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The Rise & Fall of the Irish Celtic Tiger: Why Fiscal Policy Matters

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Introduction

This paper traces the development of the Irish economy from independence, to economic decline, to unprecedented levels of growth and prosperity, and back to decline and bankruptcy. We look at the role of fiscal policy in this rollercoaster ride and see how fiscal policy was used to both create and subsequently destroy the Irish economic miracle, commonly referred to as the Celtic Tiger. Ireland went from being the shining light of Europe, with unprecedented levels of economic growth, record low unemployment and record high GDP per capita, to being the first economy in Europe to officially enter recession in 2008 and the second to receive IMF/EU/ECB bailout funds following the collapse of the Irish banking sector and with it the Irish economy. The paper considers the role of fiscal policy in contributing to this crisis and also look ahead to determine what role fiscal policy can and must play in reviving the prospects of the Irish economy over the next decade.

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1. Development of Irish Economic Policy

The story of the Irish economy is one of dramatic twists and turns. From an independent economy attempting to find its way in the 1920s through a policy of self-sufficiency based on small-scale agriculture with minimal exports, to recognition of a need for free trade and the subsequent move towards an open economy and inward foreign investment in the 1960s. Joining the European Economic Community (nowadays called the EU) in 1973 provided an opportunity to further develop the Irish economy through wider access to European markets and membership of a common economic market. This helped to reduce dependency on the UK market and provided a boost to Irish agriculture through the Common Agriculture Policy (CAP). The 1970s also saw a significant change in fiscal policy through the rapid increase in government expenditure that occurred mostly on welfare, health, education, housing and infrastructure, in an attempt to develop the economy into a modern nation capable of holding its own in Europe.

Such a rapid increase in government expenditure, along with high oil prices in the 1970s, led to a significant increase in inflation and a deterioration in the public finances. The 1970s and early 1980s were characterised by high unemployment and the subsequent return to high levels of emigration that plagued the economy in the 1950s. Table 1 provides average annual growth rates of some key economic variables showing the gradual growth of the Irish economy from a very low base in the 1920s to signs of growth and development in the 1960s and 1970s.

Table 1: Selected Economic Variables (Average Annual Growth Rates)

	1926-1947	1948-1960	1961-1980
GDP	0.9	2.3	4.1
Population	0	-0.4	0.9
GDP per Capita	0.9	2.7	3.1
Employment	0	-1.3	0.5
GDP per Worker	0.9	3.6	3.5

As the 1980s developed the prospects for the Irish economy deteriorated sharply. High government deficits and low economic growth led to high unemployment. Concern was raised at the high level of

graduates emigrating with 200,000 graduates leaving in the 1980s alone². The general mood at that time was one of despair, a sense of hopelessness, and a loss of faith in Government and their policies. This mood was summed up with 'The Economist' running a cover page in January 1988 calling Ireland the "Poorest of the Rich".

However the turning point for Ireland came a few months earlier in late 1987, when politicians from all parties realised the need for consensus building to ensure economic survival. Significant increases in public debt, unemployment peaking at 18% and mass emigration, prompted the Irish government into action. The government took control of fiscal policy and enacted large expenditure cuts to bring the budget back into line. Such tightening of fiscal policy helped convince the European Commission to provide Ireland with significant funding for infrastructure, called Structural Funds. This, along with the creation of a 'friendly' business environment (including low corporation tax rates) and a highly educated workforce set the scene for what was to become a rapid increase in economic growth and with it large increases in employment and wealth. The Celtic Tiger was born.

2. The Celtic Tiger Phase

Attempting to pin point the exact start of the Celtic Tiger phase of Irish economic growth is difficult, but commentators generally agree that the early 1990s, when significant increases in Irish GDP occurred, was the beginning of the tiger economy. The policy changes of the late 1980s took time to develop into economic growth and for many years up to 1994 it was difficult to see the effect of EU funding, the focus on foreign direct investment and the unpopular budgetary tightening. When growth did occur, it did so in dramatic effect and continued for many years.

