Rebuilding the Irish economy: Policy responses to stimulate sustainable recovery in the ‘real’ economy.

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Abstract

Few countries entered the global recession so poorly positioned as Ireland. Yet its erstwhile-sustained growth achievement for almost two decades has been widely admired. This paper explains Ireland’s economic reversal, and seeks to identify policy responses that would stimulate a sustainable recovery in the real economy.

How then did an economy where employment doubled and real GNP quadrupled during the so-called "Celtic Tiger" era from 1990 to 2006, come to have GNP contract by 17% by late-2009? The deepest and swiftest contraction suffered by a western economy since the Great Depression. Clearly, Ireland’s economy faces severe challenges. The spike in secondary-market spreads on Irish government debt is symptomatic of the twin crisis in the country’s banking sector and public finances. The Irish government’s commitment to absorb the losses of it’s banking system - calcified by the EU/ IMF agreement - has heightened concerns in relation to a spiralling debt ratio and the solvency of the sovereign. In addition, the unemployment rate currently stands at over 13% - very far from the full employment of what was called the "Celtic Tiger" period. The key to understanding what happened to Ireland is to realise that the sustained growth from 1991 to 2006 stemmed from two very different booms which attended a significant change in the structure of the Irish economy. The export-led growth of the 1990s gave way to a second boom in housing based on credit-led consumer spending, financed by net external borrowing, after 2000. Indeed, if the construction sector is subtracted from national output, Ireland was in recession from 2001.

Therefore, the basic domestic policy prescription appears straight-forward - to promote the export-led growth model as the only sustainable path to recovery. In addition, the recent and necessary budgetary 'consolidations' have had a dampening effect on growth potential. A government enterprise/ jobs stimulus will facilitate a better growth trajectory and help to correct the fiscal imbalance. In its recently published National Recovery Plan, the Irish government stands behind its long-standing pro-export pro-business strategy. Moving forward, Irish policymakers will need to be more proactive in promoting entrepreneurship and innovation, as well as a much bigger role for indigenous based firms. Clearly, there is need for a targeted emphasis on economic growth with jobs growth. Proactive policies to stimulate labour demand should be given immediate effect. Simply put, the stimulus has to be calibrated for employment creation.

The prime contribution of the current paper is in terms of the insights it provides regarding the 'real' economy in Ireland. The task of the Irish Government at this point in time is to find the balance between reordering the financial/ banking sector and stimulating growth (enterprise and employment policies).

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Section 1: Ireland – from good example to major warning

“It is clear to us all what went wrong in our economy. In the period leading up to the crisis, the construction sector and property prices grew to unsustainable levels. The appetite of a rampant building industry for labour and other resources put upward pressure on our cost structure. As a result, our competitiveness was damaged and we lost market share for our goods and services. Excessive public spending on the back of the enviable but transient taxes of the boom added to the overheating of the economy. A huge expansion in bank borrowing for property and construction-related investment was the final and most lethal domestic ingredient in the causes of our crisis. The international financial crisis added pace and severity.”

Brian Lenihan, TD and Irish Minister for Finance, Budget 2011 speech (7th December 2010).

Introduction

While it could not have been fully understood at the time, few countries entered the global recession so poorly positioned as Ireland. After all, this was an economy where GNP grew at a rate in the range of 5 - 15% every year from 1991 to 2006, and its sustained growth achievement had been widely admired. However, Ireland once seen as a good example, now serves notice of a major warning. Kelly (2010: 1) describes the Irish economic growth performance during the past two decades as a sequence of transitions “from basket case to superstar and back again – or almost.” The story is certainly compelling, and is characterised by what appeared to be a remarkable economic transformation, followed by a very pronounced and ongoing correction. This paper explains Ireland’s economic rise and reversal, and seeks to identify policy responses that would stimulate a sustainable recovery in the real economy.

The key to understanding what happened to Ireland is to realise that the recorded surge in growth stemmed from two very different booms that attended a significant change in the structure of the Irish economy. Ireland is a textbook Small Open Economy, where exports represent c.80% of GDP, and the transformation and reversal of Ireland’s sustainable economic performance mirrors the dynamic in the country’s exports growth. Ireland’s huge exports to GDP ratio and privileged position in global supply chains helped it grow rapidly in the 1990’s. This export-led growth gave way to a second boom based on credit-led consumer spending, financed by net external borrowing, after 2000. The current Irish crisis has resided, to a great extent, in property-related bad loans - too much construction lending (financed by heavy foreign borrowing by the Irish banks) fuelled an unsustainable property price bubble. In the period from 2001-2006, new homebuilding disguised problems in the export sector. Indeed, if the construction sector is subtracted from national output, Ireland was in recession from 2001. Undoubtedly, many of the causes of Ireland’s current malaise reside within the domestic economy, and, in this sense, are home-grown. Yet, there were important international factors at work that cannot be overlooked. External or wider dimensions included Ireland’s membership of the eurozone in particular, while the additional expansion of credit that attended the entry of foreign banks into the Irish market provided a significant but less influential element.

The second growth-phase was pre-ordained to end in a hard landing, and, unsurprisingly, in the Irish Government’s response to the economic crisis, the policy landscape has been dominated by deference to the efficacy of the export-led growth model as a vehicle for sustainable recovery. Of course, this is very much dependent on a return to growth in external markets, and domestic agents can only seek to put in place a facilitating policy platform. The second boom offers little by way of positive guidance to policymakers, except as hard lessons to be learned. However, the after effects which are so clearly manifest in the crisis in the country’s banking sector and public finances, will constitute a very considerable
constraint on policy possibilities and growth performance in the medium term at least. This notwithstanding, our primary interest in this paper is located in the first boom, where the broad policy stance that helped foster the initial recovery has an obvious resonance given the current economic climate.

Ireland’s economic transformation and growth convergence

Before the onset of the current worldwide economic downturn, the turnaround in the performance of the Irish economy, especially during the 1990’s, had received considerable international attention. The focus of this attention was generally concerned with how an economy with severe fiscal imbalances and endemic unemployment in the 1980’s was transformed in the 1990’s to exhibit remarkable economic growth and employment gains. During the 1990s, Ireland emerged from a lengthy period of economic stagnation marked by high unemployment, emigration, and crippling public debt despite high tax levels (Ó Gráda and O’Rourke, 1996, Honohan and Walsh, 2002).

In the mid-to-late 1980’s, the case for considering Ireland a failed economic entity had been compelling and this was reflected in both the tone of domestic and international economic commentary. Domestically, the pre-occupation of most economists centred on “fiscal rectitude,” and an unfortunate but generalised malign attitude to public sector involvement in the economy was prevalent. The gloomy domestic prognosis for the economy was reinforced by international commentators culminating in the January 1988 survey in The Economist,” “The Poorest of the Rich,” and a subsequent contribution by Dornbusch (1989) which concentrated on "Ireland’s failed stabilisation." Subsequently, in the 1990’s and later, it was Ireland’s economic turnaround that attracted international attention. Prominent among these contributions was a focus on what Ireland can teach the rest: "Ireland shines – lessons and questions from an economic transformation” and "Ireland’s growth strategy: lessons for economic development.” The appellation ‘Celtic Tiger’ (though something of a misnomer) became widely used as a metaphor for the Irish boom (presumably comparing Ireland’s sudden economic take-off to the Asian tiger economies).

Ireland’s economic transformation during the 1990’s constituted something of a macroeconomist’s ‘vision of utopia’, characterised as it was by high and sustained economic growth, low inflation, a current account balance of payments surplus, falling unemployment, net immigration and a growing budget surplus. Also, an expanded flow of European Union structural funds amounting to as much as 3 per cent of GDP also helped fund sufficient public infrastructure in those years.

Following a number of failed attempts to correct significant fiscal imbalances the Irish Government introduced a programme of severe fiscal retrenchment in 1987 (this year also marked the beginning of a renewed social partnership/ national wage bargaining ethos). While the curtailment of Government’s share of GDP (from half of GDP to 40% in two years) cannot alone explain subsequent performance this move is generally accepted as the catalyst for future performance. Table 1.1 below indicates remarkable progress over the 13-year period from 1987-1999 on several key measures of macroeconomic performance. This is most dramatically reflected in the sustained increase in GNP volume, the growth in

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employment after a slow start, the decrease in the percentage of the labour force unemployed and the turn-around in the budgetary position.

Table 1.1: Key Indicators of Macroeconomic Performance, 1987-1999.

