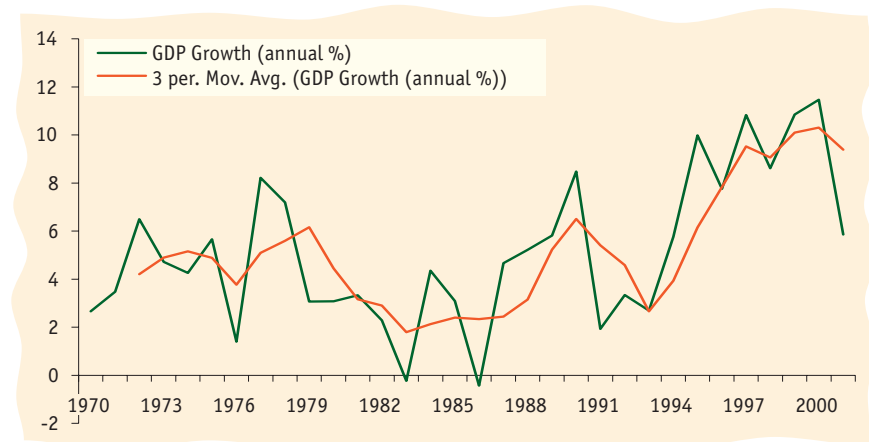
As a result, according to the Organization for Economic Cooperation and Development (OECD), Ireland's GDP amounted to \$122 billion in 2002, or more than \$30,000 per capita, surpassing the United Kingdom, Canada, Germany, France, and many other industrially developed countries. Fifteen years ago, per capita income in the country was less than two thirds of the average income in the EU. In late 2002, based on complex empirical calculations, the Heritage Foundation and the Wall Street Journal calculated and published the 2003 Index of Economic Freedom, evaluating social and economic conditions in 156 countries. Ireland was ranked fourth on the list.

## Macroeconomic Performance

### Real Sector Development

From independence to the mid-1980s, Ireland tried without success to find ways of speeding up its economic development. During the 1970s and up to mid-1980s, GDP growth in the country was unstable, and its general trend was even negative. Such dynamics were caused by a large fiscal deficit, rapid consumer price growth, and high unemployment rates. Starting in 1987, when the government decided to implement a set of reforms designed to stabilize the economy, the trend of economic growth changed dramatically. From 1987 to 1994, the Irish economy was growing an average of 5.5% every year; since 1995, GDP growth has accelerated to 9% annually. Besides macroeconomic stabilization, the key growth factors for the Irish economy were: increased human resources, availability of a qualified and relatively cheap labor force, mass inflows of foreign capital, and the consequent rapid development of hi-tech industries and the financial sector. A rather fast increase in the number of employed due to higher employment of women, a rise in net migration, and birth rate growth, together with controlled wage increases and consistent business liberalization resulted in higher economic potential, lower internal costs, and increased competitive strength of the Irish economy.

**Figure 1. Economic Growth in Ireland, 1970–2002**



Ireland's economic development was accompanied by significant changes in the structure of the economy. The closeness of economy until the 1960s greatly influenced its production structure. The fact that agriculture remained an important sector, while the industry and services developed relatively slowly, was the reason Ireland lagging behind other countries in Western Europe. After joining the EU in 1973<sup>1</sup>, the country long remained one of the weakest. By economy structure, Ireland still differs from other EU members. Up until the late 1980s, industrial growth (which later became the key driver for economic growth) was

<sup>1</sup> In 1973, integration of the EU members was at the stage of customs union. Active implementation of the program to create a single European market, envisaging a deeper economic integration of the countries, did not start until 1986.

relatively small, and the share of this sector remained virtually unchanged (see Table 1).

**Table 1. Ireland's Economic Structure, 1970–2000**

% GDP	1970	1980	1990	2000
<b>By Income</b>				
Agriculture	16	12	9	4
Industry	35	36	35	42
Services	49	52	56	55
<b>By Expenditure</b>				
Ultimate Consumption	85	87	74	62
Gross Capital Investments	23	27	21	24
Gross Internal Savings	15	13	26	38
Net Exports	-8	-14	5	14

Source: World Development Indicators, 2003

At the same time, the services sector was developing rapidly, which was a direct positive result of European integration. The economic boom of the 1990s was accompanied by intensive industrialization. Presently, industry (particularly manufacturing) is relatively more important to the Irish economy, compared to other developed countries. In 2000, industry accounted for 42% of Ireland's GDP, which is approximately 1.5 times more than in the United Kingdom, the USA, France, Belgium, and the Netherlands. The share of services in total production (55% of GDP) remains slightly lower than in other countries with a similar level of development (an average of 70% of GDP).

**Table 2. Ireland: Key Macroeconomic Indicators, 1973–2001**

aop	1973– 1980	1981– 1986	1987– 1990	1991– 1994	1995– 1998	1999– 2001
GDP (\$ bn)	13.63	23.37	42.23	56.30	83.65	99.30
GDP Growth, %	4.54	2.32	5.35	5.45	9.50	8.65
Consumer Price Index (CPI), %	16.10	8.08	3.20	2.35	1.78	5.25
Fiscal Revenues, % of GDP	28.05	37.42	37.13	36.43	30.98	27.55
Fiscal Expenditures, % of GDP	38.99	48.28	39.30	38.80	29.70	22.00
Fiscal Balance, % of GDP	-10.94	-10.87	-2.18	-2.38	1.28	5.55
Current Account Balance, % of GDP	-7.65	-4.63	-0.45	2.53	1.68	-0.80
Net FDI, % of GDP	1.58	0.62	1.15	2.15	9.85	16.75
Net FDI, \$ mln	215.02	124.26	540.21	1,211.93	8,752.65	16,321.61
Exports of Goods and Services, \$ bn	6.07	12.06	24.45	38.01	73.94	94.39
Imports of Goods and Services, \$ bn	7.51	11.93	22.18	32.59	63.11	79.99
Trade Balance, \$ bn	-1.74	-0.16	2.24	5.61	10.41	14.46
Trade Balance, % of GDP	100.35	105.07	111.68	127.08	153.95	175.72
Official Exchange Rate (IRP/USD)	0.66	1.01	0.82	0.81	0.87	1.10
Unemployment Rate, %	10.50	15.42	14.83	14.50	8.98	4.70

The income policy resulted in reduction of ultimate consumption levels in Ireland with high rates of economic growth. For comparison, domestic consumption decreased from 87% of GDP in 1980 to 62% of GDP in 2000, which is much lower than in other developed countries (on average above 80% of



GDP). Such a low level of ultimate consumption given high GDP growth demonstrates that external demand is extremely important for the growth of the Irish economy. Net exports reached 14% of GDP in 2000, while 20 years ago it had a negative input to the national income (-14% of GDP). Savings in Ireland increased from around 15% of GDP in the early 1970s to a record high 38% in 2000. Capital investment dynamics generally reflected those of GDP growth: an increase in capital investments in the 1970s changed to a sharp decline in the 1980s. Over a short period from 1980 to 1986, the share of capital investments dropped from 28% to 16% of GDP; then, capital investment began to gradually increase. The combination of foreign capital inflows and growth in domestic savings 7–10 years after the beginning of stabilization emphasize the complexity and length of the process of investment climate formation and the necessity for consistent, sustainable economic policies.