Many policies contributed to this phase, with several uninformed commentators putting it down solely to Ireland's low corporation tax rates. The real cause was somewhat more complex and involved a series of policies that (subsequently) happened to work well together. The low tax

² Representing approximately 15% of the labour force.

rate was certainly critical, it made many multinational look at Ireland as a possible place for investment. However, such investment could not, and would not, have taken place without other policy decisions falling into place. These include developing a young well educated workforce, a credible fiscal policy, light regulation, adequate infrastructure, as well as membership of the EU. A key turning point came in 1989 when Intel announced it was setting up in Ireland, the first such multinational company to do so. This sent a powerful signal that Ireland was open for business and it set the scene for others, mostly US firms, to follow³. US firms earned more in Ireland than almost anywhere else (up to 20%).

Such foreign direct investment (FDI) was a key driver of growth and employment, with FDI inflows reaching 20% of GDP by 2000. This played a significant part in increasing Irish living standards, which went from 66% of EU-12 average in the 1990s to 140% of the EU-25 average by 2004. Irish emigrants returned in their droves to take up employment positions in domestic and multinational companies and a further 20,000 immigrant workers per year were required to fill other positions (including the retail sector) in the economy. Ireland therefore went from an era of exporting our talented youth to one where Ireland was the place to come to for the youth of Europe and beyond. Unemployment fell to a historic low of 3.9% in 2001 with the average annual growth rate in GDP per capita at 6.3% between 1993 and 2000, thereby becoming one of the richest countries in the developed world.

The economy also grew rapidly as a result of increased world trade and significant growth in Irish exports arising from a competitive tradable sector. By 2000 the economy was reaching capacity output with immigration helping to fill labour shortages. Such rapid growth was clearly unsustainable and the natural mechanism to slow an economy in such circumstances was a real appreciation of the currency. Given our membership of the Euro such a tool no longer existed and the resulting wages and prices increases relative to the rest of the Euro Area led to a significant loss of competitiveness. Here is where a strong fiscal policy was called for, but such a policy never came. Instead government spending continued to grow on the back on increased tax revenues, leading to a further erosion in competitiveness.

³ Nowadays Dell, Microsoft, Google, Linkedin, Facebook, Apple all have established bases in Ireland.

A significant proportion of these tax revenues came from the construction bubble that was allowed to grow in the Irish economy. Demographic changes resulted in increased demand for housing during the 1990s among the 20-24 age group and this coupled with increasing immigration led to a surge in the demand for housing. The increases in living standards along with the free flow of cheap credit provided all the ingredients necessary for a housing bubble, and so one emerged. During the 2002-2007 period, 75,000 houses per annum were built in Ireland. To put this in perspective, the UK built 2.5 times the number of houses for the same time period despite having 14 times the population. Not surprisingly, the Irish house price index rose by 231% during the 1997-2006 period, compared with 165% in Spain, 95% in the US and 175% in the UK.

Tax receipts associated with the property bubble increased dramatically over the 2002-2007 period. Addison-Smyth and McQuinn (2010) estimated that at the peak in 2006, 12% of total exchequer returns came from residential construction, up from 6% in 2000. This equated to €2.4 billion or 1.2% of GDP, implying that the actual general government balance in those years was artificially inflated. Housing investment peaked at 14% of GNP in 2006 compared to just under 6% in the EU-15. Whereas growth in the earlier years of the Celtic Tiger was driven by exports, from 2003 onwards, Irish economic growth was fuelled by the housing bubble and growth in retail spending, both driven by the availability of cheap credit. Irish economic output rose well above potential output, putting it on an unsustainable path (Bergin et al., 2011).

Table 2: A Tale of Two Economics

	1986	2006
GDP (% EU mean)	67%	139%
Gov/GDP	53%	27%
Budget Balance/GDP	-12%	1%
Debt/GNP	115%	24%
Debt Service/Tax Revenue	33%	5%
Employment	1.1m	2.0m
Unemployment Rate	17%	4%

Table 2 provides some summary data for the Irish economy highlighting the significant changes that occurred between the 1980s and the 2000s. Not only did the size of the economy dramatically increase from

67% to 139% of the EU mean, employment doubled to 2m, the ratio of debt to GNP fell from 115% to just 24%, and the budget balance as a proportion of GDP went from -12% to +1%.