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<tr>
<td>GNP (1995 prices) % change</td>
<td>4.4</td>
<td>6.3</td>
<td>7.8</td>
</tr>
<tr>
<td>GDP (1995 prices) % change</td>
<td>4.9</td>
<td>6.4</td>
<td>9.2</td>
</tr>
<tr>
<td>Average GNP per capita (1995 prices) % change</td>
<td>4.5</td>
<td>5.8</td>
<td>6.6</td>
</tr>
<tr>
<td>Population % change</td>
<td>-0.1</td>
<td>0.5</td>
<td>1.1</td>
</tr>
<tr>
<td>Labour Force % change</td>
<td>0.3</td>
<td>2.4</td>
<td>4.7</td>
</tr>
<tr>
<td>Employment % change</td>
<td>1.0</td>
<td>3.3</td>
<td>7.4</td>
</tr>
<tr>
<td>Unemployment rate % change</td>
<td>-3.5</td>
<td>-5.8</td>
<td>-25.5</td>
</tr>
<tr>
<td>Average GNP per person employed (1995 prices) % change</td>
<td>4.0</td>
<td>3.8</td>
<td>3.0</td>
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</tbody>
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<tr>
<th></th>
<th>1987</th>
<th>1992</th>
<th>1999</th>
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</thead>
<tbody>
<tr>
<td>Current Budget Balance/GNP</td>
<td>-5.9</td>
<td>-1.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Exchequer Balance/GNP</td>
<td>-8.9</td>
<td>-2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>National Debt/GDP</td>
<td>106.9</td>
<td>83.6</td>
<td>45.4</td>
</tr>
<tr>
<td>National Debt Service/GDP</td>
<td>8.7</td>
<td>6.8</td>
<td>3.1</td>
</tr>
<tr>
<td>Labour Force Participation rate: Female</td>
<td>82.1</td>
<td>79.2</td>
<td>80.4</td>
</tr>
<tr>
<td>Economic Dependency ratio</td>
<td>2.2</td>
<td>2.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Exports of Goods and Services/GNP (1995 prices)</td>
<td>52.3</td>
<td>67.7</td>
<td>113.7</td>
</tr>
<tr>
<td>Imports of Goods and Services/GNP (1995 prices)</td>
<td>52.9</td>
<td>60.3</td>
<td>96.5</td>
</tr>
</tbody>
</table>

Sources:
GDP and GNP: CSO National Income and Expenditure - Table 2 - Items 28 and 30 respectively.
GDP and GNP (1995 prices): CSO National Income and Expenditure - Table 4 - Items 52 and 54 respectively.
Labour force, employment and unemployment: CSO Quarterly National Household Survey - Table 1 - 2nd Qrt.
National debt and national debt service: National Treasury Management Agency Report - Annual.
Exports and imports of goods and services (1995 prices): CSO National Income and Expenditure - Table 6 - Items 68 and 69 respectively.

Ireland’s openness to trade and factor flows with the wider world economy increased significantly during the 1990s when viewed in terms of exports and imports as a proportion of GNP. This pronounced increase in trade both conditioned and reflected the economic transformation. As shown in Figure 2.1, Irish exports amounted to the equivalent of 102 per cent of GNP in 1999, and the combined share of exports and imports in GNP was almost 190 per cent.
Ireland’s economic growth convergence

Ireland’s upsurge in economic growth during the 1990s was outstanding not only in terms of its own historical experience but in an international comparative context also. However, Ireland had been a laggard in terms of its poor performance during the European economy’s "Golden Age", which spanned the period 1950-73. Hence, there are elements of delayed catch-up in Ireland’s economic transformation (Barry and Crafts, 1999). The Irish growth performance in the 1990s is a clear outlier, in terms of GDP per capita based on purchasing power parities, relative to the group of OECD countries considered in Figure 1.2, which presents initial income levels and subsequent growth. Ireland is located well above the trend line (not shown) illustrating the very robust annual average growth in income per head experienced between 1992 and 1999. It is clear that Ireland’s belated catching-up was a comparatively rapid phenomenon. At the beginning of the 1990s, Ireland was grouped with the other peripheral EU countries (Greece, Portugal and Spain) in having among the poorest living standards in the OECD.
Ireland’s rapid convergence on EU average GDP per head figures is shown in Table 1.2 below. The extent to which Ireland lagged behind the other European states until the economic transformation is clear. Table 1.2 makes this comparison using standardised data in terms of purchasing power parity for the period from 1960. What is most striking about the data presented in Table 1.2 is the rapidity of Ireland’s progress, from 64% of the EU average in 1986 to 113% by 1999.

**Table 1.2: GDP per head of population (PPS): EU-15 = 100.**

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<tr>
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</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>60.8</td>
<td>58.9</td>
<td>63.7</td>
<td>113.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>123.9</td>
<td>104.4</td>
<td>101.9</td>
<td>102.0</td>
</tr>
<tr>
<td>Greece</td>
<td>42.5</td>
<td>62.4</td>
<td>61.4</td>
<td>67.5</td>
</tr>
<tr>
<td>Portugal</td>
<td>43.2</td>
<td>61.1</td>
<td>54.0</td>
<td>73.9</td>
</tr>
<tr>
<td>Spain</td>
<td>56.9</td>
<td>74.8</td>
<td>69.7</td>
<td>81.2</td>
</tr>
</tbody>
</table>


**Labour force and employment growth in Ireland (1990s)**

The most remarkable feature of the first Irish economic boom during the 1990s was the economy’s previously undiscovered capacity for creating employment on a rapid and sustained basis (Figure 1.3). In a short period, the extraordinary growth in employment transformed the economy from a situation of chronic labour surplus to one with labour scarcity.
Figure 1.3: Labour force and total employed in Ireland (1985-2000).

Table 1.3 is reproduced from Kennedy (2001) and shows the growth rates of output volume, population and employment in Ireland over various periods since 1926. The period 1993-2000 is taken as the so-called Celtic Tiger phase. The amazing acceleration in the growth of output (measured here as the total volume of GDP at constant factor cost) and GDP per capita distinguishes the Celtic Tiger from all previous phases of Irish economic history. Of particular note, however, was the absence of any increase in the rate of growth of overall labour productivity, as measured by GDP per worker. All of the acceleration in the growth of output, therefore, is accounted for by the acceleration in the growth of employment to an average annual rate of 4¾ percent per annum.

Figure 1.3 shows that while the labour force increased sharply, the acceleration in jobs growth was even more marked. Total persons at work increased from 1,183,100 in April, 1993 to 1,670,700 for Quarter 2, 2000 - an increment of 41.2 per cent. This manifested itself in a consistent narrowing of the gap between the labour force and total employment time series as the economy moved toward a position of 'full employment'.

Table 1.3: Average Annual Growth Rates of Real GDP, Population and Employment, Various Periods Since 1926 (%)

<table>
<thead>
<tr>
<th>Period</th>
<th>(i) GDP</th>
<th>(ii) Population</th>
<th>(iii) GDP/Cap</th>
<th>(iv) Employment</th>
<th>(v) GDP/Worker</th>
<th>(vi) Employment-Population ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926-1947</td>
<td>0.9</td>
<td>0.0</td>
<td>0.9</td>
<td>0.0</td>
<td>0.9</td>
<td>0.0</td>
</tr>
<tr>
<td>1947-1960</td>
<td>2.3</td>
<td>-0.4</td>
<td>2.7</td>
<td>-1.3</td>
<td>3.6</td>
<td>-0.9</td>
</tr>
<tr>
<td>1960-1980</td>
<td>4.1</td>
<td>0.9</td>
<td>3.1</td>
<td>0.5</td>
<td>3.5</td>
<td>-0.4</td>
</tr>
<tr>
<td>1980-1993</td>
<td>3.3</td>
<td>0.4</td>
<td>2.9</td>
<td>0.0</td>
<td>3.3</td>
<td>-0.4</td>
</tr>
<tr>
<td>1993-2000</td>
<td>8.3</td>
<td>0.8</td>
<td>7.4</td>
<td>4.7</td>
<td>3.5</td>
<td>3.8</td>
</tr>
</tbody>
</table>

In considering its impact on living standards, it is necessary to note the qualification that the rise in GDP per capita overstates the improvement in average living standards, chiefly because of the large and increasing outflow of profits in multinational enterprises, which do not add to domestic living standards. A better measure uses GNP instead of GDP. The annual average growth rates of real GNP, and real GNP per capita, in the period 1993-2000 were only marginally lower than the corresponding GDP measures at 7.1 and 6.2 per cent respectively.

**Sectoral contribution**

Figure 1.4 outlines trends in the composition of employment in Ireland for the period 1985-2000. The diminishing agricultural sector is as notable as the inexorable rise in services employment. The services sector as a whole, in the year 2000, was over twice the size of the industrial sector and three times that of manufacturing. Of the 488,000 net jobs created between 1993 and 2000, 346,000 were in services.

**Figure 1.4: Decomposition of the total employed in Ireland (1985-2000).**

Note: See Figure 1.3.
Source: See Figure 1.3.

In terms of employment, the services sector was the largest contributor to the overall employment increase from 1993-2000 – because it had by far the largest number of jobs. However, as far as relative growth is concerned, industry was the leader in terms of both output and employment. Table 1.4 (abbreviated from Kennedy 2001: 128) gives the growth rates of volume of output, employment, and output per worker in each of the three main sectors – agriculture, industry and services – for three periods since 1960. Though much has been made of the growth of services, there can be little doubt about the critical importance of industry in driving the Celtic Tiger economy. Importantly though, and similar to overall national output, there was essentially no acceleration in the growth rate of productivity in the three main sectors during the period 1993-2000.