## **Ireland's Investment Climate Organized According to the Nine Drivers Framework<sup>2</sup>**

Macroeconomic stability and the quality of the institutional environment are major determinants of a successful economic development. Government policies and actions that ensure sound macroeconomic stability, defined as long-term stability in prices (domestic stability) and foreign exchange rates (external stability) are important elements of the investment climate of the country. Efficient business regulation and institutions that enforce it provide for firms making investments, creating jobs, and improving productivity, and thus spur economic growth and improve standards of living. Presently, Ireland is an example of the best practices in business regulation and investment climate.

### **1. Macroeconomic stabilization**

#### ***Fiscal Policies***

In the 1970s and the first half of the 1980s, the Irish government's fiscal policies were excessively expansionary, leading to a serious fiscal crisis and a slowdown of economic development. At that time, the fiscal deficit amounted to an average of 11% of GDP, which greatly exceeded the sustainability limit. Public debt was growing rapidly and reached more than 110% of GDP by 1986.

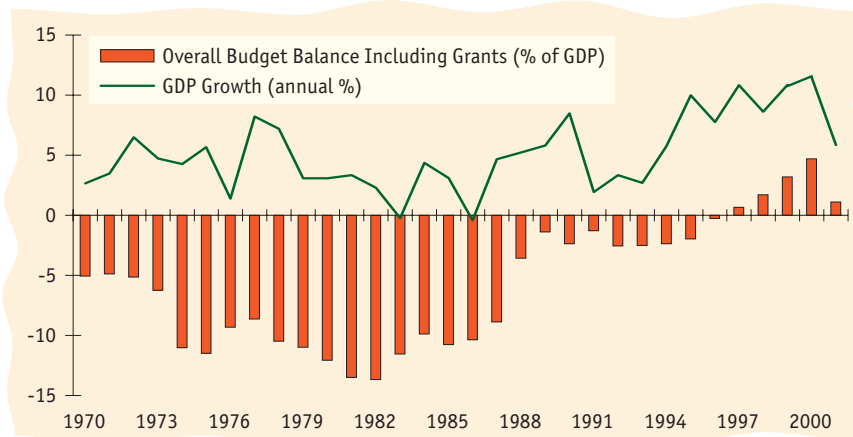
In the early 1980s, the Irish government attempted to balance the fiscal budget by raising tax rates; however, these measures were ineffective. A turning point was the reforms of 1987, when the government decided to cut fiscal expenditures by reducing the number of government officials and improving the social insurance system. Simultaneously, a tax amnesty was introduced, which greatly expanded the tax base and tax collections as early as 1988. Thus, the government of Ireland managed to find ways of macroeconomic stabilization and public debt reduction. Throughout the whole period since 1987, Ireland has maintained fiscal discipline. Fiscal revenues grew faster than expenditures, and the fiscal deficit gradually declined from 11% of GDP

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<sup>2</sup> See Appendix 2 for explanation of the nine investment drivers.

in the first half of the 1980s to 2.2% in 1987–1990. Later, the country managed to balance the budget, with the surplus reaching almost 5.6% of GDP in 1999–2001. By 2002, public debt decreased to 34% of GDP. Fiscal stabilization was undoubtedly the key for the gradual deceleration of inflation, which was also one of the factors for stability and growth.

**Figure 2. Fiscal Deficit and GDP, 1970–2000**



Between 1987 and 2000, Ireland pursued a tight fiscal policy but maintained a significant level of government investments. The latter was made possible with support from the EU within the framework of various financial aid programs for less developed EU countries (in particular, the Delors Packages). From 1989 to 1999, Ireland received more than \$50 billion from the EU as development aid (2–3% of GDP annually). The country used these funds to create a modern infrastructure (building motorways<sup>3</sup>, hotels, and airports), teach and train government officials, and develop modern industries. These additional funds are believed to have played an important role in increasing Ireland's attractiveness for foreign investors. The share of capital investment in the government budget in 1995–1996 was 2.3% of GDP, increasing later to 3.3% of GDP in 2000. An urgent need in creating conditions for further growth requires large investments in the next years. The National Development Plan for 2000–2006 envisages investing more than \$24 billion from the budget in developing social and economic infrastructure (43% of total investments), employment and human resources (23%), industry (11%), and regional development programs (12.5%).

### ***Monetary Policies***

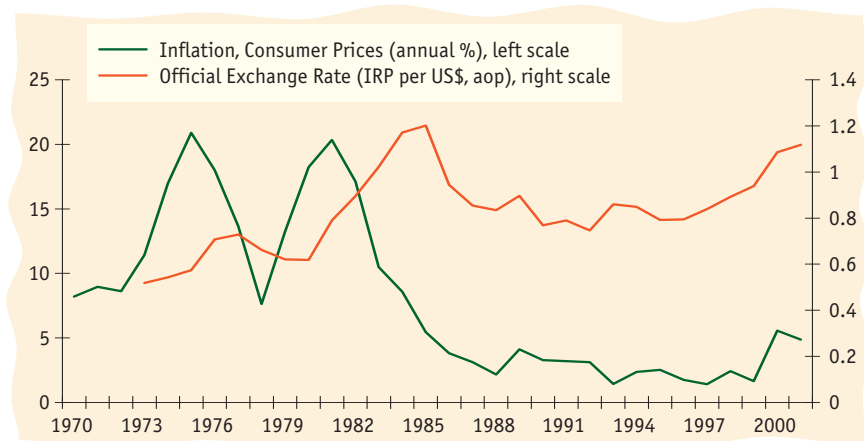
Unbalanced fiscal policies and an oil crisis in the 1970s provoked sustainable high inflation in Ireland that lasted for more than a decade. During this time, consumer prices in Ireland grew at an average rate of 16% annually. Fiscal consolidation in the second half of the 1980s helped substantially reduce inflation. From 1987 to 1999, consumer prices were growing by only 2–3% per year, which is quite low given the high rates of economic growth at that time.