There is no real evidence to suggest that the policies that led to the Celtic Tiger were all part of a grand plan. A certain amount of luck and opportunities came Ireland's way, but importantly the Irish economy was ready and able to take advantage of them. However having helped create the environment for such rapid growth, the Irish government were negligent in controlling it. Fiscal policy helped create and accommodate economic growth, but it subsequently failed to manage such growth. Fiscal policy went from credible in the late 1980s and early 1990s to one of recklessness in the early and mid 2000s. The Irish government were running budget surpluses, with revenue exceeding expectations, for many years. Rather than putting such funds away for the 'rainy day', Irish fiscal policy was summed up by the then Minister for Finance in the 2006 budget as "if I have it [surpluses], I'll spend it".

3. The Crash and the Subsequent Bailout

When growth in economies across the world stalled, Ireland was ill-prepared. House prices which rose to record levels during the boom began to fall and fears were expressed of a housing bubble. Government fiscal policy was based on the assumption of continued steady growth in house prices and economic growth, with any fears of a downturn dismissed as scare mongering. Warning signs such as the loss in competitiveness, sustained increases in house prices and credit were not widely accepted by government, business or households (Nyberg, 2011). O'Leary (2010) noted that the EU Commission and the IMF also failed to heed the warning signs and warn of a need to change fiscal policy. Any reduction in growth, if it were to occur, was seen as gradual with the belief that the Irish economy would adjust accordingly. Nothing was further from the truth. House prices fell dramatically, falling up to 60% from their peak. The GDP growth rate went from 5% in 2007 to -4% in 2008 and -8% in 2009, with the general government balance subsequently falling from 0% of GDP in 2007 to -7% in 2008 and -12% in 2009, compared with an

average of 6.3% in the Euro Area. Such a rapid downturn in growth and the fiscal position was unprecedented in Irish economic history and the economy was left reeling. Unemployment soared to over 14% and emigration, once thought of as banished for good, returned to the peak levels seen in the 1980s.

What were the warning signs and were these easily recognisable? Annual average productivity growth fell from 4% in 2000-2003 to just over 1% in 2003-2006, prices rose 20% above the Euro zone average and annual inflation averaged 4.5% in the 2000-2003 period. Average growth in labour costs was almost 7% compared to 4% in the EU in this period. Ireland's gross domestic expenditure on R&D fell to 1.5% of GDP, well below the EU Lisbon target of 3%. Ireland was ranked as the 4th most competitive nation in the OECD ranking at the start of the boom and this subsequently fell to 30th before settling at 26th by the mid 2000s.

At another level, Ireland was comfortably meeting its obligations under the Stability and Growth pact, government budget deficits were well below the 3% threshold, with surpluses occurring in some years and our debt/GDP ratio was well below the 60% guideline, reaching 25% at one stage. This provided many observers with the 'evidence' needed to justify a continuation of existing policies. Politicians, bankers, economists at these banks and the construction industry were all convinced of the underlined strength of the Irish economy and saw no need to change course. All, of course, had a vested interest in this course continuing.

So what could the government have done to prevent the collapse in the Irish economy? The collapse, when it came, was not completely inevitable and was caused by the failure of two areas in domestic economic policy, namely an inappropriate fiscal policy for the late 1990s and the first half of 2000, and a failure of financial regulation to impose rules to limit the negative effects of the availability of cheap credit. Since joining the Euro in 1999 monetary policy was set by the ECB, thereby making fiscal policy a critical instrument available to the government in controlling the path of the economy – all the more reason to play particular attention to it.