6 Admittedly, the data for services are problematic because of the difficulties of measuring real output growth in that sector.
Table 1.4: Sectoral Growth Rates (% p.a.)

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<tbody>
<tr>
<td>Agriculture</td>
<td>1.6</td>
<td>-2.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Industry</td>
<td>5.5</td>
<td>1.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Services</td>
<td>4.0</td>
<td>1.7</td>
<td>2.2</td>
</tr>
<tr>
<td></td>
<td>2.3</td>
<td>1.5</td>
<td>0.8</td>
</tr>
<tr>
<td></td>
<td>6.9</td>
<td>5.3</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: As in Table 1.3.

Growth of capital and total factor productivity

If the growth of labour productivity did not increase during the Celtic Tiger, what about capital productivity? Kennedy (2001: 129-130) shows that there was a substantial acceleration in the overall rate of growth (physical) capital productivity (measured as output per unit of capital) during the 1993-1999 phase compared to earlier periods, and this improvement was concentrated in industry.

Given that the growth rate of labour productivity was unchanged, it follows that the overall growth of Total Factor Productivity (TFP, or output per unit of combined labour and physical capital input) was higher during the Celtic Tiger than previously. Clearly as industry was driving the rise in the growth rate of capital productivity, the acceleration in the growth of TFP was confined to this sector.

Growth of human capital

FitzGerald and Kearney (2000) show that the average annual growth rates of education per worker and its (weighted) contribution to output growth declined during the 1990s. In fact, the rise in human capital per worker during the Celtic Tiger was greatly dominated by the rise in labour input (unadjusted for quality) – so that the outstanding feature of the Celtic Tiger was the increased utilisation of labour rather than the increase in its quality.

Nonetheless, it is possible, as Kennedy (2001) rightly observes, that human capital plays a greater role than is allowed for in the growth accounting framework, which essentially measures only its supply side contribution. Human capital may also have had a significant influence on the demand for labour in that it proved an attraction to foreign enterprise which in its absence might have chosen another location.
**Exports during the first boom**

During the Celtic Tiger period, the exceptionally large contribution of exports to GDP increased, and the vertical integration of much of Ireland’s manufacturing sector into the global production chains of major multinational firms deepened. These were characteristics which, when combined with the sustained growth in World Trade, contributed to a sustained output boom during the 1990s.

The volume of Irish goods exports grew at the phenomenal rate of 16½ per cent per annum from 1993-2000 - a rate that would lead to a doubling of exports every 4½ years. Ireland experienced a rapid increase in its share of export markets during the Celtic Tiger period, but in accounting for the overall surge in Irish export performance, this effect was secondary to the growth of the export markets themselves. There were two important external dynamics that made for a resurgence in trade:

1. In the 1990s, the United States returned to the rapid growth rates experienced during the "Golden Age" before the first oil crisis in 1973. High US economic growth translated into massive growth of US imports.
2. Despite continued low growth of European GDP, the import elasticity of demand with respect to GDP in the European Union was substantially higher in this period than in the preceding thirty years.

The buoyancy of the US economy helped Ireland on both the supply side and on the demand side. On the supply side, Ireland secured an increased share of the flow of US foreign direct investment to Europe, while on the demand side, the strong growth in US imports underpinned the buoyancy of world trade, as well as providing a rapidly expanding market for Irish goods.

In 1992, the US was only the fourth most important market for Irish exports, corresponding to about one-third of Irish exports to the UK. By 2000, the US was on the way to overtaking the UK as Ireland’s most important export market. However, closer examination of the data indicates that the growth in Irish exports to the US was heavily concentrated in high-productivity labour extensive industries – so that the impact on Irish employment was comparatively small. For example, by the year 2000, organic chemicals (SITC Division No 51) accounted for nearly half of all Irish exports to the US. Even without any consideration of transfer pricing, this category has very high value-added relative to its employment.

The Irish growth rate would have been constrained though without the major acceleration in the growth of the volume of goods imports in the EU - the area receiving two-thirds of Irish exports. A wider consideration concerns why other EU countries, apart from Ireland, did not derive more benefit in terms of higher exports and GDP growth. US foreign direct investment was critical in enabling Ireland to realise the potential offered by the Single European Market.7

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7 Plausible reasons often advanced to explain why Ireland was such a favoured location for US investment compared with other areas of Europe include the generous industrial incentives (and particularly the favourable tax treatment of profits), the plentiful supply of young well educated labour at competitive wages, and the improvements in physical infrastructure funded by EU Structural Funds.
The second boom and its 'legacy'

"Until about 2000, the growth had been on a secure export-led basis, underpinned by wage restraint. However, from about 2000 the character of the growth changed: a property price and construction bubble took hold.” — Honohan (2009a: abstract)

Overview

The Irish economy continues to be afflicted by three problems: a retail banking solvency crisis that was initially (mis)presented by the banks themselves as a liquidity difficulty; a large budget deficit; and negative or very marginal economic growth. These issues are not independent of each other. The Irish government’s commitment to absorb the losses of its banking system - calcified by the EU/IMF agreement - has heightened concerns in relation to a spiralling debt ratio and the solvency of the sovereign. In this sense, private banking debt has become public debt. In the case of Ireland, the banking sector misallocated resources in the economy and then stopped working. The spike in secondary-market spreads on Irish government debt is symptomatic of what has become a twin crisis in the country’s banking sector and public finances - a debt crisis that has led to the recent EU/IMF intervention. Even aside from the huge banking loan losses, the severe economic downturn has given effect to a large budget deficit. Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these surpluses was coming from taxes on the value and volume of property asset transactions. The tax base had narrowed during the boom years, and Ireland’s over-reliance on this source of revenue has been sharply exposed by the collapse in the property market. In the Irish case, the combination of falling numbers of transactions and falling property prices has been deadly. But the deep recession in construction has had an indirect impact on the rest of the economy. Employment in service sectors linked to property and building has declined rapidly. The economy-wide unemployment rate currently stands at over 13% - very far from the full employment of what was called the "Celtic Tiger" period (the unemployment rate had shrank from 16 per cent, on the ILO basis, in 1994 to 4 per cent in 2000). The automatic stabiliser effects for the exchequer are obvious. In addition, lower employment leads to a decline in consumer spending with a multiplier effect on the rest of the economy. As a result, tax revenue from all sources is falling.

Clearly, Ireland’s economy faces severe challenges. The twin crisis in the banking sector and in the public finances have in turn fed back negatively into credit availability and rising tax rates, deepening the output loss. It follows from the above that the broad policy response to the economic crisis has three pillars, with significant cross-over effects between them:

- Correcting the fiscal imbalance.
- Addressing banking bad loans and capitalisation issues, and facilitating credit flow to enterprise.
- Providing for a stimulus to nudge the economy towards a stable natural growth path, as well as decisive labour market policy measures.

The rationale for a stimulus is obvious, especially in light of the recent, and necessary, budgetary adjustments. These 'consolidations' have had a dampening effect on growth potential, and a jobs and growth package needs to be given effect in parallel with the ongoing process of fiscal correction. Ireland was one of the first countries to introduce tough budgetary austerity in this recessionary cycle. Despite the cuts, Ireland currently has one of the highest budget deficits in the EU. The problem is clear: when you cut spending you also lose tax revenues from people who earned incomes from that money. Further, the newly unemployed seek benefits, so Ireland’s spending cuts in one category are partly offset by more spending in another. Without growth, the budget deficit still looms large. Also, the growth rate is a key issue for the international investor community, which is trying to work out whether the Irish economy will grow sufficiently quickly to make its public and private
debt levels sustainable. Increased growth, including export growth, must be located in the enterprise sector. This will deliver corporation tax revenues, but must be incentivised for job creation (which will also generate tax incomes and, at the same time, relieve the burden on welfare). The policy instruments available to the Irish government are limited. Membership of the euro removes any unilateral discretion in relation to devaluation or 'quantitative easing' options. While, the European Central Bank has been of critical importance in providing liquidity to the Irish banks, private sector imbalances, such as excessive credit growth and large current account imbalances, were not at the core of the scrutiny framework used under the euro-area’s existing surveillance arrangement. Furthermore, the Stability and Growth Pact was created to ensure that no country would pursue fiscal policy that would endanger the financial and economic stability of the other member states and the euro area as a whole. However, this mechanism was not broad enough in scope, as it left non-fiscal economic imbalances outside the scope of surveillance. Ireland is an unfortunate (though far from blameless) example of this. In addition, the "one size fits all" low interest rates prevailing in the eurozone were orthogonal to Ireland’s business cycle for virtually all of the period between the launch of the single currency and the onset of the global recession.

The second boom – what went wrong in Ireland?

How then did an economy where employment doubled and real GNP quadrupled during the so-called "Celtic Tiger" era from 1990 to 2006, come to have GNP contract by 17% by late-2009? The deepest and swiftest contraction suffered by a western economy since the Great Depression. How can we ‘explain' this crash-landing, and what are the ongoing ill-effects?