<sup>3</sup> Note: In 1986, there were no motorways in Ireland.

In a small and open economy, exchange rate fluctuations greatly affect consumer prices dynamics. Until 1986, depreciation of punt to dollar also contributed to inflation pressures. At the same time, punt depreciation became one of the key drivers increasing the competitive strength of the Irish economy and induced a rise in economic activity. In particular, a 12% depreciation of the Irish punt in 1993 led to a rapid increase in GDP growth the following year. While GDP grew by 2.7% in 1993, the GDP growth rate reached almost 6% in 1994.

In 1999, Ireland introduced the common European currency at par with the ECU currency basket. Since then, monetary policies have been formulated by the Central European Bank in Frankfurt. Another additional stimulus for the increased competitive strength of Ireland's exports was the significant depreciation of the Euro to the Dollar in 1999–2000. Euro notes and coins replaced the Irish punt in January 2002.

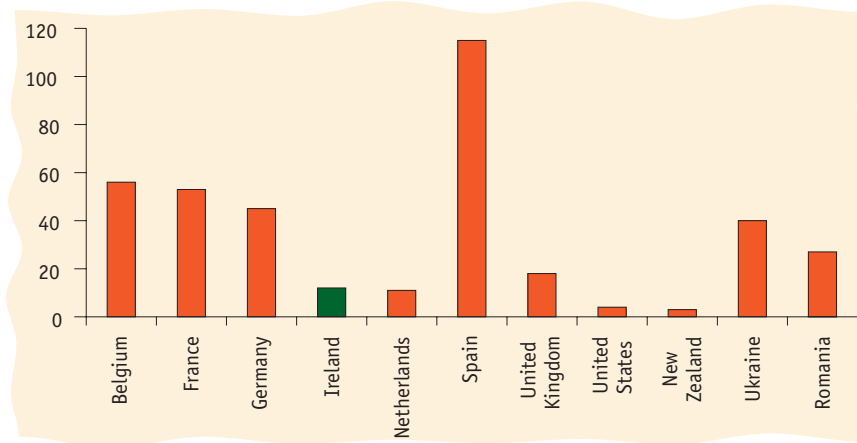
**Figure 3. Consumer Prices and Exchange Rate, 1970–2001**



## 2. Business Liberalization and Deregulation Policies

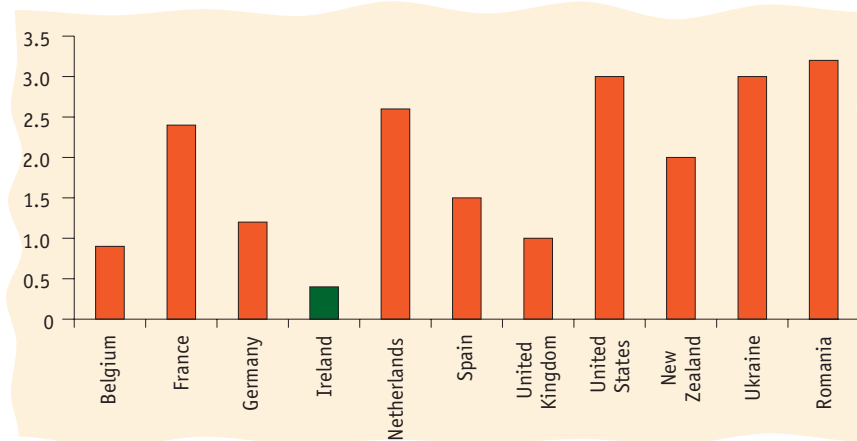
One of the most important steps towards a liberal business environment is easy entry and exit procedures. In 1995, the Task Force on Small Business and Services produced recommendations that were put in place and resulted in the reduction of business licenses and permits, simplification of information requirements provided by firms, and streamlining the process of company registration. In particular, the current registration procedure in Ireland is quite simple, permitting registration of a company in less than two weeks. To help foreign investors, the Industrial Development Agency (IDA Ireland) set up "one-stop-shops" that significantly simplified market entry procedures. For instance, the number of procedures that are officially required for an entrepreneur to start a business amounts to 3 in Ireland, which compares very favorably with the United States (5) and the UK (6). The charts below show that Ireland is now one of the best performing countries in the world in terms of liberalization of market entry and exit.

**Figure 4. Starting Business Indicators (time in days)**



Source: Doing business in 2004: Understanding Regulation

**Figure 5. Closing a Business Indicators (time in years)**



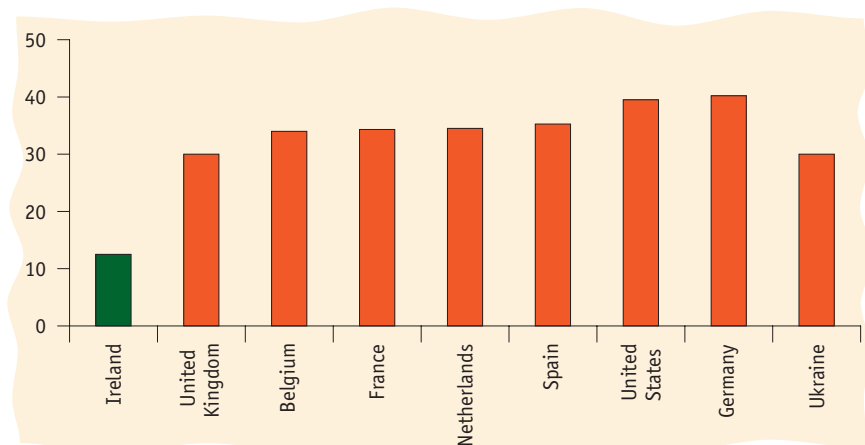
Source: Doing business in 2004: Understanding Regulation

Since the course of protectionist policy was abolished, Irish government has developed a comprehensive FDI promotion strategy that had notable effect on the tax system in the country. The Irish tax system has long been dualistic with low rates applicable to export sales or manufacturing and internationally-traded services, on the one hand, and a high standard rate applicable to the rest of the private sector on the other. In the early 1980s, the standard corporate profit tax was 50%, while a zero (up to 1981) or 10% (after 1981 and through the 1990s) tax rate was applied to the export oriented activities mentioned above. Over the last decade, the government of Ireland has been pursuing a business-friendly tax policy through the gradual reduction of the tax burden. Initially in the mid-1950s, the main element of Ireland's policy towards FDI promotion was an automatic tax holiday for foreign manufacturing companies on the profits from all new export sales. The peculiar feature of this fiscal incentive was its continuity and certainty — in the late 50s, the tax holiday was given for ten years, but then it was subsequently extended to fifteen years. When introduced in the mid-50s, the tax holiday was set to terminate in 1990. Prior to 1990, however, Ireland was forced by the European Commission to alter the policy for new firms, as the tax holiday distorted market development.