In Ireland fiscal policy should have adapted to the housing bubble by taking measures to limit demand. In particular, as Barry and FitzGerald (2001) suggested, mortgage interest payments could have been taxed, effectively raising borrowing costs in a manner similar to that of raising

interest rates. Instead the Irish government fuelled the housing bubble by providing tax incentives for property, such as holiday homes and hotels, along with maintaining tax exemptions for mortgage interest payments. As the economy was reaching capacity in the early 2000s, the government aggravated the situation by implementing a budget stimulus in the 2001 budget and did so again in the 2006 budget. Both of these stimulus budgets occurred in the run up to elections in 2002 and 2007. Therefore there was a significant miss match between the business cycle and the political cycle in Ireland. A more appropriate fiscal policy would have seen the accumulation of surpluses and a dampening of the property bubble through a tighter fiscal policy as implemented in Finland and Sweden when they experienced a financial crisis towards the end of the 1980s (Lane, 2010).

4. What Now for the Irish Economy

Challenging times now confront Ireland due to past policy mistakes that allowed both a housing and a credit bubble to emerge. What emerged was a banking system that became over exposed to the construction sector. The result was a collapse in economic output and a major financial crisis. Government deficits increased dramatically to 14% of GDP in 2009, compared to small surpluses on average in the 2000-7 period, and government debt jumped to a debt\GDP ratio of 125%. €67.5bn in bailout funds from the IMF/EU/ECB were required for the banking and fiscal crises.

The resulting problems now facing the Irish government are how to grow the economy and put the public finance back on a sustainable track so that no further bailout funds are required. This involves making fiscal policy choices with varying effects on citizens through different impacts on growth, employment and incomes. Fitzgerald (2012) identifies three impacts of fiscal policy for Ireland:

1. A contractionary fiscal policy will result in reducing domestic demand, thereby reducing output and employment.
2. Fiscal policy that results in large deficits, increases financial markets' perception of risk and this is reflected in the bond market

3. Fiscal deficits increase debt levels and will reduce future growth due to debt repayments

These impacts present a dilemma for Ireland. Public finances need to be brought back into line to achieve sustainability, but doing so will, in the short run, depress economic growth and employment, putting increased pressure on the public finances. In this ‘austerity’ versus ‘growth’ scenario, austerity is taking precedence in order to convince bond markets of our financial sustainability and thereby exit the bailout. In a summary of the literature, the IMF (2010) finds that such a process of fiscal consolidation is, generally, contractionary while cutting expenditure is generally more successful than increasing taxes. In Ireland cuts of €30bn (approximately equivalent to 20% of GDP) are planned through austerity budgets up to 2015, two thirds of which will come from expenditure cuts, and the remaining from tax increases, both income and consumption taxes. Table 3 outlines some of these planned austerity measures.

Table 3: Summary of Actual and Planned Austerity Measures (2008-2015, €bn)

	2008-2010	2011	2012	2013	2014	2015	2011-2015
Revenue	5.6	1.4	1.6	1.3	1.1	0.7	6.1
Expenditure	9.2	3.9	2.2	2.3	2.0	1.3	11.7
of which is capital	1.6	1.9	0.8	0.6	0.1	0.0	3.3
Total	14.8	5.3	3.8	3.6	3.1	2.0	17.8
% of GDP	9.2%	3.3%	2.3%	2.1%	1.8%	1.1%	10.6%

The first part of the fiscal policy plan over the next few years is to achieve the 3% general government balance target by 2015. This will very much depend on the growth of the UK, EU and US economies, which are key export markets for Ireland. If these economies underperform then it is likely that this deficit target will not be met. Since the resultant deficit would be cyclical and not structural the IMF (2012) in its latest report for Ireland recommends sticking to the current adjustment plan rather than seeking additional expenditure cuts and/or tax increases. The second part of the fiscal policy plan is to reduce the debt in order to restore the confidence of financial markets and also to cushion against future shocks. This will require running surpluses and increasing GDP to get our debt/GDP ratio under 60%. Selling the government stake in the nationalised banks will also help achieve this goal.

It is unlikely that such a set of circumstances that brought about the Celtic Tiger in Ireland will ever present themselves again in the way they did. Future growth will therefore be less dramatic and more hard earned. The reduction in prices and wages already underway in the Irish economy, a process of internal devaluation, is testament to this. On the positive side this internal devaluation process does provide a platform for future sustainable growth through exports markets

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