Characterising the second boom

"This boom sustained employment and output growth until 2007 despite a loss of wage competitiveness. The banks fuelled the boom, especially from 2003, exposing themselves both to funding and solvency pressures."

Honohan (2009a: abstract)

Ireland recorded prolonged and rapid economic growth even after the 1990s had witnessed a belated convergence in living standards towards the highest in Europe. This growth had also endured beyond the cyclical downturn in Irish export performance after 2001 (see Figure 1.5). From 1988 to 2007, real GDP expanded by 6 per cent per annum on average (having reached double digits on average during 1995-2000). Non-agricultural employment jumped from 33 per cent of the population in 1993 to 41 per cent in 2000 and 46 per cent by 2007. After almost two decades of rapid growth, Ireland was at the frontier of economic prosperity.

From 2001, the sources of growth shifted sharply (Honohan and Lane, 2009, Honohan, 2009a). An unsustainable property price and construction boom, had taken over from exports as the main driver of Irish growth. Initially prompted by the increased household formation (related to unprecedented levels of net immigration) and by the sharp fall in interest rates that accompanied the transition to EMU membership, the property boom was increasingly financed after 2003 with foreign borrowing by the banks, who lent, in turn, to overleveraged households. At the same time, Ireland experienced a sharp loss of competitiveness as domestic demand-led growth drove up prices and wages in the economy. Also, the consumer boom increased imports, resulting in a deteriorating trade balance. The effects were not yet felt in aggregate unemployment while the domestic boom continued.
Ireland in 2007 was relatively poorly positioned heading into the global crash for

"[t]hree distinct but related domestic reasons: a home-grown banking crisis, a trend loss in wage competitiveness that had been underway since 2000 and a tax structure whose yield was far too heavily dependent on a continuation of the boom"

Honohan (2009a: 1)

The global recession influenced the timing and severity of the Irish economic crisis from 2007, but Ireland was not just an aspect of international pressures. Certainly, the global credit crisis brought the wholesale funding, risk management and capitalisation of the Irish banks into sharp focus. However, the collapse of the construction and property bubble has brought rapidly unwinding property prices, a near failure of the banking system, a very large fall-off in tax revenues and uncompetitive wage structures in its wake. This would all have resulted in a recession even without the global crisis, though the banks would have been better placed to survive without exceptional intervention.

The full extent of the Irish retail banking system solvency position was not known at the onset of the global economic downturn in 2007. However, by this time, Ireland’s competitiveness
position had been severely eroded, growth had been heavily concentrated in construction, and private debt had risen sharply. In an Irish context, this was a “perfect storm” embracing a symphony of domestic and exogenous factors.

**Fiscal crisis**

Although the Irish government ran annual budget surpluses until 2006, an increasing share of the revenue that supported these surpluses was coming from taxes whose yield was sensitive to high and increasing asset prices and asset transactions, including housing (capital gains taxes, capital acquisition taxes and stamp duties). Once the asset markets turned, the volume of transactions dried up, the level of tax revenues plunged during 2008 exposing a structural deficit – exacerbated by a strong upturn in public expenditure in the last few years.

The Irish government had entered the crisis period with a healthy balance sheet – the gross government debt stood at only 24.8% of GDP at the end of 2007 and Ireland had a sizeable sovereign wealth fund in the form of the National Pension Reserve Fund (Honohan and Lane, 2009). The period of sustained economic growth allowed the Irish government to cut income taxes, increase spending and still run a budget surplus. During the four years, 2003-2006, the surge in tax revenue directly related to property transactions was another manifestation of the credit boom. The Irish property tax system was highly geared to activity and property prices: stamp duty is a straight transaction tax; VAT is charged on the gross purchase price of a new home; and CGT liability is triggered, where it is applied, through the realisation of gains. Revenue from property jumped from 8% of total tax receipts in 2002 to 18% by 2006. However, after the collapse of the construction and property bubble, total direct revenue from property dropped to €3.6bn in 2008 from €8bn in 2006 (McCarthy & White, 2008: 8). Between 2007 and 2009, overall tax revenue fell by 20%, while expenditure rose by 9%, moving the state from a balanced budget to a deficit of 12% of GDP (Kelly 2010). The dependence of the government on transitory property revenue is remarkable and should not have been seen as a platform for expenditure increases.

In combination with the collapse in tax revenues in 2008-9, the fiscal crisis was partly driven by an autonomous surge in Total Government Expenditure (after 2004). Figure 1.6 presents data for Total Government Expenditure (Gross Current Expenditure plus Exchequer Capital Expenditure) and Gross Current Government Revenue for the period 1996-2009, and reveals the sudden collapse in taxation. It also shows the way in which Government spending had a strong upward momentum.

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8 The sustained output, profit and asset price boom which extended for two decades from 1988 – with only two brief hesitations in 1993 and 2001/2 – lulled policymakers into a false sense of security as to the sustainability of the revenues from cyclically sensitive taxes, and induced them to take advantage of the extra revenues by narrowing the base of the personal income tax and lowering rates.

Additional overlapping context is provided by the restoration of social partnership. From 1987, the former process of national wage agreements was re-established with a view to achieving economic recovery. In each negotiation, in order to obtain or cement agreement of the unions to moderate basic pay trends, Government offered policy concessions, generally including an explicit or implicit understanding that income tax would be reduced. These tax reductions did help to buy wage restraint in the 1980s and 1990s, but left the government accounts exposed to a downturn. See Honohan (2009a: 3-4).

9 This excludes income tax from construction workers, VAT on furniture and electrical goods, and corporation tax receipts from construction firms.
The property bubble, the banking crisis and public debt

The economic fault-line in relation to the debt crisis in which Ireland finds itself runs from (delinquent) bank lending practices feeding an unsustainable property bubble, resulting in a banking crisis that required extraordinary intervention by the State with the manifestation that the enormous private debt of the Irish banking system has been loaded on the taxpayer.

The severe budgetary difficulties described in the previous section would be manageable but for the transfer of banking system loan losses to the public domain. In addition the government since 2008 has had to provide a series of capital injections to the three main Irish banks, to the extent that the State is now the dominant shareholder in these institutions. Anglo-Irish Bank has been fully nationalised since January 2009, and AIB Bank is now under full State ownership in all but name. Private banking debt has become public debt and it is this huge burden that threatens the solvency of the sovereign.

"Ireland went from getting about 5% of its national income from house building in the 1990s - the usual level for a developed economy - to 15% at the peak of the boom in 2006-2007, with another 6% coming from other construction."

Kelly (2010)

At root cause, the property bubble was funded by the Irish banking system, which in turn relied heavily on the international inter-bank market and accumulated substantial net external liabilities. By early 2008, net foreign borrowing by Irish banks had jumped to over 60 per cent of GDP from 10 per cent in 2003 (Honohan: 2009a: 5). Accordingly, the collapse of the construction and housing bubble, and the concentration of Irish banking loans in these sectors has been centrally important in the deterioration in the financial health of the Irish banking system. To the lack of diversification in loan assets, we can add spiralling loan-deposit ratios and a pronounced deterioration in shareholder equity to assets and to risk weighted assets ratios. In a wider context, while Basel II was designed to improve prudential risk management, this was at a time when the general international application of Basel II risk weighting would have released capital for most banks. At a minimum, the internal risk
management of the main Irish Banks left much to be desired. This was compounded by what could euphemistically be described as "light-touch" regulatory oversight.\footnote{Prior to the onset of the current global credit crisis, a light-touch regulatory orthodoxy held sway in many countries. Over the previous decade, the financial system had expanded hugely. This was encouraged by a general belief in laissez-faire regulation based on the assumption that financial innovation was spreading risk, not concentrating it. Ultimately, financial regulators were not equipped to see the risk concentrations and were not able to contain the risks resulting from rapid innovation and increased leverage, which had been building for years. In response, it has been argued, by the IMF among others, that inter alia the regulatory perimeter, or scope of regulation, needs to be expanded, and procyclicality in regulation and accounting should be minimised. In relation to the latter, increasing the amount of capital required of banks during upswings would create a buffer on which banks can draw during a downturn. An international framework for provisioning is needed to reflect expected losses through-the-cycle rather than in the preceding period.}

Competitive pressure on the two domestic big banks’ (AIB Bank and Bank of Ireland) lending decisions, in the mid-2000s, came especially from the reckless expansion of the third one, Anglo-Irish Bank. Foreign controlled banks, especially the Irish subsidiary of HBOS also contributed. Anglo-Irish bank was allowed to grow at an average real rate of 36% per annum, bringing its market share from 3% to 18% of Irish-controlled banks in 10 years (Honohan and Lane, 2009). In 1997, Irish banks’ lending to the non-financial private sector was 60% of GNP. By 2008, this had grown to 200% of national income. Irish banks were lending 40% more in real terms to property developers alone in 2008 than they had been lending to everyone in Ireland in 2000, and 75% more to house buyers (Kelly, 2010). By 2006, two-thirds of loans to first time buyers had loan-to-value in excess of 90 per cent; one-third were getting 100 per cent loans (Honohan, 2009a: 5).