Therefore, since 1982, all new firms have been entitled to an automatic preferential corporate tax rate of 10 %, which was applied to all profits and not merely to those arising from export sales. It is worth mentioning, however, that the termination of the tax holiday was not applied to individual investing firms who had already been given tax-holiday status before 1982, and thus were able to hold it afterwards. At that time, the government also committed to keeping the preferential tax regime until 2000, and ten years later this period was extended to 2010. In such a way, the government of Ireland kept as much certainty as possible with regards to its fiscal incentives, and this was a great benefit to the investment climate in the country. Still, goods exports are fully exempt of VAT, except for non-EU resident companies. Companies that export 75% or more of their output can apply to the Revenue Commissioners for authorization to receive almost all of their goods and services from Irish and foreign suppliers free of any VAT. This reduces administration and the need to get a refund of VAT.

Since 1990, the Irish government has been transforming its tax system in order to gradually eliminate distortionary targeting of specific sectors. Thus, consistent reduction of income taxes has been taking place (see Appendix 1 on chronology of Irish reforms). Starting in 1995, the government has also reduced the corporate profit tax for small businesses from 40% to 30%. Eventually, corporate profit tax was cut to 12.5% in 2003, one of the lowest rates in the world (see chart below)<sup>4</sup>. Taxation of personal income remained considerably higher, though it has been reduced several times over 1990–2003. Currently, personal income in Ireland is taxed on a progressive scale ranging from 22% to 44%. Back in 1990, personal income tax rates ranged from 32% to 56%. Thus, there exists a large gap between the tax rates applied to corporate and personal income, which is deemed to be an important component of Ireland's economic success.

**Figure 6. Corporate Tax Rates (as of Jan, 2003)**



Source: Deloitte&Touche

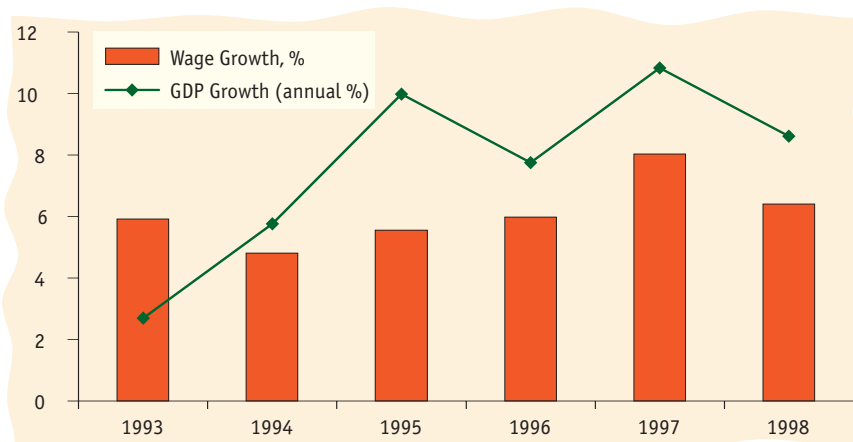
In addition to the preferential tax regime, there are many other incentives the Irish government provides in order to reduce the cost of doing business in the country for foreign companies. Financial support for foreign firms

<sup>4</sup> Except for qualifying foreign companies, which will enjoy preferential tax rates until 2010.

locating in Ireland in the 1950s was primarily in the form of cash grants towards the cost of the plant and machinery that would be used to produce goods for export markets. As with the tax holiday, the basis for grant eligibility had to be changed in 1982, so that the grants now apply to all manufacturing firms and not merely exporters. Currently, there are four categories of grants: capital grants, employment grants, training grants, and R&D grants. While investors are free to choose the location of their investment (subject to planning considerations), grant aid has become increasingly dependent on investors' willingness to establish operations in the more remote western and border regions of Ireland, where unemployment is higher and infrastructure is less developed. Screening mechanisms for grant aid purposes are transparent and do not impede investment, limit competition or protect domestic interests. Potential investors are also required to examine the environmental impact of the proposed project and to meet with Irish Environmental Protection Agency (EPA) officials. The core state body that provides incentives for investors is IDA Ireland. IDA Ireland assesses potential investment projects for eligibility for grant aid; the amount of subsidy or grant aid is determined by negotiation. Grant aid is largely tied to job creation and linkages with the local economy.

The remarkable economic performance of Ireland was also achieved thanks to fairly liberal Irish labor regulations as compared with most continental EU countries. The Irish labor force is characterized by a high degree of flexibility and mobility. It has also remained highly competitive throughout the last decade. Much credit should be given to the Irish system of centralized wage determination that maintained the supply price of labor at competitive levels. In 1987, the government of Ireland managed to bargain the first "social partnership" agreement with employers and trade unions envisaging wage growth moderation for three years. The government's promise of steady reductions in income taxation levels helped to ensure moderate rates of wage increases. Overall, the government managed to negotiate six "social partnership" agreements since 1987, which ensured low wage growth relative to the overall economic expansion (see chart below).

**Figure 7. Real GDP and Average Wage Growth Dynamics in 1990s**



Source: World Development Indicators, 2003

The highly educated labor force also facilitated the economic development of the country by easing entry of foreign and local companies into hi-tech sectors because it was easy to hire qualified staff. Ireland can claim to be a "knowledge economy". It has one of the best education systems in the world according to the 2001 independent IMD World Competitiveness Report. At present, almost 1 million people (one third of the country's population) are in full time education, and 60% of graduates go on to third level education. The majority of these undertake courses in business, engineering and computer science.

**Table 3. Public Expenditure on Education as % of Total Public Expenditure By Level of Education in 2002.**

Country	Total % All levels	Primary and Secondary %	Tertiary %
Ireland	13.5	9.3	4.1
Portugal	12.7	9.2	2.3
UK	11.8	8.3	2.5
France	11.4	8.0	2.0
Spain	11.2	7.8	2.4
Netherlands	10.7	7.0	2.9
Belgium	10.6	6.9	2.6
Italy	10.0	6.9	1.8
Germany	9.9	6.6	2.4

Source: IDA Ireland, Education At A Glance, OECD 2003.

Throughout its economic history, the Irish government maintained a significant level of public investment in education. Table 3 shows that Ireland spends relatively more public resources on education than other European countries. It is important to note that large expenditures alone do not guarantee a satisfactory educational system. An equally important determinant of the quality of the system as a whole is the manner in which this investment is spent; efficient investment of relatively small amounts in the right areas may provide a more appropriate system than large amounts of misallocated funds. Radical changes in the education policy in the 1960s combined with significant investment in primary, secondary and more recently third and fourth level education, resulted in a system that produced a large pool of well qualified potential employees. Policy actions in this key area included the introduction of free secondary education and the decision to pursue a wider and more internationally-regarded curriculum.

### 3. Stable and Predictable Legal Environment

The Irish legal system is based on common law, legislation and the constitution. The Companies Act, 1963, which was amended in 1990, is the most important body of law dealing with commercial and bankruptcy law, and is consistently applied by the courts. Irish bankruptcy laws give creditors a strong degree of protection. The Department of Enterprise, Trade and Employment is the state agency with primary responsibility for drafting and enforcing company law. The judiciary is independent and litigants are entitled to trial by

jury in commercial disputes. Ireland is a member of the International Center for the Settlement of Investment Disputes, and the Irish Government has been willing to agree to binding international arbitration of investment disputes between foreign investors and the state.

#### **4. Effective Corporate and Public Governance**

Ireland's corporate governance system fully conforms to internationally recognized standards. According to Irish legislation, company ownership information is publicly available. Auditing practices are fully compatible with international standards. Also, there is a fairly restrictive law on shareholder protection, similar to the one adopted in the UK, which completely excludes oppression of minority shareholder rights.

Public governance in Ireland has been constantly improving in order to meet the challenges in adapting to a high-growth and pro-market environment in which consumer interests are dominant. The public sector and its institutions have changed in the past decade and half. The Irish approach to modernization of the public sector during the past decade was based on prudence, pragmatism, and an incremental approach to change rather than the adoption of 'big projects'. A recently approved regulatory reform program "Reducing Red Tape" is an important addition to an array of initiatives and policies stretching back more than a decade that are intended to increase efficiency, transparency and accountability of the Irish public administration. The main vehicle for these improvements was the launching in 1994 of the "Strategic Management Initiative" (SMI). SMI was the third attempt to reform the Irish administration. Earlier attempts to reform the public service were of value in diagnosing the problems of the public service and raising awareness about new management approaches and tools. The SMI is regarded as the first successful reform of the Irish Public Service since the foundation of the independent state. One of the reasons for the success of the SMI is that it has had strong support, not only from senior civil servants, but also from three successive governments. Another reason is that many of its central policies were underpinned by legislation adopted in 1997 (the Public Service Management Act, the Freedom of Information Act, and the Committee of the Houses of the Parliament Act). In many ways, the laws provided formal structure and content to informal and heterogeneous procedures and practices. As a result of the implemented reforms, public administration has become much more efficient. The fact that total employment in the public sector grew by only 5.1% in 1989–99 when the level of economic activity increased enormously provides indirect evidence of the increased efficiency of public administration in Ireland. An important step towards efficiency of public administration was implementation of the e-government initiative. Ireland has invested in new information and communication technologies to improve transparency and delivery of government services. Earlier existing state agencies' office infrastructure was replaced with a countrywide virtual private network, which covers the entire government sector.



## 5. Liberalization in Foreign Trade and International Capital Movements

In the late 1950s, Ireland abandoned its protectionist policy and began integrating into the global economy. Until the mid-1960s, Ireland had a highly protected economy with some of the highest rates of effective protection of any economy in the world. Reductions in tariffs began in 1966 as a consequence of the Anglo-Irish Free Trade Area Agreement. In 1973, Ireland joined the European Union (or European Economic Community), which at that time was effectively a customs union. Following a five-year adjustment after Ireland joined the EEC, the process of tariff reduction was eventually completed in 1978. Starting in 1986, the process of deepening the level of economic integration by means of the Single Market Initiative began. Creation of the Single Market within the borders of the EU assumed removal of all non-tariff barriers to trade such as border controls, national-specific product standards, etc. In 1993, foreign exchange control regulations were completely abolished, and Ireland became a member of the WTO in 1995.

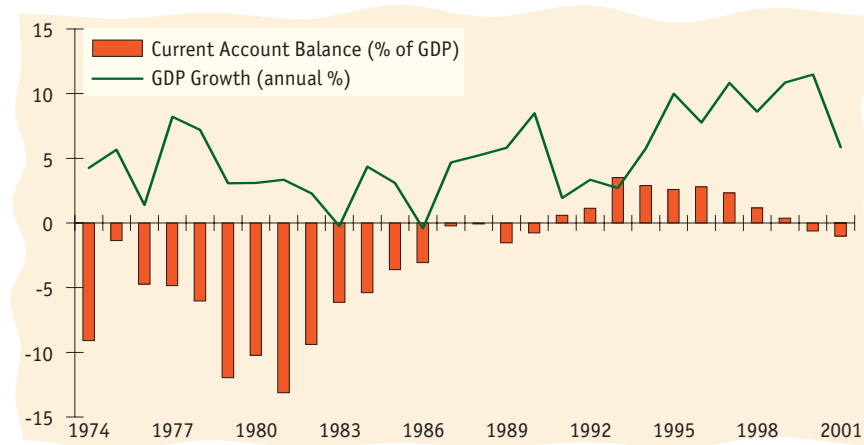
Today Ireland is one of the most open economies (trade turnover was 175% of GDP in 2000). Currently, there are no restrictions on inward investment, foreign trading, or the repatriation of capital and profits of foreign companies based in Ireland. The Central Bank of Ireland controls and approves all foreign investment flows, repatriation of profits and dividends, although this regulation is just a formality for monitoring purposes rather than a capital control instrument.

Trade and investment liberalization in the country resulted in great increase in Ireland's foreign trade and large foreign capital inflows. From the early 1980s to 2000, rapid growth of exports, with imports moderated by the low punt exchange rate, created a classic pattern of economic development under favorable exchange rate conditions. During the 20-year period, this small island state with no considerable natural resources managed to increase its exports by eight times. In the early 1980s, Ireland exported goods for \$8.4 billion; in 2000, its exports of goods reached \$77 billion. Today, most export products are in several hi-tech sectors (namely, IT and the pharmaceutical industry), while twenty years ago textiles and apparel was the major industrial product in the country's export structure. For historical and geographical reasons, Great Britain remains Ireland's major trade partner, despite the fact that exports have diversified considerably over the last twenty years. In 1983, Great Britain's share in the country's foreign trade turnover was 38% of exports and 45% of imports; in 2000 these figures were 24% and 36%. At the same time, the US' share of Irish exports almost doubled (from 10% in the early 1990s to 18% in 2002), which can be attributed to the presence of numerous American companies in Ireland.