At the end of September 2008, apparently faced with the inability of Anglo-Irish Bank to secure funding, and to rollover its debt, and fearing a contagious reaction onto the other banks, the government announced a blanket guarantee of the liabilities of the main Irish-controlled banks, including senior bondholders. As well as guaranteeing the deposits and most bonds of Irish banks, the Government announced in April 2009 that a National Asset Management Agency (NAMA) would be created to buy the non-performing development property loan portfolio of the banks at a written-down value. NAMA acquires these loans at a discount (‘haircut’), paying the banks with government backed bonds, issued by a special purpose vehicle. The banks can then use these bonds as collateral against which they can borrow (access liquidity) from the European Central Bank. By October 2010, a total of €27bn of loans had been transferred at an average discount of 52 per cent. An estimated €73bn of loans (book value) are currently expected to be transferred to NAMA. NAMA, however, does nothing about the Irish banks’ losses for mortgages, personal lending, and the small-to-medium enterprise sector.

The NAMA process has left the banks with insufficient capital. As loan losses crystallize and get taken into account in a bank’s balance sheet, its cushion of capital (essentially the difference between its assets and its non-risk-bearing liabilities) shrinks. Government injections of capital mean it will end up owning a large fraction of the shares (unless it can find new providers of capital), and are more about protecting the depositors and other creditors against future risks as they are about making loanable funds available (Honohan, 2009b: 5-6).

The upscaling, during the past two years, of estimates of bank losses that might fall on the exchequer seems to have contributed a lot to continuing market ‘concerns’ about the public finances. On 30th September 2010, Minister for Finance Brian Lenihan announced "finality"
of bank losses at €50 billion. On 7th December, in his budget speech, he announced the following position:

“As the Governor of the Central Bank has previously indicated, over the period 2008 to 2012, the total loan losses of the domestically-owned banks are expected to reach €70-80 billion, equivalent to about half of this year's GDP.”

Brian Lenihan, TD and Irish Minister for Finance, Budget 2011 speech (7th December 2010).

By November 2010, the markets had lost faith in Ireland. The root cause of this is open to interpretation. Irish debt markets could be understood to be saying: there is a solvency crisis; there is no way that Ireland will be able to prevent an unsustainable escalation in its national debt. In context, there was fallout engendered by the proposed enforced "burden sharing" (compulsory investor participation) of €2.4 billion for Anglo-Irish Bank subordinated bondholders. The ratings agencies quickly assumed the loss of "systemic support" for similar categories of subordinated debt issued by both Bank of Ireland and AIB Bank. Contagion spread rapidly to the senior bank and sovereign debt markets, while German chancellor Angela Merkel’s subsequent "bail-in" proposal for a post-2013 sovereign debt restructuring mechanism only added fuel to the fire of an Irish debt-spiral.

Whatever the precise weight of events motivating bond market dynamics, it is the banking difficulties that have especially caught the adverse attention of international financial markets - the sharp fall in tax revenues and the heightened pressure on government spending notwithstanding. In the weeks before the commencement of negotiations on the EU-IMF bail-out, sustained selling of Irish Government securities was reflected in falling prices and 10-year bonds yields soaring towards 9 per cent. The yield spread over German Federal Government bonds at 10 years maturity jumped to over 600 basis points, and was climbing. At the same time the cost of insuring Irish sovereign debt, as evidenced by CDS spreads, was spiralling (see Figure 1.7). Figure 1.7 shows the remarkable fluctuations in the premium charged in the CDS market to insure Irish Government bonds. (In the figure, a gap such as 400 means the premium is 4 per cent per annum of the sum insured.)
Despite the EU-IMF intervention, fears about Ireland’s underlying solvency position have not gone away. At an average interest rate of 5.8 per cent, the EU-IMF loans are unlikely to improve Ireland’s long-term debt situation. The interest rate is very likely to be higher than Ireland’s nominal annual growth during the period of the loan, and that means the real value of the debt will increase.
Overleveraged households

"In 1995 the average first-time buyer took out a mortgage equal to three years’ average industrial earnings, and the average house cost 4 years’ earnings. By the bubble peak in late 2006, the average first-time buyer mortgage had risen to 8 times average earnings, and the average new house now cost 10 times average earnings … As the price of new houses rose faster than the cost of building them, investment in housing rose. By 2007, Ireland was building half as many houses as Britain, which has 14 times its population." (Kelly 2010)

The legacy of this second boom is that Ireland now has a large excess stock of housing, with the effect that this industry will not represent an area of significant economic activity in the medium term. In parallel with the property bubble, there was a sharp escalation in private debt. Overleveraged households are likely to spend quite some time repairing their balance sheets. Hence, it is clear that households are not in good shape to drive the economic recovery. Moreover, despite the fall in disposable incomes - owing to tax increases and public and private sector pay cuts - the savings rate has increased, as the drop in consumption has exceeded the decline in incomes.

The role of Euro membership

"Elements of eurozone membership certainly contributed to the property boom, and to the deteriorating drift in wage competitiveness. Low interest rates and the removal of exchange rate risk facilitated the boom; the insensitivity of the exchange rate and of interest rates to domestic developments removed a traditional external constraint or at least warning sign. The enlargement of the EU also meant that the boom could continue longer than otherwise, fuelled as it was by strong inward migration.”

Honohan (2009a: 6)

Among the triggers for the property bubble in Ireland was the sharp fall in interest rates following euro membership. During the period 1998-2007, real interest rates averaged minus 1 per cent.

Furthermore, in sourcing loanable funds, the Irish banks borrowed heavily in eurozone inter-bank money markets. Up to 2003, the property boom was financed without significant recourse to foreign borrowing, but after this the Irish banks started to borrow heavily from abroad. This was an effortless undertaking due to the removal of currency risk. In addition, unlike imbalances of the past, overborrowing did not lead to interest rate increases, again because currency risk had been altogether removed. Only when credit risk became an issue after September 2008 did the financial markets belatedly sound a warning sign.

It is possible these imbalances could have happened outside of EMU – indeed, similar problems were experienced in other non-euro countries in the EU and the EEA (Iceland, in particular, comes to mind).

What could best be described as a "light-touch" regulatory approach certainly prevailed in Ireland before the crash. Indeed, the Irish regulator was probably an extreme limiting case among banking and financial regulatory authorities who might have rationalised their laissez-faire regulation based on the assumption that financial innovation was spreading risk, not concentrating it. However, unlike the US or the UK, Ireland’s position has, in many ways, been complicated by its membership of the euro. Banks in eurozone countries hold the greatest share of the Irish banks’ senior debt, because this can be used as collateral for liquidity from the ECB. Hence, the Irish banks are "systemic" within the euro-area – any default on senior debt would have great consequences for the capitalisation of the eurozone
banking system. Furthermore, in pursuing stabilisation objectives, Irish policymakers no longer have any unilateral discretion in relation to monetary policy instruments, including devaluation and 'quantitative easing' options. In Ireland, adjustment must be through a real devaluation – through lower wages and prices.

Of course, at the same time, it could be argued that membership of the euro has protected Ireland from an even worse financial collapse. The ECB has provided a liquidity backstop for the Irish banks.

Summary

The basic domestic policy prescription appears straight-forward: to promote the export-led growth model as the only sustainable path to recovery. Of course, this is very much dependent on a return to growth in external markets. Recent Irish industrial production data shows promising signs in this respect. Moreover, the balance of payments current account position displays continued improvement, while the fall in nominal wages has reduced unit labour costs. The downward adjustment of this competitiveness indicator could be given further effect by increased productivity fostered by policies that promote new products and innovation.

Section 2: Supporting the real economy: enterprise and employment policy

Introduction

In its recently published National Recovery Plan, the Irish government stands behind its long-standing pro-export pro-business strategy. It also promises a range of measures to further support both foreign-owned and indigenous export firms. However, the FDI landscape has changed considerably since the 1990’s. Ireland now has to compete with new EU member states from Eastern Europe and the BRIC economies. Moving forward, Irish policymakers will need to be more proactive in promoting entrepreneurship and innovation, as well as a much bigger role for indigenous based firms. Clearly, there is need for a targeted emphasis on economic growth with jobs growth. Proactive policies to stimulate labour demand should be given immediate effect. Simply put, the stimulus has to be calibrated for employment creation. Urgent Government action is required to transform and integrate each of the three key elements of employment policy: job creation, training, and ensuring that the welfare system incentivises work. A government enterprise/jobs stimulus will make possible a more sustainable growth trajectory and help to correct the fiscal imbalance.

Interest in industrial/ enterprise policy has dramatically increased of late at both national and EU levels (Allen, Herbert & Koopman, 2006; European Commission, 2004) having been off the agenda (particularly industrial policy) for several years. Given that many economies are currently in recession, governments are looking to entrepreneurship and small firm activity to act as an engine for economic growth11. Hence, the renewed interest of policymakers in enterprise policy interventions.