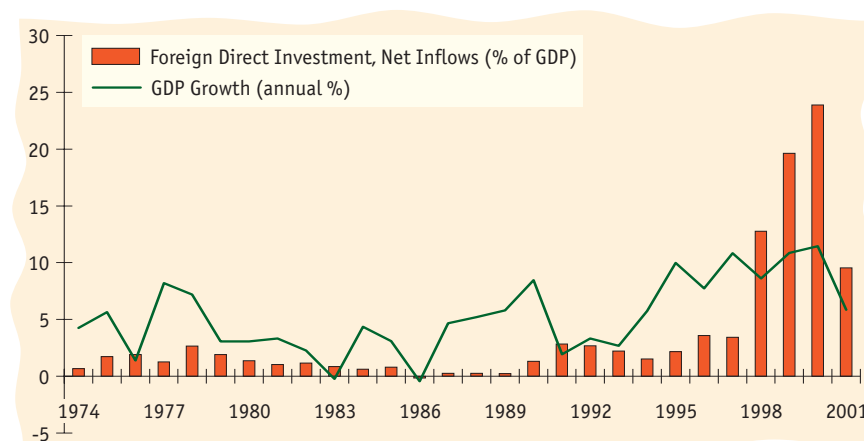
Depreciation of the Irish currency led to leveling off and then quite strong growth of the current account balance, which remained at 2–3% of GDP in the 1990s. In Ireland, the dynamics of the key components of the current account is somewhat unusual, because foreign multinational companies dominate the

export sectors. A considerable surplus in the trade of goods account offsets a deficit in the trade of services and the income account. This is attributed to repatriation of profits by foreign companies and payments for administrative and other services provided to subsidiaries by the headquarters.

**Figure 8. Current Account Balance and GDP Growth, 1970–2001**



**Figure 9. FDI Dynamics and GDP Growth, 1970–2001**



A remarkably high foreign trade turnover in Ireland is largely due to a great volume of foreign direct investment (FDI), made primarily in exporting companies. The existence of a large Irish community in the USA, good knowledge of the country on the part of American businesses, an English-speaking population, and all the advantages of EU membership have accelerated the inflow of American investments in Ireland. The creation of a single market within the EU generated incentives for American capital to invest in Ireland in the 1980s and 1990s. Between 1987 and 1994, the average annual net FDI inflow was 1–2% of GDP; in the second half of the 1990s it reached almost 10% of GDP. It is important to note that the inflow of FDI in Ireland keeps accelerating: over recent years (1999–2001) Ireland received an average of over \$16 billion of net FDI, which is a record high 16.8% of GDP. At the same time, in 1995–1999, the country paid net factor income of 1.2–2.5% of GDP annually.

The adequacy of direct investments and payments of factor income emphasizes the importance of the development factor in attracting foreign direct investments.

Large volumes of FDI inflow into the Irish economy were the result of the government's consistent policies concerning foreign investments, especially in the sector of information technologies. In addition, the volume of FDI in greenfield projects is much higher in Ireland than in other countries. This can also be explained by the fact that the actions of the Irish government proved that it can fulfill its commitments and implement coordinated and consistent foreign investments policies, thus winning investors' trust.

## **6. Healthy Financial Sector**

Ireland's banking and financial sector is both advanced and generally competitive. The Irish financial system has experienced a series of changes over the past decade. New legislation has been introduced to allow more competition between different types of financial services organizations. Consequently, there exists a very sophisticated banking environment, which offers many sources of financing to organizations doing business in Ireland.

Ireland has attracted a number of foreign banks through its International Financial Services Center (IFSC) located in Dublin. In 1987, the Irish government established the IFSC in an attempt to broaden the financial services industry in Ireland. Institutions qualifying for IFSC status (a key criterion was that activities be carried out with non-residents and in non-Irish currencies) were offered a preferential 10% corporate tax rate. In 1998 the government, under pressure from the European Commission, agreed to phase out IFSC corporate tax incentives. The main activities of IFSC institutions include international banking, corporate treasury, insurance and reinsurance, fund management, asset financing, custody and administration services, and back-office operations. The Irish Stock Exchange (ISE), which has operated independently of the International Stock Exchange of the UK since 1995, provides a market for the purchase and sale of negotiable securities, mostly Irish equities and government bonds.

Since May 2003, the Single Regulatory Authority (SRA) has been responsible for both prudential supervision and consumer protection across the entire financial services industry. Establishment of the SRA improved the efficiency of the sector because the regulation of financial services was earlier done by many different bodies.

## **7. Corruption Minimization**

Corruption is not a serious problem for foreign investors in Ireland. The principal Irish legislation relating to anti-bribery and corruption includes the Public Bodies Corrupt Practices Act, 1889, the Prevention of Corruption Act, 1906 the Prevention of Corruption Act, 1916 and the Prevention of Corruption (Amendment) Act, 2001, which make it illegal for Irish public servants to accept bribes.

The "Ethics in Public Office Act, 1995" provides for the written annual disclosure of interests of people holding public office or employment.

### **8. Political Uncertainty Minimization**

Since 1987, Ireland has shown unique consistency in pursuing market reforms, regardless of the political forces who won the elections. The government declares the course for reform as its long term strategy — the National Development Plan — usually developed for a six-year time span.

### **9. Country Promotion**

In 1988, the Industrial Development Authority (IDA) was re-established. It was first established in 1949 to promote industrial development and development of the export capacity of the country. The Agency was given increasing powers to provide grant aid to the manufacturing industry. Currently, IDA Ireland is the primary government agency with responsibility for the promotion of foreign direct investment into Ireland and the development of the existing base of overseas companies. Government promotional agencies have selectively targeted certain areas of industry, in particular those that produce sophisticated and high value-added products and services. IDA Ireland also has responsibility for attracting foreign companies to Dublin's International Financial Services Center (IFSC). IDA Ireland maintains offices in New York, Boston, Chicago, Los Angeles, San Jose, and Atlanta, as well as at locations in Europe and Asia.

## **Concluding Remarks**

Ireland's economic success in recent decades was determined by favorable preconditions on the one hand and efficient government policies on the other. A most important external element of the Irish success was EU membership, which sharply increased competition, expanded markets, and spurred productivity growth. Many countries had favorable conditions in these decades, though not all of them managed to take advantage of it. A decisive impulse took place in 1987, when the government managed to significantly improve public finances, though the rates of economic growth leapt forward seven years later. For more than thirty years, the Irish government worked on improving the investment climate, implementing a number of institutional reforms. In the long term, these reforms became an impetus to form a favorable business environment and stable macroeconomic situation, which created good overall conditions for economic growth.

The Irish economic growth in the 1990s was propelled by two groups of factors:

Internal Factors:

1. Fiscal stabilization and consistent fiscal policies aimed at reducing the tax burden;
2. Consistent policies in controlling wage growth, based on mutual understanding between the government, trade unions, and employers (the principle of Social Partnership);
3. Trade and investment liberalization;
4. Creating a favorable business environment in the country and simplifying business entry and exit requirements;
5. Creating an efficient public governance system through regulatory reform;
6. Sound policies aimed at attracting foreign direct investments. Most importantly, the policies for attracting direct investments remained uninterrupted for fifteen years;
7. Substantial long-term investment in education, resulting in a relatively young, inexpensive, and well-educated labor force.

External Factors:

1. EU accession and economic assistance from the EU to develop infrastructure;
2. Rapid development of information technologies all over the world;
3. A large Irish diaspora in the USA.

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## Appendix 1. Chronological Order of Economic and Institutional Reforms in Ireland

Year	Action
1947	A customs free zone was created at Shannon Airport
1949	Industrial Development Authority (IDA) of Ireland was established given increasing powers to provide aid to the manufacturing industry.
1956	Export profit tax relief (EPRT) was introduced to promote development of export-oriented manufacturing. Foreign manufacturing companies were provided an automatic tax holiday on the profits from all export sales.
1958	Restrictions on inward investment were removed by the repeal of the Control Manufactures Act (enacted in the mid 30s)
1963	Adoption of the Company Act (amended 1990), the most important body of law dealing with commercial and bankruptcy law
1966	The Anglo-Irish Free Trade Agreement was passed.
1969	Publication of Report of Public Services Organization Review Group (Devlin). It presented a series of recommendations to permit the administration to cope with new demands generated by the creation of a European welfare state providing more services to a wider array of citizens. It concentrated on key functional elements, the most important of which was a separation of policy making from implementation and service delivery functions. However, the reform initiative failed achieving only piecemeal results.
1973	Ireland joined the European Economic Community (the first enlargement)
1978	The process of tariff reduction was completed
1982	All new firms were entitled to an automatic preferential corporate tax rate of 10 %, which has applied to all profits and not merely those arising from export sales.
1984	Government White Paper, Serving the Country Better. It advocated greater decentralization, improved budgetary management and greater mobility across departments of top level administrators. However, the basic structural changes envisaged by the program were not implemented.
1986	New Judicial Review Procedures introduced.
1987	Fiscal consolidation (public expenditures were cut significantly: public sector wage bill was put down through reduction of the number of public employees)
	Establishment of International Financial Services Centre (IFSC) in an attempt to broaden the financial sector industry. Institutions qualifying for IFSC status (a key criterion was that activities be carried out with non-residents and in non-Irish currencies) were offered a preferential 10% corporate tax rate.
	The 1st social partnership agreement was stricken which in essence, entailed an exchange of wage moderation in return for tax-cuts. The government, trade union and business agreed to limit wage increases to preserve international competitiveness of Irish exports.
1990	Tax rates were reduced (corporate profit tax (CPT) for residents from 43% to 40%; personal income tax (PIT) from 32% to 30% (standard) and from 56% to 53% (top).
	The 2nd social partnership agreement
1991	Competition Act. The Act establishes a competition authority. The Act was later amended and strengthened in 1996 by the introduction of criminal offences and penalties.
1992	Personal income tax (PIT) further reduced from 30% to 27% (standard) and from 53% to 48% (top).
1993	Foreign exchange control regulations were completely abolished.
	The 3rd social partnership agreement.
1994	Strategic Management Initiative (SMI) launched. Regarded as the first successful reform of the Irish Public Service since the foundation of the independent state. Eight initiatives formed the core of SMI. Four were aimed at improving customer service and delivery of policies (in particular, Quality services for customers; Simplification of administrative procedures and regulatory reform; Open and transparent service delivery; Effective management of cross-cutting issues.) Another four initiatives were aimed at internal improvements of the administration (in particular, Devolving authority and accountability; New approaches to human resource management; More effective financial management, and Improved use of information technology to meet business and organizational needs.) The program was based mainly on a 'bottom-up' approach to reform.



Year	Action
1995	Corporate profit tax (CPT) for residents further reduced from 40% to 38%; profit tax for small enterprises was set at 30%
	Ethics in Public Service Act: new enforcement accountability mechanisms. Also provides for a register of interests and other procedures against corrupt practices.
	The Irish Stock exchange started operating independently of the International Stock Exchange of the UK.
	Ireland became a member of the World Trade Organization (WTO)
1996	Telecommunication (Miscellaneous Provisions) Act. The Act makes provision for the establishment of the Office of the Director of Telecommunications Regulation, (an independent regulator); transfers functions and pricing authority from the minister to the Director; provides for the imposition of a levy on providers of telecommunications services to finance the regulator.
	The 4th social partnership agreement.
1997	Corporate profit tax (CPT) for residents further reduced from 38% to 36%; profit tax for small enterprises was cut to 28%. Personal income tax (PIT) further reduced from 27% to 26% (standard) and from 48% to 46% (top), tax band and personal tax allowances were also changed.
	Freedom of Information Act. The Act enables members of the public to obtain access, to the greatest extent possible consistent with the public interest and the right to privacy, to information in the possession of public bodies; to have personal information relating to them in the possession of public bodies corrected; to have the right of access to records held by public bodies; to be entitled to an independent review of decisions of public bodies. The Act also establishes the office of the information commissioner.
	Public Service Management Act. The Act provides for a new management structure to enhance the management, effectiveness and transparency of operations of departments of state and certain other offices of the public service. It also increases the accountability of civil servants while preserving the discretion of the government in relation to their responsibility to Parliament. Committees of the Houses of the Parliament (Compellability, Privileges and Immunities of Witness Act.) The Act together with the Public Service Management Act provides the framework for accountability of civil servants to committees of the Parliament's
1998	Corporate profit tax (CPT) for residents further reduced from 36% to 32%; profit tax for small enterprises was cut to 25%.
	Preferential treatment of institutions operating within IFSC was abolished under pressure from the European Commission.
1999	Corporate profit tax (CPT) for residents further reduced from 32% to 28%. Personal income tax (PIT) further reduced from 26% to 24% (standard), tax band and personal tax allowances were also changed.
	Electricity Regulation Act. The Act establishes the Commission for Electricity Regulation (independent regulator), transfers certain regulatory functions from the Minister to the Commission, and provides for the imposition of an industry levy to finance the regulator.
	Publication of Reducing Red Tape-An Action Program for Regulatory Reform in Ireland.
2000	Corporate profit tax (CPT) for residents further reduced from 28% to 24%; profit tax for small enterprises was cut to 12.5%.
	Publication of Governance and Accountability in the Regulatory Process: Policy Proposals.
2002	New competition legislation came into force, increasing the autonomy and the power of the Competition Authority.
	Significant progress made in liberalizing the public utilities — the gas and electricity sectors have been brought under the control of a single independent regulator, the Commission for Energy Regulator
2003	Corporate profit tax (CPT) for all businesses set at 12.5%. Personal income tax (PIT) further reduced from 24% to 22% (standard), and from 46% to 44% (top), tax band and personal tax allowances were also changed.
	New financial sector regulator — Single Regulatory Authority (SRA) was set up. Its responsibilities include prudential supervision and consumer protection across the entire financial services industry, operates within the Central Bank of Ireland