11 An example of this is the concern in many OECD countries with the creation of high growth firms/high potential start-up companies (e.g. see BERR, 2008 in the context of the UK).
In Ireland, much emphasis has correctly been placed on an export-led recovery. Indeed, the most recent industrial production data (for September, published 10 November 2010) showed that those areas of the Irish economy dependent on foreign demand continue to diverge from the domestic parts. Industrial output, of which 85% is exported, has grown strongly in 2010. In the three months to September, industrial production rose by 12% yoy. This improvement has been led by the so-called modern sector (mainly the multi-national companies based in Ireland), particularly the chemical and pharmaceutical sector where production was up 19% yoy in the three months to September. However, traditional indigenous output is also going in the right direction and was up 5% yoy in the three months to September.

However, despite the improvements in industrial output, employment performance continues to be weak:

"Among foreign owned companies, total full time employment amounted to 139,457 in 2009, a decrease of 15,176 (9.8 per cent) on the previous year. These job losses combined with the 0.9 per cent employment decreases in 2008, results in employment among foreign owned companies being 16.2 per cent (26,977 jobs) lower than 2000 employment levels."

Forfas (2010: 33)

Moreover, during 2009, 7,443 new jobs were created in Enterprise Ireland-supported companies, bringing the total number employed to 133,523. However, there was an overall net decline of 19,078 jobs.

With many of the unemployed experiencing long spells of joblessness, the risk that the sharp increase in unemployment, during the current economic crisis, will become structural (long-term) in nature is rising.

The new enterprise policy approach, of which entrepreneurship policy is a component, is 'systemic' in nature: it encourages and shapes externalities and capabilities. At its heart are dynamic externalities (e.g. knowledge spillovers and network externalities) whereas in the past, the rationale for enterprise policy was in most cases viewed from a purely market failure perspective. Innovation is hailed as key to firm/economy growth and development. Moreover, innovation policy is seen as crucial to achieving sustainable economic growth in a globalised world (Metcalfe & Ramlogan, 2008). Additionally, such an approach views innovation systems and clusters as important policy frameworks. The new enterprise policy approach, also emphasises the importance of interdependencies between firms/development agencies/universities due to the fact that it views knowledge as a key competitive asset. The approach also acknowledges a move in thinking away from direct intervention towards creating a more supportive and enabling environment for small firms to operate and entrepreneurship to thrive more generally.

Irish Industrial and Enterprise policy overview

Starting with the Economic Development Plan (1958), Irish policymakers focussed on promoting and attracting Foreign Direct Investment. In the 1960s, Ireland’s economic policy strategy changed from inward-looking protectionism to external openness which targeted FDI.

as the engine of industrial growth. In a nutshell it was a strategy of 'industrialisation by invitation'.

In the 1980s, basic MNE software activity was attracted to locate in Ireland. Additional pharmaceutical companies and MNEs in other sectors also began processing and manufacturing activities in the small open economy. The 1980s was also associated with an industrial strategy of creating sectoral and spatial clusters. Clusters were witnessed in two sectors namely, electronics (in particular, microprocessors, software, computer products and printers) and chemicals/pharmaceuticals. While empirical evidence on the impact of industrial clusters in Ireland is scant, the limited evidence that does exist suggests that there has been little sectoral clustering between MNEs and local firms (Gleeson et al., 2005 and Buckley and Ruane 2006).

One of the most significant industrial policy documents relating to SMEs and indigenous firm activity was published in 1992. The Culliton (1992) Report critically appraised the state of industrial development in Ireland and emphasised the need for the Irish policymakers to adopt a more ‘holistic’ strategy to industrial development. It pointed out a worrying dichotomy between indigenous and foreign-owned firms highlighting that there was little connection between the two. It also cautioned against the branch plant nature of MNE activity located in Ireland. Another significant policy statement was published in 1994 with the publication of the 'Task Force on Small Business Report' (Government of Ireland, 1994). As outlined by Andreosso-O’Callaghan and Lenihan (2006), this was the first formal policy document by the Irish government which concerned itself primarily with SMEs despite the fact that as far back as 1979 some 95% of all manufacturing units could be classified as SMEs. In light of the fact that the majority of SMEs in Ireland are indigenous firms, one can reasonably argue that the Irish government overlooked the indigenous (largely SME sector) until the mid-1990s.

Of late, industrial/enterprise policy documents have recognised the importance of a thriving SME/Indigenous base of firms. For example, the 'Report of the Small Business Forum' (2006) emphasised that as more low-value-added activities move to lower-cost economies, an increased proportion of Irish GNP will have to be produced by indigenous firms (predominately SMEs). A recent industrial/enterprise policy statement from the Irish government, entitled "Building Ireland’s Smart Economy" (Government of Ireland, 2008), from the outset highlighted yet again the importance of indigenous firms and entrepreneurship more generally.

The more recent policy statements have concerned themselves with issues such as business networking, promoting entrepreneurship, innovation and R&D. From the mid-2000s onwards, policymakers strove to strengthen Irish competitiveness by promoting a knowledge-driven economy (see for example the 2004 report of the Enterprise Strategy Group).

Whereas the 1990s saw the arrival of IT hardware corporations (e.g. Dell and Intel), to Ireland, the beginning of the new millennium witnessed new entrants in software development, the e-business sector and bio-pharmaceuticals, with many of these choosing to locate European and R&D activities in Ireland. Iconic examples included Google, which in 2003 opened its first overseas office (located in Dublin), e-Bay and Genzyme Corporation. Many of the world’s high-profile pharmaceutical companies also choose to locate in Ireland (e.g. Pfizer, Glaxo SmithKline and Johnson & Johnson).

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14 As argued by Andreosso-O’Callaghan and Lenihan, (2006) the reason for the significance of the 1992 Culliton Report was that it placed an emphasis on the importance of the overall competitive business environment in which firms operate.

15 Data from 2004-2006 for example, shows that 89-90% of SME enterprises in Ireland are classified as Irish firms – CSO (2010).
According to the "National Recovery Plan 2011-2014" (Department of Finance, 2010) IDA Ireland supported companies alone sustain over 135,000 jobs (p. 41). Manufacturing of pharmaceuticals and medical devices, financial services and the provision of ICT and professional services are the key sectors.

Previous sections engaged with the issues surrounding Ireland’s high growth performance during the 1990s. However, it is interesting to note that this high growth was achieved without any major improvements to levels of innovation. According to data from EUROSTAT (2010), the number of applications to the European Patent Office (EPO) by priority year\(^ {16} \) shows that for the general manufacturing category (NACE D), Sweden (another small open economy) made significantly more patent applications every year than has Ireland (97 against 1 in 1977; 917 versus 60 in 1987; and 1,403 versus 144 in 2006).

In summary, it could reasonably be argues that the Irish industrial policy approach placed too much emphasis on FDI without recognising its limitations (including for example, the fact that until relatively recently, many MNEs located in Ireland were manufacturing assembly type branch plants that failed to become embedded in their local economies and were largely at the destiny of decisions made by some parent plant located elsewhere-usually somewhere in the US). Although FDI was a key contributor to the phenomenal growth rates during the 1990s, we argue that the overriding presence of FDI in official policy discourse led to the at times large neglect of the indigenous SME sector. In a similar vein, Anyadike-Danes et al. (2010) argue that this preoccupation with the role of FDI may go towards explaining why entrepreneurship is overlooked in mainstream analysis and commentary of the factors that drove Ireland’s economic growth.

**Efficacy of promoting enterprise and export-led growth**

"Ireland is a small, open economy and export performance during the recession has been markedly robust."

Department of Finance (2010: 9)

Recent Government strategic and planning publications pertaining to recovery and sustainable growth have placed heavy emphasis on the importance of the export-led growth model. As outlined in "Trading and Investing in a Smart Economy: A Strategy and action plan for Irish Trade, Tourism and Investment to 2015" at least 85% of the value of total exports is from foreign-owned companies. One of the Governments high-level objectives to be achieved by 2015 is to increase the value of indigenous exports by 33%. The "National Recovery Plan 2011-2014", released at the end of November 2010, posits that "(l)ong-term sustainable growth in the Irish economy is export-led" (p. 20). Moreover, the prospects for a return to enterprise-led growth are favourable due to the modern nature of Ireland’s export base. As illustrated in Figure 2.1, the large proportion of exports from high-tech sectors demonstrates that Ireland has already established a strong base which can act as a good launching pad for further improvements in terms of achieving a knowledge intensive period of growth.

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\(^ {16} \) EUROSTAT (2010), Science and Technology Database, Patent Statistics (pat_ep_nnac). Priority year is the first year of filing a patent application to protect an invention.
According to the most recent Global Entrepreneurship Monitor (GEM) report for Ireland (Fitzsimons and O’Gorman 2008), two in every three early-stage entrepreneurs are not exclusively focussed on the Irish market. In relative terms vis-à-vis the UK, EU and OECD, this is a relatively high export orientation. Established entrepreneurs are, however, more focussed on the Irish market. The challenge in moving forward is to ensure that this cohort of entrepreneurs/SMEs increase their propensity to export.

“Reducing the budget deficit will not, by itself, solve our economic difficulties. We must build on our strong export performance by improving our competitiveness.”

Department of Finance (2010: 5)

We discussed in earlier sections how the Irish boom in the 1990s saw rising employment associated with increased competitiveness and a quadrupling of real exports. After this, growth continued at high rates until 2007 despite falling competitiveness, driven by a second boom in construction. However, this second period is characterised by relatively weak growth in merchandise exports. The link between a trend loss of competitiveness, particularly in relation to hourly earnings and unit labour costs vis-à-vis Ireland’s main trading partners, after 2000 and poor exports performance is unremarkable. While the economic crisis has seen significant improvement in wage competitiveness indicators after 2007, data pertaining to non-wage input costs and broadband infrastructure for the period 2009-2010 (Figure 2.2 below) show considerable scope for improvement.
The importance of Entrepreneurship and Innovation

An innovation driven economy is key to stimulating entrepreneurship. Although not all entrepreneurship is based on innovation it is one of the key conduits through which innovation is brought to the market place.

**Entrepreneurs and start-ups as a driver of economic growth**

The benefits that emanate from the activity of entrepreneurs are manifold: By starting and growing new ventures, entrepreneurs contribute to economic growth and development including inter-alia job creation. Through their new ventures, entrepreneurs’ can increase competition and productivity, in addition to bringing new innovations to the market. Entrepreneurship also plays a key role in regional development and reducing regional disadvantage. See further, Acs and Szerb (2007), Fitzsimons and O’Gorman (2008), Acs and Audretsch (1988) and Wenekers and Thurik (1999).

However, there is a concern of late in the international academic literature that most entrepreneurship policies are not generating the expected results (Minniti, 2008). As outlined by Vaillant et al (2010) reasons attributed to this ‘diluted impact are increasingly being related to the quality of new ventures being created’ (p.1).

It has been argued that in terms of focusing on quality as opposed to quantity of new ventures that policy interventions should on the one hand focus on individuals with already prevailing high human capital and/or on the other hand, target on increasing the human capital of potential (Hvide, 2009; Samuelson and Davidson, 2009). Here we agree with Vaillant et al (2010) when they put forward the view that that increasing the quality of entrepreneurial initiatives can have a much more potent effect on socio-economic development than merely focussing solely on the actual number of entrepreneurs and resulting new ventures. The challenge for Irish policymakers in moving forward is to be concerned not purely with the 'quantity' of new ventures created (entrepreneurship) but also with the 'quality' of such ventures. To some degree, it could be argued that some inroads have already been made in this regard given the focus of agencies such as Enterprise Ireland with focusing on what they term ‘High Potential Start-Up’ firms (HPSUs) but in our view there is room for further analysis and debate around this issue in the Irish case.
In the most recent GEM (2008) report for Ireland (Fitzsimons and O’Gorman) what is interesting is the move away from 'opportunity' entrepreneurship (which characterised a period of almost full employment for over a decade) towards 'necessity' entrepreneurship, driven by increases in unemployment whereby people in Ireland are looking to entrepreneurship as a means of creating a job for themselves (often following redundancy). Moreover, one in five ventures in Ireland are now motivated by necessity (p. 9). According to GEM Ireland (2008), enterprises that grow and internationalise have a disproportionately large economic impact. It follows that policies to promote internationalisation should be given greater priority.

Underlining an increasing focus on innovation among policymakers in Ireland, the Department of Enterprise, Trade and Employment (DETE) published the "Innovation in Ireland" report in 2008. This report emphasised the importance of collaboration and recognised the advantages that firms that network and collaborate attain. Business networks (and clusters) were highlighted as one of the ten key policy areas that underpin the Irish Government’s approach to innovation.

"The smart economy combines the successful elements of the enterprise economy and the innovation or 'ideas' economy..."

Department of the Taoiseach (2008: 7)

A key pillar of Ireland’s enterprise policy is the fostering of innovation through the 'smart economy'. To this end, the Government published the document, "Building Ireland’s Smart Economy - A Framework for Sustainable Economic Renewal", in December 2008. To the fore was the concept of building the Ideas Economy - creating the 'Innovation Island' with an emphasis on the indigenous sector:

"In order to secure its economic future, Ireland must develop its own indigenous industry to complement the considerable external investment in enterprise. Innovation is the key ingredient to ensuring rising standards of living."

Department of the Taoiseach (2008: 27)

Innovation had been highlighted as the 'key building block' to develop the indigenous sector (DETE, 2008). In order to achieve this goal, ameliorating the availability of both capital and business networks were highlighted as catalysts for converting "research and innovation into valuable commercialised products and services" (DETE, 2008, p. 62). The 'Smart economy' also targeted a wider international dimension:

"The key objective of Ireland’s Smart economic growth framework is to make Ireland the innovation and commercialisation capital of Europe - a country that combines the features of an attractive home for innovative multinationals while also being an incubation environment for the best entrepreneurs from Europe and further afield."

Department of the Taoiseach (2008: 60)

A key issue is to ensure the appropriate balance/mix between indigenous and foreign-owned firms. In the past Industrial development strategy was criticised for being one-dimensional in focusing on attracting MNEs, and failing to support indigenous industry. For example, the Telesis Report (1982) stated that "Successful indigenously-owned industry is in the long run essential for a high income economy..." (p. 185).

More recently, the Forfás (Ireland’s national policy advisory body for enterprise and science) document "Making it Happen - Growing Enterprise for Ireland" (October 2010) affirms that governments’ most impactful role is in providing an enabling environment for entrepreneurship and enterprise to flourish. Elements of such an enabling environment include:
• Education and training (ensure the education system promotes entrepreneurship and creativity).
• Tax and finance.
• Competition and regulation.
• Physical infrastructure.
• A business environment that values (and invests in) collaboration and knowledge and intellectual property and facilitates commercialisation.

It follows that micro-level action (in this instance at the level of the firms) will be more effective if the business environment elements are in place. Note other authors such as Levie and Autio (2007) also emphasise the important role of government (public policy) in creating an enabling environment for entrepreneurship or what Levie and Autio (2007) term enabling framework conditions for entrepreneurship.

Barriers to entrepreneurship in Ireland

With a relatively low rate of informal investment activity in Ireland, coupled with a relatively high rate of early stage new business creation, access to debt and equity finance (which tends to be particularly acute at the very early business stages) is the most frequently cited barrier to entrepreneurship in Ireland by those respondents of GEM Ireland’s (2008) informant panel. The informants also mention the insufficient number of business angels/informal investors and venture capital funding in the Irish entrepreneurship landscape. Other barriers to entrepreneurship cited include: the burden of government bureaucracy and the regulatory burden. Along the same lines, respondents also mentioned the need for a more integrated and co-ordinated approach with respect to enterprise policy supports. There was a widespread view that information and assistance for entrepreneurs and their new ventures could not be assessed through a single contact point. In terms of specific enterprise measures, concern was also voiced with respect to Science Foundation Ireland - the belief here being that the latter’s support for research tends to be focused at basic research and is not sufficiently targeted at commercialisation or the needs of enterprise. Informants also saw R&D transfer as an issue needing to be addressed. More specifically, the key issue of concern here is that key informants were not convinced that new technology, science or other knowledge from third level institutions was being efficiently transmitted into new and growing enterprises.

The recent "Entrepreneurship Report" (2010) published by the Institute of Public Accountants in Ireland corroborates the information provided by GEM Ireland’s informant panel. This report highlights difficulties for entrepreneurs and enterprises in accessing credit and also highlights late debtor payments as a key threat to entrepreneurship and new venture creation. It also draws attention to issues such as stigma that attaches to business failure in Ireland, and the level of bureaucracy in accessing support.

The future for industrial/enterprise development will not look the same

The nature of the projects that Ireland will attract is changing as we move up the value chain. According to the "National Recovery Plan 2011-2014", in the region of half of IDA Ireland investments in 2009 were in Research, development and innovation activities. The number of jobs tends to be smaller, even if the jobs are of higher quality. Facebook’s establishment of an international headquarters in Dublin in 2009 was seen as a coup for the IDA, but it only created an initial 70 jobs. The days of (typically) US firms creating hundreds of manufacturing or assembly jobs in the provincial towns of Ireland are long gone.
In its "Trading and Investing in a Smart Economy: A Strategy and action plan for Irish Trade, Tourism and Investment to 2015" document, the Government heralded its ambitious target to create 150,000 new jobs directly associated with exporting enterprises over the reference period, with a similar number of indirect jobs. The outlined strategy further envisages IDA Ireland securing an additional 780 investment projects. The strategy also envisages tourist numbers growing by one million.

Possible sectors where Ireland could do well include the emerging areas of E-learning, Education, Nanotechnology, Microelectronics, Biotechnology, Alternative Energy (renewable energy), Food, Financial Services, ICT, and Environmental goods and services.