## Appendix 2. The Nine Drivers Framework

A study by SigmaBleyzer<sup>5</sup> identified the most important measures that a Government can take up to improve the business environment and attract foreign direct investments. The study reviewed 50 countries around the world and carried out statistical analyses to identify the policy that could have the greatest impact on the flows of FDI. Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that a country could receive based on the implementation of these key "policy" investment drivers. The study concluded that "first generation reforms" — macroeconomic stabilization, achieved by sound fiscal and monetary policies — are essential pre-conditions to achieving a favorable business climate and attracting foreign direct investments. But they alone are not sufficient to improve the business environment and achieve increases in international capital inflows. Within this macroeconomic framework, a number of "second-generation" reforms are needed. Our benchmarking statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments group of 50 developing countries could be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g. geographical location, country size, population, etc.). These key investment drivers were the following, in order of priority:

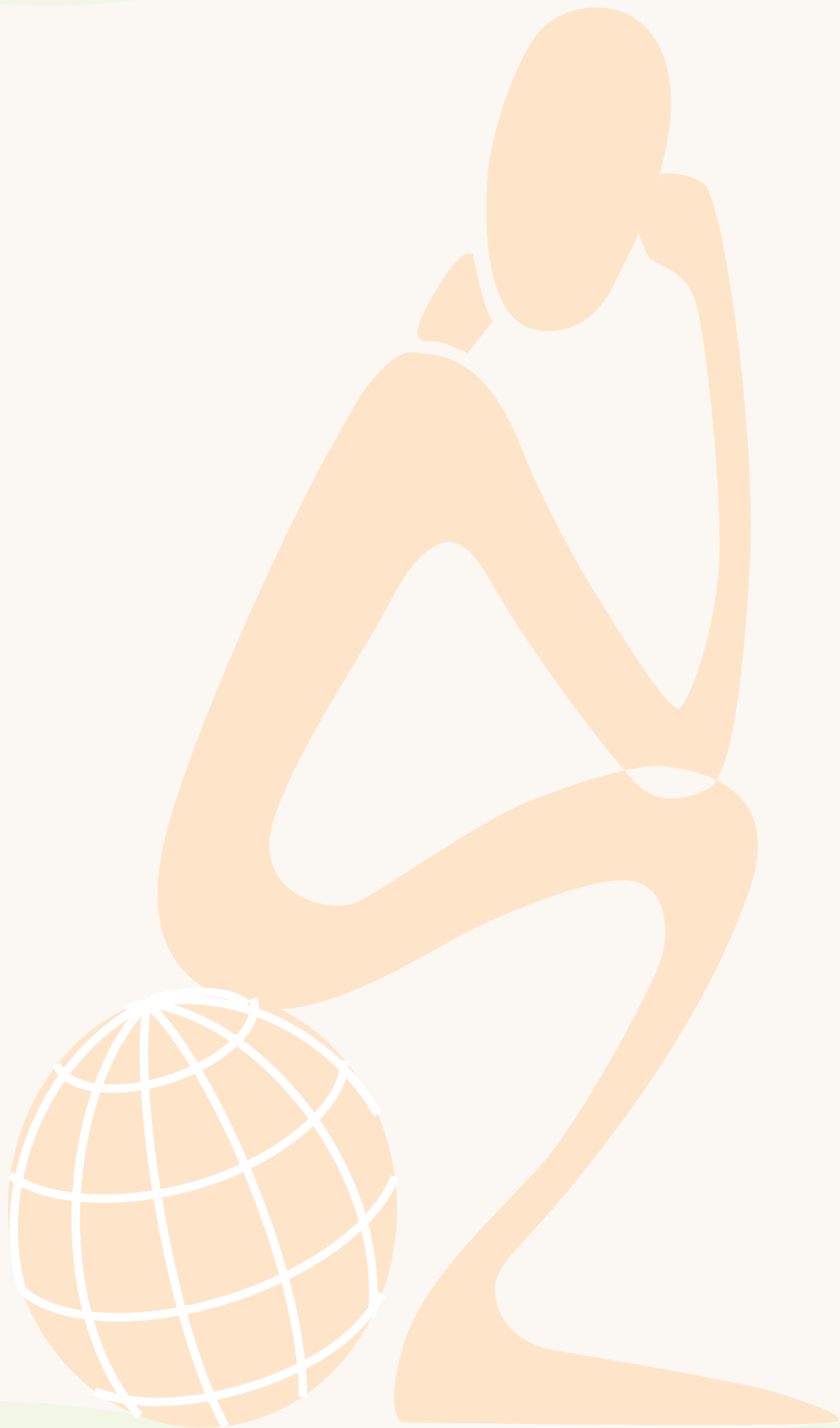
- (1) Macroeconomic stabilization
- (2) Business liberalization and de-regulation policies
- (3) Stable and Predictable Legal Environment
- (4) Effective Corporate and Public Governance
- (5) Liberalization in Foreign Trade and International Capital Movements
- (6) Healthy Financial Sector
- (7) Corruption Minimization
- (8) Political Uncertainty Minimization
- (9) Country Promotion

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<sup>5</sup> The Bleyzer Initiative: Completing the Economic Transition in FSU Countries, Sigma Bleyzer 2002.

See also "Accelerating the Flow of International Private Capital to Ukraine", Houston, April 2001.





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