**Government interventions: Employment policy**

One of the most distinguishing features of the current recession has been the scale and speed in deterioration of labour market conditions. However, the Government response is heavily constrained by the debt crisis.

> “We must remove barriers to employment and ensure that those who have lost their jobs are retrained and ready to take up employment as the labour market recovers.”
> 
> Department of Finance (2010: 5)

There is a substantial body of economic research presenting evidence that patterns of job search, financial behaviour and so on among many unemployed people are self-defeating. In this context, policy interventions that keep people in some form of labour market activity will produce employment results to a far greater degree than generic off-site training programmes designed for a different economy.

In this regard, some measures are already in place, for example, the Back to Work Allowance Scheme (BWEA) encourages people in receipt of jobless benefits to become self-employed by facilitating them to retain some of their welfare benefits for up to a two-year period.

In relation to creating employment through the promotion of enterprise, the Institute of Public Accountants’ recent "Entrepreneurship Report" makes a number of recommendations to Government. Among these:

- A new tax incentive to facilitate business angels and other private investors to write off investment losses in start-up and early stage enterprise against income tax.
- Some form of limited loan guarantee scheme for start-up businesses to be administered through the City and County Enterprise Boards.
- A "one-stop-shop" – the overlap in enterprise support agencies causes confusion and a lack of clarity for the entrepreneur.

Other policy responses, in this area, have included the establishment of an Enterprise Stabilisation Fund, and an Innovation Fund for Ireland.

At the same time, training agencies need to ensure that employees have the necessary skills to cope as industries change, with access to high-quality, flexible education and training programmes. Education and retraining have crucial roles to play so that when the economy does improve such people are positioned to come back into sectors where the new jobs will be. In the long term, Ireland cannot compete on low-end manufacturing. Yet shifting to higher-value added manufacturing and services requires putting in place policies to help workers retrain and firms shift strategically.
According to GEM Ireland (2008) participation in entrepreneurship education or training has positive impacts in terms of an individuals’ preparedness and their probability of becoming an entrepreneur.

“From the late 1990s, the benefits of our booming economy were felt across every section of the population. Working-age social welfare rates are now more than twice their rate in 2000 ... These increases were well ahead of the cost of living.”

Department of Finance (2010: 6)

Unless jobless benefits are made relatively less attractive, replacement rates for lower-paid family types will increase, as will the disincentive to stay in, or to find employment. Employment increasingly becomes relatively less attractive.

It follows from the above that there are three major strands in an integrated employment policy:

1. Job creation and placing/ matching those out of work in/ to jobs.
2. Providing appropriate and adequate training.
3. Welfare system - ensuring the welfare system incentivises work and/ or up-skilling for everyone in receipt of benefits.

In the short term, we recommend a focus on the following key target areas:

- Graduate unemployment
- Rationalising and reorientation of state training.
- Social economy reform.

Graduate unemployment

The graduate labour market is worthy of particular policy attention. While graduates, in general, still have far better job prospects than non-graduates, the graduate unemployment rate in the current recession is substantial. According to the most recent Quarterly National Household Survey (QNHS, published 21 September 2010) which presents data for Q2 2010, the unemployment rate among persons with a third level honours degree or above was 6.7% compared with 9.0% for persons with a third level non-honours degree (Table 23a). Anecdotal evidence suggests that 30 per cent of graduates from the 2009 university cohort interviewed for a recent survey by UCD’s Geary Institute described themselves as unemployed.

The Irish Business and Employers’ Confederation (Ibec) has been running a programme matching graduates to companies for internships, and this may present a model that the Government may want to incentivise and scale up.

The state has made a considerable investment in third level education, and idle graduates claiming jobseekers’ allowances/ participating in state-run training deprives the exchequer of tax and other revenues (this is more pronounced when consideration is given to the relatively higher salaries that graduates should obtain), while increasing the burden on the welfare budget. Programmes matching graduates to companies for internships is a pro-active response by policymakers at a time of labour market weakness.

\[
\text{Replacement Rate} = 100 \times \frac{\text{Out of work family disposable income}}{\text{In work family disposable income}}
\]

Replacement rates can vary significantly depending on family size, the timing and duration of unemployment etc.
Training reform

The replacement of Fás (the national training agency) could, in parallel, aggressively cultivate internship training opportunities within a more diverse range of sectors. Participants would be on-site, getting valuable work experience particular to the job (as opposed to taking part in generic courses/schemes).

Most OECD countries have maintained or even expanded core job-search assistance and have also sought to provide more targeted re-employment services.

Work experience or placement programmes could be extended to non-graduate cohorts, including young people from disadvantaged backgrounds. This would likely require state incentives to both workers and employers. This approach has merit, as the work-readiness of the young people involved should be improved substantially.

A potential saving opportunity to the exchequer is presented by the replacement of Fás where the Government should urgently act to abolish courses that are not now needed – particularly in construction-related activity, where there is an obvious structural decline and a major oversupply of labour.

It is also important to ensure close monitoring of job-search efforts by the unemployed, especially the long-term unemployed, to avoid benefit dependence.

The jobs crisis provides an opportunity to invest in the development of a more comprehensive and effective activation strategy, one that strengthens the links between getting benefits, searching for a job and participating in employment and training programmes.

The merger of Fás’ employment services with the benefits agency under the Department of Social Protection is, at least, a good start.

However, giving effect to such an activation strategy generally takes time, as it involves institutional changes associated with the implementation of policies and co-ordination with the private sector. The new public employment service (Fás II) should not hesitate to work much more closely with private employment agencies, training providers and employers.

Incentives to employers

Commonly applied instruments for supporting labour demand, across OECD countries, have been cuts in taxes on labour, in particular reductions in social security contributions, and scaling-up hiring subsidies, such as the French subsidy to small firms.

Tight fiscal conditions suggest shifting the focus from across-the-board cuts in labour taxes, such as social insurance, to employment subsidies targeted at new hires, especially for employers recruiting the long-term unemployed.

Social Economy

Active Labour Market Policies (ALMPs), which provide training and subsidized employment to the unemployed, are an important part of Ireland’s welfare state. However, the Forfas (2010) report, Review of Labour Market Programmes, stated in its key findings that

"Community Employment, while having a main stated objective of helping long term unemployed persons to re-enter the active workforce, was estimated as having little

additional impact on employment outcomes, notwithstanding that it is the most costly of all programmes and of the longest duration” (p. 256).

The Community Employment Scheme – which is the largest training programme in the State – cost over €390 million in 2008. The average cost per person completing a course under the scheme was €127,000 (Forfas, 2010: 255). Despite the enormous cost, and given the 3 years average duration on the programme, only around 37 per cent of those completing courses progress on to employment. The Forfas report found that 42 per cent go straight back on to welfare (p. 262).

The benefits from social economy programmes will only accrue if they genuinely enhance skills.

Conclusion

The Irish economy provides an interesting case study as an economy that has not only experienced one, but indeed two phenomenal booms over a 16 year period (1990-2006). As the analysis in the current paper has demonstrated, both booms were radically different, with the export-led growth boom of the 1990s being followed by a second unsustainable boom underpinned by credit-led consumer spending, financed by net external borrowings after 2000. As the analysis and discussion in this paper has outlined, both booms were radically different but each has played its own part in terms of significant changes in the structure of the Irish economy.

The legacy of the second boom (coupled with a poor international external environment) has left Ireland with major economic (and social) challenges to grapple with. These include inter-alia: high rates of unemployment, a large excess of housing, a sharp escalation in private debt, severe public and private sector wage cuts, loss of competitiveness, deteriorating trade balance and what can be summed up as a twin crisis in the small open economy’s banking sector and public finances.

As alluded to above, one of the greatest challenges that the economy faces is an unemployment rate currently standing at c. 13.5%, a far cry from the 4 ¾% rate (full employment) that characterised the so-called ‘celtic tiger’ period. Clearly, such a high rate of unemployment not only has economic but also social consequences.

Faced with the above, the paper contributes to the lacuna of literature on the possible domestic policy prescriptions for getting the ‘real’ economy on to a sustainable growth path. Key amongst the possible avenues for policymakers is the promotion and implementation of an export-led growth model. We also argue that policymakers need to be more active in terms of promoting a pro-business environment coupled with interventions at the level of the firm to promote entrepreneurship and innovation more generally. In a similar vein, Irish policymakers need to strive towards achieving the optimal mix of industry type (indigenous and foreign-owned firms; large and small firms; sector type) in its industrial/enterprise strategy approach in moving forward so as to ensure that we don’t ‘put all our eggs in the one basket’.

Finally, we argue that it is imperative that a targeted emphasis by policymakers on economic growth coupled with jobs growth take place. Proactive interventionist policies to stimulate labour demand should be given immediate effect.

The overriding contribution of the current paper is vis-à-vis the insights it provides regarding the ‘real economy’ in Ireland, an issue that to date has been largely overlooked by academic and policymakers alike given the preoccupation by commentators on the financial system.
Getting the financial system “right” is critical, but we also need intelligent policies along the lines suggested in the current paper to tackle the crisis in the real economy.

References


